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# FIDUCIARY IDEOLOGY IN TRANSACTIONS AFFECTING CORPORATE CONTROL

*Victor Brudney\**

THE fiduciary role in which corporate insiders<sup>1</sup> are cast in their dealings with, or affecting, their corporations embraces a multitude of parts. Hence the range of restrictions on their conduct varies from inhibitions as rigorous as those imposed on express trustees to limitations almost as flexible as those governing arm's length dealings among strangers. As has often been pointed out, the characterization of a corporate officer, a director, or a person controlling the corporation as a "fiduciary" does not define his status with precision; rather, it sets a tone to his role and suggests the existence of obligations and of special sanctions for their enforcement.<sup>2</sup> The actual restrictions on, or prescriptions for, the fiduciary's conduct in any particular context are to be found more in the reasons for characterizing him as a fiduciary in that context than in any rules or articulated proscriptions derived from the mere fact of such a characterization.

For almost two generations it has been suggested, with increasing frequency, that the powers of management or of controllers of public corporations are exercisable in a fiduciary capacity, not merely for their stockholders, but also for a wide variety of other constituencies—labor, suppliers, consumers, and the community or nation at large. With that view and the debate attending it we are not presently concerned. Whatever may be the nature and source of management's obligations to other constituencies, our interest here is with its fiduciary responsibility to its stockholders.

In that context, the fiduciary responsibility of an officer or director

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1. "Insiders" and "control" are terms of considerable elasticity. At a minimum, however, the former includes executive officers, directors, and holders of stock who are able to exercise control or a controlling influence on the conduct of a corporation's affairs. While "control" and "controlling influence" are concepts which vary with the context, see 2 LOSS, *SECURITIES REGULATION* ch. 5 (2d ed. 1961); Comment, *The Meaning of "Control" in the Protection of Investors*, 60 *YALE L.J.* 311 (1951), they mean no less than possession of the power to direct or cause the direction of a corporation's operations and policies, whether through ownership of securities, occupancy of office, or directorship, with no practical chance of reversal. See SEC Rule 405, 17 C.F.R. § 230. (1964).

2. In Mr. Justice Frankfurter's classic formulation:

But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?  
SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

attaches as a concomitant of his selection by the stockholders to represent them in managing their investment. Because the power over their investment thus delegated to him is representational, the duties he owes and the restrictions to which he is subject in his dealings with respect to their "property" are rooted in the law of agency and the law of trusts, which govern comparable representational relationships.<sup>3</sup> To be sure, persons whose controlling position is attributable to their ownership of a significant block of stock do not, like officers or directors, acquire their power over the investment of the other stockholders as designated representatives of the latter. But their power to direct the use of, and to exploit, assets in which the other stockholders have substantial economic interests is no less than that of persons who are only officers or directors. Hence, although the analogy is strained, courts of equity have historically seen fit to restrict controlling stockholders' power by reference to the restrictions they had developed for trustees and agents faced with conflicts of interest.<sup>4</sup>

At the heart of the matter is the lack of identity between the economic interests of those who control corporations while owning only a portion, or none, of the equity and the economic interests of the owners of the equity. This lack of identity of interest permits the controlling group to obtain for itself two distinct kinds of rewards from its direction of corporate affairs. One results from the economically successful operation of the corporation's business and takes the form of a derivative benefit—a return on the investment and an increment in the value of both the enterprise's assets and the stockholders' equity. This reward is enjoyed by all stockholders, including, but not in any disproportionate measure, those of the controlling group of stockholders. The other reward is a direct benefit to the insiders stemming from the use of

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3. To suggest such roots for the obligations of management or controlling stockholders to public stockholders is not, of course, to say that directors are technically agents or that controlling stockholders are technically trustees.

4. Although the duties and obligations of trustees and agents originate in consensual arrangements, they are not entirely a function of consent. The law of trusts and of agency might have left the scope of the trustee's loyalty (the restrictions on his conduct in the event of conflicts of interest or diversity of aims) to the parties to define in the same manner in which the arrangements were created—by express provision in the instrument of trust or agency. Instead, presumably in deference to the absence or remoteness of the principal or to his inability to police the conduct of the agent or the trustee in handling the property placed in his control, fiduciary duties were fashioned by the courts, essentially from prevailing conceptions of desirable behavior in handling or dealing with property of others in such circumstances. Formulation of general standards and their application in concrete cases are left largely to the chancellor's conscience, which plainly permits shifting the balance of the competing values from generation to generation.

the corporation's assets or facilities in such a way as to compensate disproportionately those in control.<sup>5</sup> These direct benefits consist not merely of private payments or uses which are readily found to be unlawful, but also of emoluments which either are lawful or whose lawfulness is not policed or readily determinable.<sup>6</sup> It is to prevent insiders from taking advantage of their strategic position in order to obtain, or maximize, such direct benefits for themselves that fiduciary restrictions (occasionally categorical, but more often selective)<sup>7</sup> are imposed on insiders' exercise of their power over corporate assets.

If outside stockholders thus have an interest in how control is exercised, which interest is protected against insider abuse by more or less rigorous fiduciary standards,<sup>8</sup> they have a similarly protec-

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5. The myriad modes of unlawfully diverting corporate funds to the private benefit of those in control need not be explored here. See, e.g., Hornstein, *Corporate Control and Private Property Rules*, 92 U. PA. L. REV. 1 (1943); Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956).

6. Along with the conflict over immediate division of corporate revenues (i.e., as between dividends and compensation) there may be conflicts as to corporate operating goals (e.g., depreciation policy, expansion policy, investment in new enterprises) when management does not own significant quantities of stock. See Donaldson, *Financial Goals: Management vs. Stockholders*, HARV. BUS. REV., May-June 1963, p. 116. Moreover, while the governing rules do not permit the controlling group to take freely private emoluments from corporate revenues, a large tolerance generally prevails. The lawful, if not entirely legitimate, emoluments of control often include at least the upper reaches of a wide range of permissible payments and such collateral benefits as may be derived from the powers to direct the use of corporate assets, to derive tax benefits, or to take advantage of many kinds of corporation "opportunities." This, of course, is entirely apart from the insider's opportunity to exploit his position for returns which the law might make him disgorge if his activities were discovered in time by persons sufficiently financed and motivated to seek to compel such disgorgement.

In addition to its economic potential, the power accompanying control of a public corporation carries with it prestige, status, and other social or political perquisites which various insiders may desire in varying degrees. These concomitants of control are not readily split into one for the potential benefit of general stockholders and another for potential private benefit.

7. The fiduciary restrictions are characteristically implemented by attempting either (1) to deny categorically, or (2) to offset, the insider's advantages of position. The former sanction purports to enforce literally the admonition to single minded devotion, and to prevent potential conflict of interest from maturing. It does so by prophylactic rules which preclude the insider from assuming a position of conflict and make him liable, or accountable for his profits, when he engages in behavior which produces the *possibility* of conflict, regardless of whether in any particular case his conduct injures the corporation or its stockholders. The latter, and more generally invoked, sanction permits the conflict of interest to mature, but under rules which are designed to give the beneficiary the minimum protection deemed necessary to offset the advantageous position of the fiduciary, such as the rule that the insider must obtain the informed consent of his beneficiary to the proposed activity, or that the transaction be "fair," and that, when challenged, the insiders must carry the burden of proving that they are not serving their own self interests at the expense of the corporation or its stockholders. See note 8 *infra*.

8. To the extent that necessary or desirable social and economic ends are served

tible interest in the determination of where control is located and how it may be shifted. It is not necessary to insist that control is an "asset of the corporation," or that the non-controlling stockholders' interest in the locus of control or in how it may be shifted is "property," in order to recognize that the stockholders' vote has a value which insiders may curtail or appropriate for their own benefit.<sup>9</sup> For example, insiders unilaterally diminish the value of the stockholders' vote if they increase their own proportionate voting power by causing the corporation either to issue stock to themselves or to purchase the corporation's stock from outsiders. They also diminish that value when they use their own assets to buy up outsiders' stock. The value of the stockholders' vote is affected when insiders use corporate cash and facilities to solicit proxies. And insiders appropriate some portion of that value when they sell control.<sup>10</sup> In varying degrees, therefore, such efforts by insiders unilaterally to preserve or alter control arrangements for their own benefit and to the possible disadvantage of the other stockholders call in to play the insiders' fiduciary role. The problem with which the courts have dealt somewhat less than satisfactorily is that of defining the limitations which that role imposes in these contexts and the consequences which should follow from a failure to observe such limitations.

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by permitting direct self-dealing (e.g., the purchase and sale of property, the leasing of property, or other transactions between insiders and their corporations or between two corporations in which insiders share some interest), the most rigorous fiduciary commands have been relaxed. See BERLE & MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 230-31 (1933). Ideology may categorically forbid a trustee from dealing with himself on behalf of the trust, at least without the informed and competent consent of the beneficiaries. RESTATEMENT (SECOND), TRUSTS §§ 170, comment *h*; 206, comments *c-g*; 216 (1959). However, accommodation to felt commercial and economic needs in corporate enterprise is made by permitting insiders to engage in self-dealing, while at the same time, insisting upon protective offsets against the potential abuse which such permission includes. The offsets are embodied in the requirement of full disclosure of the insiders' interest or other relevant facts, the requirement of receipt of approval from the apparently disinterested directors (albeit not necessarily the stockholders), and the requirement of "fairness" in the terms of the transaction. These requirements can, within somewhat broad limits, be measured and enforced. 1 HORNSTEIN, *CORPORATION LAW AND PRACTICE* §§ 439, 440 (1959); Note, 61 HARV. L. REV. 335 (1948); *cf.* *Ewen v. Peoria & E. Ry.*, 78 F. Supp. 312, 315-17 (S.D.N.Y. 1948).

9. See authorities cited note 112 *infra*; *Honigman v. Green Giant Co.*, 309 F.2d 667 (8th Cir. 1962), *cert. denied*, 372 U.S. 941 (1963); *Manacher v. Reynolds*, 39 Del. Ch. 401, 165 A.2d 741 (Ch. 1960); *United Funds, Inc. v. Carter*, CCH FED. SEC. L. REP. ¶ 91288 (Md. Cir. Ct., May 16, 1963); *Stokes v. Continental Trust Co.*, 186 N.Y. 285, 78 N.E. 1090 (1906); *Allen v. Chase Nat'l Bank*, 180 Misc. 259, 40 N.Y.S.2d 245 (Sup. Ct. 1943).

10. Compare, e.g., Berle, "Control" in *Corporate Law*, 58 COLUM. L. REV. 1212 (1958), and Berle, *The Price of Power: Sale of Corporate Control*, 50 CORNELL L.Q. 628 (1965), with Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986 (1957).

## I. USE OF CORPORATE ASSETS OR FACILITIES TO AFFECT CONTROL

A. *Corporate Issuance of Stock to Insiders or Corporate Purchase of Stock To Enable Insiders To Strengthen or Retain Control*

Both the issuance of stock to insiders and the purchase by a corporation of its own stock raise thorny questions of economic abuse of the corporation and the other stockholders because, in the former case, the price may unfairly favor the insiders while, in the latter instance, the price may unfairly injure either the corporation and its remaining stockholders<sup>11</sup> or the selling stockholders.<sup>12</sup> But apart from the problem of economic abuse,<sup>13</sup> a second problem

11. Charges of unfairness to the corporation and the remaining stockholders are crystallized in claims that the amount paid per share was more than the fair market value of the stock, *Mathes v. Cheff*, 41 Del. Ch. 166, 190 A.2d 524, 525 (Ch. 1963), *rev'd*, 41 Del. Ch. 494, 194 A.2d 548 (Sup. Ct. 1964); *Propp v. Sadacca*, 40 Del. Ch. 113, 175 A.2d 33, 34 (Ch. 1961), *modified sub. nom.* *Bennett v. Propp*, 41 Del. Ch. 14, 187 A.2d 405 (Sup. Ct. 1962); *Kors v. Carey*, 39 Del. Ch. 47, 158 A.2d 136, 138 (Ch. 1960), or was more than was left, per share, for the outstanding stock, or that the corporation had better use for the cash (e.g., as working capital, for future expansion, as a cushion for senior securities, or debt) than to "shrink" the enterprise by buying in its own stock. See, e.g., *Mathes v. Cheff*, *supra*, at 176, 190 A.2d at 529; *Lawrence v. Decca Records, Inc.*, 20 Misc. 2d 424, 195 N.Y.S.2d 431 (Sup. Ct. 1959). See also *Reifsnnyder v. Pittsburgh Outdoor Advertising Co.*, 396 Pa. 320, 326, 152 A.2d 894, 897 (1959) (Cohen, J., concurring and dissenting).

The wisdom, if not the lawfulness, of reposing in a corporation the power to purchase its own shares has repeatedly been questioned. See, e.g., *Dodd, Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law*, 89 U. PA. L. REV. 697-98, 706 (1941). Nevertheless, statutes permit such purchases in almost all states and prohibit them in none. See Note, *Buying Out Insurgent Shareholders with Corporate Funds*, 70 YALE L.J. 308, 320-21 (1960). Furthermore, the practice appears to be increasingly popular. See Guthart, *More Companies are Buying Back Their Stock*, *Harv. Bus. Rev.*, March 1965, p. 40; Zilber, *Corporate Tender Offers for Their Own Stock: Some Legal and Financial Considerations*, 33 U. CINC. L. REV. 315 (1964).

12. Efforts to protect selling stockholders have taken the shape of restrictions on corporate repurchase plans and requirements of disclosure to such stockholders of relevant facts. See CCH FED. SEC. L. REP. (Transfer Binder) ¶¶ 77354, 91692 (1966). See generally Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1149-54 (1950); Note, *SEC Action Against Fraudulent Purchasers of Securities*, 59 HARV. L. REV. 769, 775-78 (1946); Note, *The Regulation of Corporate Tender Offers Under Federal Securities Law: A New Challenge for Rule 10b-5*, 33 U. CHI. L.R. 359 (1966). Recently the Securities and Exchange Commission has suggested (unsuccessfully) that disclosure to the remaining (i.e., non-selling) stockholders is an obligation of the insiders seeking to preserve their control which must be met before they cause their corporation to purchase its own stock. See Brief for the SEC as Amicus Curiae, p. 11-14, *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964). The suggestion was rejected by the Court. See also *Carliner v. Fair Lanes, Inc.*, 244 F. Supp. 25 (D. Md. 1965); *Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965). See also note 108 *infra*.

13. A requirement of repurchase by call or solicitation of tenders on a pro-rata or by-lot basis might remedy many such economic abuses or similar types of unfairness, but there is no general requirement of pro-rata or by-lot repurchase, apart from the requirements of the New York Stock Exchange, NEW YORK STOCK EXCH., COMPANY MANUAL §§ A-79, -177 (1953), and an occasional prescription in connection

is raised in the cases: whether the issuance of stock to insiders or the corporate purchase of its own stock should be precluded if the purpose or "primary" purpose of the issuance or purchase is to enable the insiders to retain or strengthen their control of the enterprise. In dealing with this question, the courts appear to differentiate between close corporations and publicly held corporations. In the latter cases, particularly where corporate purchase of its own stock is challenged, the results appear to depend in part on the answer to the question of economic abuse, but primarily on the elusive answer to the question whether the insiders' motives in seeking to retain control were to further the common good rather than simply to promote their own private benefit. To rest decision on the insiders' motives raises questions as to the propriety of so assessing self-serving conduct, even if it is tested by the loosest fiduciary standards.

### 1. *The Case Law: An Overview*

Where the issuance of stock to insiders, as distinguished from corporate purchase of its own stock, is challenged,<sup>14</sup> the decisions rarely reach the question whether the insiders' efforts to preserve control are designed to achieve the common good rather than private benefit. Instead, the problem is put in terms of whether the purpose, or "primary" purpose, or "principal" purpose of issuing stock is to affect control.<sup>15</sup> If such a purpose is found, the issuance is generally proscribed.<sup>16</sup> Such a purpose is almost invariably found

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with reduction of capital. *Compare* General Inv. Co. v. American Hide & Leather Co., 98 N.J. Eq. 326, 331, 129 Atl. 244-46 (Ct. Err. & App. 1925), *with* Martin v. American Potash & Chem. Corp., 33 Del. Ch. 234, 92 A.2d 295 (Sup. Ct. 1952).

14. Issuance of stock to insiders for purposes of preserving control involves slightly different considerations than the doctrine of pre-emptive rights. See Drinker, *The Preemptive Right of Shareholders to Subscribe to New Shares*, 43 HARV. L. REV. 586, 598-99 (1930); Frey, *Shareholders' Pre-emptive Rights*, 38 YALE L.J. 563 (1929); Morawitz, *The Preemptive Right of Shareholders*, 42 HARV. L. REV. 186 (1928); *cf.* Titus v. Paul State Bank, 32 Idaho 23, 179 Pac. 514 (1919). Even when the local corporation statute rejects, or is permissive about, and the corporate charter does not provide for, pre-emptive rights, or indeed, when pre-emptive rights have been waived, courts of equity have found no difficulty in invoking the fiduciary concept to preclude such an issuance of stock to insiders seeking to affect control.

15. See, *e.g.*, McPhail v. L. S. Starrett Co., 257 F.2d 388, 394-96 (1st Cir. 1958); Borg v. International Silver Co., 11 F.2d 147, 151-52 (2d Cir. 1925); Cummings v. United Artists Theatre Circuit, Inc., 237 Md. 1, 204 A.2d 795 (1964); Dunlay v. Avenue M Garage & Repair Co., 253 N.Y. 274, 170 N.E. 917 (1930); Runswick v. Floor, 116 Utah 91, 208 P.2d 948 (1949).

16. Occasionally courts will intimate that no obligation is owing by directors or insiders to other stockholders with respect to issuance of stock for the purpose of affecting control. *State ex rel. Page v. Smith*, 48 Vt. 266 (1876) is simply obsolete. See also Griffith v. Sprowl, 45 Ind. App. 504, 91 N.E. 25 (1910). In *Standard Int'l Corp. v. McDonald Printing Co.*, 159 N.E.2d 822 (Ohio C.P. 1959), when the majority

when challenges are made by stockholders of close corporations.<sup>17</sup> In contrast, in cases involving challenges by stockholders of public corporations, the tendency is to vindicate the insiders' issuance of stock to themselves or to congenial third persons.<sup>18</sup> The courts, finding that affecting control was not a purpose, or "primary" purpose, of the insiders,<sup>19</sup> view as irrelevant the fact that the issuance

stockholders of a closely-held corporation sold out to a large competitor, the court upheld the minority's issuance to itself of enough stock to become a majority. This may be a case of judicial assistance to the minority to get the same premium price for its stock from the putative buyer of control that the majority had received. See Note, 29 U. CINC. L. REV. 264 n.2 (1960). See also *Cross v. Farmers' Elevator Co.*, 31 N.D. 116, 153 N.W. 279 (1915). In *Yasik v. Wachtel*, 25 Del. Ch. 247, 256, 17 A.2d 309, 313 (Ch. 1941), the court distinguished between the majority stockholder who was losing control and small public stockholders, and expressly rejected the notion that the latter were owed any obligation with respect to control by an insider who was wresting control from a majority stockholder.

17. *E.g.*, *Schwab v. Schwab-Wilson Mach. Corp.*, 13 Cal. App. 2d 1, 55 P.2d 1268 (Dist. Ct. App. 1936); *Canada So. Oils, Ltd. v. Manabi Exploration Co.*, 33 Del. Ch. 537, 96 A.2d 810 (Ch. 1953); *Elliott v. Baker*, 194 Mass. 518, 80 N.E. 450 (1907); *Glenn v. Kittanning Brewing Co.*, 259 Pa. 510, 103 Atl. 340 (1918); *Chrisman v. Avil's, Inc.*, 80 Pa. D. & C. 395 (C.P. 1952); *Luther v. C. J. Luther Co.*, 118 Wis. 112, 94 N.W. 69 (1903). See also *Ross Transport, Inc. v. Crothers*, 185 Md. 573, 45 A.2d 267 (1946); *Essex v. Essex*, 141 Mich. 200, 104 N.W. 622 (1905); *Dunn v. Acme Auto & Garage Co.*, 168 Wis. 128, 138, 169 N.W. 297, 300 (1918). Some of the cases expressly formulate the rule in terms of a prohibition against issuing treasury stock "for the purpose of gaining control of the corporation without giving the other stockholders an opportunity to subscribe." *E.g.*, *Kullgren v. Navy Gas & Supp. Co.*, 110 Colo. 454, 465, 135 P.2d 1007, 1012 (1943); *L. E. Fosgate Co. v. Boston Mkt. Terminal Co.*, 275 Mass. 99, 108, 175 N.E. 86, 90 (1931). And California appears to find the prohibited purpose from the mere fact of a shift in control. *Sheppard v. Wilcox*, 26 Cal. Rptr. 412 (Dist. Ct. App. 1963). In other cases, preliminary injunctions are issued pending trial. *Snelling v. Richard*, 166 Fed. 635 (S.D.N.Y. 1909).

The courts are not, however, so firmly attached to the principle prohibiting use of corporate facilities to preserve control that they cannot be persuaded on occasion to lose sight of it in freeze-out cases. See O'NEAL & DERWIN, *EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES* 91-98 (1961); Note, 35 N.C.L. REV. 271, 272, 278 (1957).

18. *McPhail v. L. S. Starrett Co.*, 257 F.2d 388, 395-96 (1st Cir. 1958); *Borg v. International Silver Co.*, 11 F.2d 147, 151-52 (2d Cir. 1926); *Wyles v. Campbell*, 77 F. Supp. 343, 351 (D. Del. 1948); *Schwartz v. Miner*, 37 Del. Ch. 575, 146 A.2d 801 (Ch. 1958); *Cummings v. United Artists Theatre Circuit, Inc.*, 237 Md. 1, 15-22, 204 A.2d 795, 802-06 (1964); *Runswick v. Floor*, 116 Utah 91, 208 P.2d 948 (1949). See also *Zweifach v. Scranton Lace Co.*, 156 F. Supp. 384 (M.D. Pa. 1957). *But cf.* *Kahn v. Schiff*, 105 F. Supp. 973 (S.D. Ohio 1952); *Sachs v. Seminole Oil & Gas Corp.*, 38 Del. Ch. 246, 150 A.2d 20 (Ch. 1959), *appeal dismissed*, 39 Del. Ch. 73, 159 A.2d 276 (Sup. Ct. 1960); *Gerlach v. Gillam*, 37 Del. Ch. 244, 139 A.2d 591 (Ch. 1958); *New Quincy Mining Co. v. Johnson*, 114 Utah 342, 199 P.2d 561 (1948); *State ex rel. Kahn v. Johnson*, 114 Utah 333, 199 P.2d 556 (1948); *Floor v. Johnson*, 114 Utah 313, 199 P.2d 547 (1948); see *Yasik v. Wachtel*, 25 Del. Ch. 247, 256, 17 A.2d 309, 313 (Ch. 1941).

19. The frequency with which such a conclusion is reached casts doubt upon the applicability to public corporations of the substantive rule of law developed in the cases involving private corporations. In any event, that conclusion is difficult to square with the notion that the burden of proof should be on the insiders. Indeed, *Borg v. International Silver Co.*, *supra* note 18, seems to put the burden of proof of purpose on the plaintiff rather than on the directors. 11 F.2d at 152. See also *Cummings v. United Artists Theatre Circuit, Inc.*, *supra* note 18, at 24, 204 A.2d at 807; *McPhail v. L. S. Starrett Co.*, 157 F. Supp. 560, 563 (D. Mass. 1957). Compare *Zweifach v. Scranton Lace Co.*, 156 F. Supp. 384, 397 (M.D. Pa. 1957). In contrast, where close



of the stock may have some incidental effect on control. The larger latitude thus left for insiders of public corporations to issue stock to themselves reflects the looser conception of control applying to public corporations. But it also reflects accommodation to the differing needs of the two kinds of enterprises and to the differing bases of participation in them.

For example, issuance of additional stock to one group of participants in a close corporation is more likely to be aimed at freezing out another faction theretofore participating in control than at thwarting an outsider bent on acquiring control. Such a denial or curtailment of participation is apt to deprive that faction of its primary economic interests in the corporation—the compensation its members receive and the value of the growth of the enterprise attributable to their contributions to the direction of its affairs. In the case of a close corporation, no legitimate commercial or economic purpose would be frustrated by a rigid rule precluding insiders from purchasing stock from the corporation under any circumstances, regardless of purpose or motive, without first offering other participants their pro-rata share; it is always feasible for insiders to make such an offer, since whatever need the corporation may have for the proceeds of the issuance of the stock can be met promptly by such an offer or by a loan from the insiders pending the response to that offer.<sup>20</sup> In contrast, publicly held corporations may require issuance of stock to, *inter alios*, insiders or their friends for legitimate corporate purposes (for example, as compensation pursuant to stock options, or in mergers or asset acquisitions) which would be frustrated if the consent of all the stockholders were required every time stock were to be issued for such purposes.<sup>21</sup>

If the cases involving issuance of stock to insiders in order to

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corporations are involved, although on occasion the burden appears to be placed on the challenger, *Dunlay v. Avenue M Garage & Repair Co.*, 253 N.Y. 274, 170 N.E. 917 (1930); *cf.* *Bennett v. Breuil Petroleum Corp.*, 34 Del. Ch. 6, 99 A.2d 236 (Ch. 1953), the appellate court opinions in most cases do not articulate the problem in terms of burden of proof, but rather reflect a ready perception of the forbidden purpose as the dominant impulse to action. Indeed, the courts have relatively infrequently failed to find such a purpose in cases involving close corporations. See *Dunlay v. Avenue M Garage & Repair Co.*, *supra*; *Chapman v. Troy Laundry Co.*, 87 Utah 15, 47 P.2d 1054 (1935); *cf.* *Berg v. United Board & Carton Co.*, 106 N.Y.S.2d 658 (Supp. Ct. 1951); Note, 35 N.C.L. REV. 271 (1957).

20. The considerations which argue against pre-emptive rights in the case of publicly held corporations, see *Drinker, supra*, note 14; *Morawitz, supra*, note 14, are not relevant in assessing rules precluding issuance of stock to insiders in private corporations. See ISRAELS, CORPORATE PRACTICE 104-05 (1963).

21. It may be noted that even with respect to the issuance of stock to insiders of publicly held corporations, a vote of stockholders is often sought or required. See, *e.g.*, NEW YORK STOCK EXCH., COMPANY MANUAL §§ A-7, at 118-21; A-15, at 284-85 (1953); Dean, *Employee Stock Options*, 66 HARV. L. REV. 1403 (1953).

affect control of close corporations have rarely addressed themselves to the question of the insiders' motives in seeking control,<sup>22</sup> it is because the decisions rest on doctrinal premises which reject the relevance of such motives, whether benign or malignant; even benign motivation is not deemed sufficient to justify either the self-serving issuance of stock by a fiduciary or the frustration of stockholder suffrage.<sup>23</sup> On the other hand, in the case of publicly held corporations, even though at least the consideration of stockholder suffrage is applicable,<sup>24</sup> in the only express reference to the matter found in the cases, the court intimated that motives of public good might justify issuance of stock in order to preserve control.<sup>25</sup>

When the *repurchase* of corporate stock by privately held corporations is challenged, the courts have traditionally invoked both corporate and trust ideologies to suggest a categorical prohibition against the use of corporate funds to purchase stock for the purpose

22. The cases generally involve a history of sharp disagreement between two factions with respect to the operation of the corporation, not infrequently affecting the emoluments of control. The courts seek to ascertain whether the issuance of stock was required by legitimate corporate needs (to pay off debt, for working capital, etc.), and, if so, whether issuance to the insiders without offering it at the same time to the other stockholders was similarly a corporate necessity. If either proposition is answered in the negative, no legitimate corporate purpose is found to have been served by the issuance of the stock to the insiders, and the courts tend to conclude that the stock was issued for the purpose of preserving, acquiring or shifting control, and that the insider has violated his fiduciary obligation to the stockholders. Often, of course, there is extraneous evidence of the forbidden purpose. See, e.g., *Sheppard v. Wilcox*, 26 Cal. Rptr. 412 (Dist. Ct. App. 1963); *Elliott v. Baker*, 194 Mass. 518, 80 N.E. 450 (1907); *Glenn v. Kittanning Brewing Co.*, 259 Pa. 510, 103 Atl. 340 (1918); *Chrisman v. Avil's, Inc.*, 80 Pa. D. & C. 395 (C.P. 1951); cf. *Lawrence v. I. N. Parlier Estate Co.*, 15 Cal. 2d 220, 100 P.2d 765 (1940); Note, 35 N.C.L. Rev. 271 (1957).

23. In *Elliott v. Baker*, *supra* note 22, the court stated:

Mere belief that they are acting for the interests of the corporation . . . does not justify the issuing to confederates of a sufficient amount of stock to give to themselves, and to oust their opponents from the control of the corporation when the issuance of the stock is not required by the condition of the corporation nor reasonably necessary for the proper prosecution of its business.

194 Mass. at 522-23, 80 N.E. at 452. See also *Glenn v. Kittanning Brewing Co.*, *supra* note 22; *Sheppard v. Wilcox*, *supra* note 22. In *Luther v. C. J. Luther Co.*, 118 Wis. 112, 94 N.W. 69 (1903), the court said:

Nothing can be more fallacious in corporate or in popular government than the argument that because they honestly believe their policy right, and another dangerous, they may rightfully invade the field of the suffrage upon which policy rests, and disenfranchise in whole or in part, those who disagree with them.

118 Wis. at 124, 94 N.W. at 73. See also *Rowland v. Times Publishing Co.*, 160 Fla. 465, 471-72, 35 So. 2d 399, 402-03 (1948); *Trask v. Chase*, 107 Me. 137, 145-46, 77 Atl. 698, 702 (1910).

24. Both *Borg v. International Silver Co.*, 11 F.2d 147, 152 (2d Cir. 1926) and the court which decided *Runswick v. Floor*, 116 Utah 91, 97-98, 208 P.2d 948, 951-52 (1949), see *Floor v. Johnson*, 114 Utah 313, 199 P.2d 547 (1948), seem to recognize this.

25. In *McPhail v. L. S. Starrett Co.*, 257 F.2d 388, 395-96 (1st Cir. 1958), the court of appeals used strong language suggesting that insiders might properly issue stock to themselves in order to frustrate raiders; but the trial court found that such was not the sole or even the principal purpose of the issuance of stock in that case. 257 F.2d at 394. Compare *Cummings v. United Artists Theatre Circuit, Inc.*, 237 Md. 1, 19-21, 204 A.2d 795, 804-05 (1964).

of effecting control.<sup>26</sup> But none of the decisions rests on facts which require such a categorical prohibition, and recently a repurchase of stock to preserve control was explicitly upheld.<sup>27</sup> The cases involving public corporations tend to reject such a categorical prohibition. In Delaware,<sup>28</sup> where the problem appears to have arisen with respect to publicly held corporations more often than elsewhere, as well as in other jurisdictions,<sup>29</sup> insiders are permitted

26. Thus in *Andersen v. Albert & J. M. Andersen Mfg. Co.*, 325 Mass. 343, 346, 90 N.E.2d 541, 544 (1950), the court said:

The acquisition of some of the stock by two of the directors, the purchase of the remainder to be held as treasury stock, and the subsequent reduction of the number of outstanding shares resulted in ousting the remaining stockholders, other than Allen, from the control of the corporation and in transferring control to such two directors and Allen. Seventy-five thousand dollars of corporate funds were expended in the purchase of this stock. Directors cannot take advantage of their official position to manipulate the issue and purchase of shares of the stock of the corporation in order to secure for themselves the control of the corporation and then to place the ownership of the stock in such a position as will perpetuate that control. Such action constitutes a breach of their fiduciary obligations to the corporation and a wilful disregard of the rights of the other stockholders.

Similar language may be found scattered in the opinions of a few other courts. See *Macht v. Merchants Mortgage & Credit Co.*, 22 Del. Ch. 74, 194 Atl. 19 (Ch. 1937); *Albert E. Touchet, Inc. v. Touchet*, 264 Mass. 499, 507, 163 N.E. 184, 187 (1928); *Petre v. Bruce*, 157 Tenn. 131, 136-37, 7 S.W.2d 43, 45 (1928); *Gilchrist v. Highfield*, 140 Wis. 476, 478, 123 N.W. 102, 103 (1909). See also *Yax v. Dit-Mco, Inc.*, 366 S.W.2d 363 (Mo. 1963).

27. *Hendricks, Jr. v. Mill Eng'r & Supp. Co.*, 413 P.2d 811 (Wash. 1966); cf. *Baker v. Standard Lime & Stone Co.*, 203 Md. 270, 100 A.2d 822 (1953).

28. *Mathes v. Cheff*, 41 Del. Ch. 166, 190 A.2d 524 (Ch. 1962), *rev'd.*, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1963). See also *Schwartz v. Greene*, 39 Del. Ch. 330, 163 A.2d 614 (Ch. 1960); *Healy v. Geilfuss*, 37 Del. Ch. 502, 146 A.2d 5, 10 (Ch. 1958), *appeal dismissed*, 40 Del. Ch. 26, 172 A.2d 574 (Sup. Ct. 1959); *Propp v. Sadacca*, 40 Del. Ch. 113, 175 A.2d 33 (Ch. 1961), *modified sub nom. Bennett v. Propp*, 41 Del. Ch. 14, 187 A.2d 405 (Sup. Ct. 1962); *Kors v. Carey*, 39 Del. Ch. 47, 158 A.2d 136 (Ch. 1960); *Martin v. American Potash & Chem. Corp.*, 33 Del. Ch. 234, 92 A.2d 295 (Sup. Ct. 1952), 35 A.L.R.2d 1140 (1954).

29. In *New York*, a lower court ruled in *Lawrence v. Decca Records, Inc.*, 20 Misc. 2d 424, 425-26, 195 N.Y.S.2d 431, 433-34 (Sup. Ct. 1959), that a cause of action cannot be founded upon purchases by a corporation of its stock and its parent's stock which "are not attacked as illegal or unauthorized or as poor business judgment exercised fraudulently or in bad faith, but merely to influence control which in itself is not actionable, particularly in the absence of any allegation of damage." The court went on to state:

It is not control which injures, but its abuse . . . . The object to support control cannot buttress a claim of wrong, if control itself is not offending, lacking an allegation of its abuse to the detriment of the corporation or to the profit of the defendants other than the mere fact of control.

This ruling was effectively modified by a later decision, *Lawrence v. Decca Records, Inc.*, 27 Misc. 2d 445, 203 N.Y.S.2d 225 (Sup. Ct. 1960), upholding, against a motion to dismiss, a second amended complaint alleging economic injury to the corporation by reason of improvident sales of assets and borrowings in order to obtain cash for the corporation to use to purchase its stock in order to preserve control. See also *Selama-Dindings Plantations, Ltd. v. Durham*, 216 F. Supp. 104, 114 (S.D. Ohio 1963), *aff'd*, 337 F.2d 949 (6th Cir. 1964) (holding that it was appropriate to spend corporate funds to investigate an outsider's character and intentions in acquiring corporate stock); *Reifsnyder v. Pittsburgh Outdoor Advertising Co.*, 396 Pa. 320, 152 A.2d 894 (1949) (where a corporation bought its own stock from a controlling person which had been ordered to divest itself of control in compliance with the antitrust laws,

to cause a corporation to purchase its own stock for the purpose of thwarting a shift in control. The propriety of such purchases is said to turn on whether the incumbents' effort to retain control is itself in furtherance of a legitimate business purpose. The suggestion is that if the outsiders seeking control contemplate a program for the corporation which will be unlawful or economically harmful, the "in" group is justified in using corporate funds to thwart them (at least so long as due care is used in the effort), since such a use of corporate funds is assumed to be made for the benefit of all investors and not merely for the preservation of the "in" group's access to the emoluments of control. Hence, the decisions appear to turn on (1) whether the "principal" or "primary" purpose of the corporate purchase was preserving control; (2) whether the insiders' motives in seeking to retain control were to promote the collective good rather than to gain private advantage; and (3) whether proper care was exercised in pursuit of those objectives.

## 2. Purpose To Affect Control

The fact that the issuance of corporate stock to insiders or the purchase by a corporation of its own stock may serve many proper purposes not connected with retaining control<sup>30</sup> raises the questions how significant the purpose to affect control must be and how such a purpose must be proved, before the transaction should be condemned or its benefits denied to insiders. In close corporations, as the cases indicate, it is not difficult to identify a purpose to affect control and to assess its significance.<sup>31</sup> In public corporations, how-

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and the court, in dictum approving the price paid by the corporation, said: "Pittsburgh's directors and stockholders felt that they had to purchase this block of controlling stock in order to continue the present management and to prevent an outsider or competitor from getting control of the company." 396 Pa. at 324, 152 A.2d at 896; see *Vulcanized Rubber & Plastics Co. v. Scheckter*, 400 Pa. 405, 413, 162 A.2d 400, 405 (1960); cf. *Allen v. Francisco Sugar Co.*, 193 Fed. 825, 841 (3d Cir. 1912).

30. Stock may be purchased, for example, in order to have treasury stock available for use in satisfying employee stock options, for use in subsequent asset acquisitions, or to reduce total dividends payable. See Guthart, *More Companies Are Buying Back Their Stock*, Harv. Bus. Rev., March-April, 1965, p. 40; Zilber, *Corporate Tender Offers For Their Own Stock: Some Legal and Financial Considerations*, 33 U. CINC. L. REV. 315, 316-20 (1964). Hence, in the absence of a rule generally proscribing corporate purchase of its own stock on a non-pro rata basis, it is necessary to determine first whether a purpose or "primary" or "principal" purpose of the transaction is to affect control.

31. See notes 17, 22 & 26 *supra*. This determination in stock purchase cases is presumably to be made by the same kinds of inquiries into the asserted non-electoral purposes to be served by purchasing the stock as in stock issuance cases. See note 22 *supra*. Compare, e.g., *Gilchrist v. Highfield*, 140 Wis. 476, 478, 123 N.W. 102, 103 (1909), with *Kors v. Carey*, 39 Del. Ch. 47, 158 A.2d 136 (Ch. 1960), and *Mathes v. Cheff*, 41 Del. Ch. 166, 190 A.2d 524 (Ch. 1962). See also *Borden v. Guthrie*, 23 App. Div. 2d 313, 260 N.Y.S.2d 769 (1965); *Reifsnnyder v. Pittsburgh Outdoor Advertising Co.*, 396 Pa. 320, 152 A.2d 894 (1959).

ever, the problem is more complicated. Mixed purposes are apt to be claimed, and in many cases there may be great difficulty in determining whether affecting control was an incidental effect rather than a purpose of the action, or whether it was a "dominant" or "primary" purpose rather than merely a lesser factor.

When corporate repurchase of stock is involved, there appears to be less basis for argument as to purpose than when new stock is issued, since either the elimination of a visible "raider" tends obviously to transcend any other possible or assertable business purpose for the repurchase, or the effect of a purchase program on retention of control appears to be immaterial and incidental.<sup>32</sup> When issuance of new stock is involved, however, purposes not involving control may loom larger, since the issuance produces cash or other assets which are generally demonstrably necessary or useful to corporate operations; hence, "non-control" purposes can not be as readily relegated to the category of "merely incidental." Strict fiduciary considerations would make any such legitimate business purpose irrelevant, and would presumably condemn the transaction, or at least deny the insider its benefits, because it constitutes a unilateral disadvantageous alteration of the stockholders' interest in control arrangements, although its purposes and effects may be substantially beneficial to the stockholders. But the categorical prohibition of such action which strict fiduciary standards suggest has been rejected because corporate action uninspired by a design to alter the control mechanism for the insiders' benefit is often independently desirable despite incidental effects on control. Examples of such transactions are the issuance of stock under bona fide stock option plans<sup>33</sup> or in bona fide asset acquisitions.<sup>34</sup> Consequently, a selective proscription operates; only those transactions which are found to serve primarily the purpose of affecting control are singled out.

In cases dealing with public corporations, the decisions acknowledging the general principle that transactions which are intended primarily to affect control are proscribed leave much to be de-

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32. See *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1963); *Kors v. Carey*, *supra* note 31. But *cf.* *Borden v. Guthrie* *supra* note 31; *Reifsnyder v. Pittsburgh Outdoor Advertising Co.*, *supra* note 31.

33. See *McPhail v. L. S. Starrett Co.*, 257 F.2d 388, 395-96 (1st Cir. 1958); *Schwartz v. Miner*, 37 Del. Ch. 575, 146 A.2d 801 (Ch. 1958).

34. See *Zweifach v. Scranton Lace Co.*, 156 F. Supp. 384 (M.D. Pa. 1957); *Cummings v. United Artists Theatre Circuit, Inc.*, 237 Md. 1, 204 A.2d 795 (1964); *cf.* *MacCrone v. American Capital Corp.*, 51 F. Supp. 462, 469-70 (D. Del. 1943). Compare the charges and explanations in full page advertisements in the *New York Times*, May 19, 1966, p. 75, and May 20, 1966, p. 69, soliciting votes with respect to the request of *Loews, Inc.*, management for stockholder approval of an increase in the number of authorized shares of the corporation's common stock.

sired, in part because of the terms in which the courts formulate the rule,<sup>35</sup> but more significantly because the application to specific facts appears to be eroding the principle. Although the courts' opinions occasionally purport to deny it, their decisions suggest that they have placed on the challengers the burden of establishing the primacy of the self-serving purpose rather than requiring the insiders to negate such a purpose. Placing this burden on the challengers is incompatible both with traditional fiduciary obligations when loyalty is questioned and with the insiders' superior ability to explain their purpose.<sup>36</sup> Thus, for example, the timing of a stock option plan, or the permissible allocations or actual issuance of stock under the plan, may be affected by a design to preserve control although the basic notion of adopting such a plan and the essential contours of the plan can be shown to have been a reasonable response to the need to keep key personnel. Similarly, the legitimate ends to be served by a particular merger or asset acquisition may be clearly demonstrable, while its terms, such as the issuance of some stock in lieu of cash, or the allocation of stock among particular participants, may be designed to serve the control aspirations of insiders. In such circumstances, fiduciary considerations would deny insiders the personal benefits they seek unless they can demonstrate the primacy of external business purposes, or possibly even the immateriality<sup>37</sup> of self-serving purposes. Insiders are in a better position than are the challengers to produce all the facts and to explain the significance of the various factors considered in deciding upon the transaction, and the benefit of the doubt is traditionally accorded to beneficiaries when fiduciaries enter into self-serving transactions with their trust.

Moreover, placing the burden of proof on the insiders would not be incompatible with any demonstrated business needs. To be

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35. While some courts state that the purpose to affect control must be the "primary" purpose of stock issuance in order to condemn the transaction, *Cummings v. United Artists Theatre Circuit, Inc.*, *supra* note 34, others have suggested that condemnation is to be withheld unless the purpose to affect control is the "sole" purpose of stock issuance, *Borg v. International Silver Co.*, 11 F.2d 147 (2d Cir. 1926); *Wyles v. Campbell*, 77 F. Supp. 343 (D. Del. 1948); *cf. McPhail v. L. S. Starrett Co.*, 257 F.2d 388 (1st Cir. 1958). Moreover, even when legitimate business purposes are shown to have been the "primary" purposes, the purpose to preserve control may have been "material," in the sense that it was necessary and was taken into account in delineating the terms or boundaries of the transaction. *Cf. Cummings v. United Artists Theatre Circuit, Inc.*, *supra* note 34, at 29-30, 204 A.2d at 810 (Horney, J., dissenting); *In re Seminole Oil & Gas Corp.*, 38 Del. Ch. 246, 150 A.2d 20 (Ch. 1959). To the extent of any such "taking into account," there is occasion for invoking the condemnatory principle.

36. See, e.g., *Ross Transp., Inc. v. Crothers*, 185 Md. 573, 45 A.2d 267 (1946); notes 42 & 44 *infra*.

37. See note 35 *supra*.

sure, such an allocation of the burden may have some discouraging effects on the incumbents' willingness to chance proposals which might be economically advantageous, and the question may fairly be asked whether that result will outweigh the benefits to be derived from preventing improper perpetuation of insiders' control. The short answer is that, in the vast bulk of cases, management can recognize, and therefore act, when external business purposes are plainly predominant or when control-preservation purposes are plainly not material to a stock issuance or repurchase. It is only in the doubtful case that the problem exists. There is no way of knowing how extensive such cases may be, although it is worth noting that a comparable uncertainty with respect to the "fairness" of many types of self-dealing transactions has not prevented management from acting on them. In the absence of empirical evidence to the contrary, there is little reason to doubt that the risk of harm from institutionally perpetuating the incumbents' grip on control outweighs any risk that economically desirable transactions will be discouraged by placing the burden of proof where it traditionally belongs—on the self-serving fiduciary.

### 3. *Justification for Seeking To Retain Control*

Once it is found that the purpose for a corporation's issuing or purchasing its stock is to preserve insiders' control, the questions arise whether any such purpose can ever be justified, and, if so, when it is justified.

As has been cogently demonstrated elsewhere,<sup>38</sup> the analysis in the Delaware cases dealing with publicly held corporations, which is cast in terms of assessing whether those seeking to preserve their control are motivated by private benefit or common good, is hardly adequate to test the propriety of such a use of corporate funds. Whatever may be said in justification of the elusive<sup>39</sup> distinction between personnel and policy to support the expenditure of corporate funds on behalf of management in the course of a policy

38. *Buying Out Insurgent Shareholders With Corporate Funds*, 70 YALE L.J. 308 (1960).

39. The ease with which personal motives can become policy reasons is suggested by the advice of the Prentice-Hall Corporation Service after reporting the decision of the Supreme Court of Delaware in *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1964):

WHAT TO DO ——— The case gives an important guideline. Make sure you can show you acted in good faith to preserve corporate interests. In addition to your own investigation, get competent professional advice to support your belief that the acquisition by outsiders would be a threat to the corporation. P-H CORP. SERV., Bull. No. 23, ¶ 23.1, May 6, 1964; cf. *Kors v. Carey*, 39 Del. Ch. 47, 52, 153 A.2d 136, 141 (Ch. 1960).

dispute in a proxy contest,<sup>40</sup> the fact that insiders disagree with "raiders" over an issue of policy is not alone, as the courts appear to recognize, sufficient to justify the expenditure of corporate funds to prevent a contest for control. When the stockholders' voting power is thus being thwarted by use of corporate funds, the courts require that there be some showing that the insiders have a reasonable basis to believe that the activities contemplated by the outsiders would be either harmful to the corporation or unlawful. The resulting emphasis in the opinions on whether the insiders reasonably could fear that the outsiders' alleged policies would injure the corporation and whether the funds are appropriately used to avert such injury tends to focus attention on the insiders' duty of care rather than on their duty of loyalty. The extent to which the courts decline to view the matter as a question of loyalty is underscored by the fact that, even in the one case holding the insiders at fault, the decision rested on a finding that they were imprudent in causing the corporation to pay too high a price for its stock by running up the bids in market purchases, rather than that they were seeking to protect their enjoyment of the private benefits of control.<sup>41</sup> Hence, although as a formal matter the Delaware courts appear to place the burden of justification upon the insiders,<sup>42</sup> their decisions and a recent Washington decision<sup>43</sup> suggest that, in accordance with their understanding of the issue as one of care rather than loyalty, they are applying the business judgment test to measure the propriety of the insiders' behavior.<sup>44</sup> The Delaware courts appear not to

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40. See notes 72-74 *infra* and accompanying text.

41. See *Bennett v. Propp*, 41 Del. Ch. 14, 187 A.2d 405 (Sup. Ct. 1962).

42. The Delaware courts proclaim that the governing substantive rule frowns upon corporate purchases of its own stock, that permissible purchases are the exception, and that the burden of justifying such use of corporate funds is on the directors. See *Cheff v. Mathes*, 41 Del. Ch. 494, 504, 199 A.2d 548, 554 (Sup. Ct. 1964); *Bennett v. Propp*, *supra* note 41, at 18, 187 A.2d at 409. *But cf.* *Kors v. Carey*, 39 Del. Ch. 47, 54, 158 A.2d 136, 141-42 (Ch. 1960); *Bennett v. Breuil Petroleum Corp.*, 34 Del. Ch. 6, 99 A.2d 236 (Ch. 1953).

43. *Hendricks, Jr. v. Mill Eng'r & Supp. Co.*, 413 P.2d 811 (Wash. 1966).

44. See Note, 50 CORNELL L.Q. 302 (1965); cases cited note 42 *supra*. See also *Zweifach v. Scranton Lace Co.*, 156 F. Supp. 384 (M.D. Pa. 1957); *Carliner v. Fair Lanes, Inc.*, 244 F. Supp. 25, 29 (D. Md. 1965). Compare *Lawrence v. Decca Records, Inc.*, 20 Misc. 2d 424, 195 N.Y.S.2d 431 (Sup. Ct. 1959) with *Lawrence v. Decca Records, Inc.*, 27 Misc. 2d 445, 203 N.Y.S.2d 225 (Sup. Ct. 1960). *But cf.* *Sachs v. Seminole Oil & Gas Corp.*, 38 Del. Ch. 246, 150 A.2d 20 (1959). Compare *Krieger v. Anderson*, 40 Del. Ch. 363, 367, 182 A.2d 907, 909 (Sup. Ct. 1962). Relieving the "disinterested" directors in *Cheff v. Mathes* from the burden of proof and relieving most of the "disinterested" directors in *Bennett v. Propp* from liability, suggest a distinction between the test for such directors (business judgment) and the test for interested directors (loyalty). See 78 HARV. L. REV. 1253 (1965). The actual decisions in those two cases do not, however, apply the distinction. In the former case, the decision exonerated both the interested and disinterested directors alike, expressly deciding that the interested directors acted in good faith and were not to be penalized for an honest mistake of judgment. In the latter case, one of the disin-



have been struck by the incongruity of applying a standard designed to vindicate the exercise of business judgment in non-conflict-of-interest situations as a measure of compliance with the duty of loyalty, which arises only in conflict of interest situations.<sup>45</sup>

However, the objection to the Delaware decisions is not simply that they measure the propriety of insiders' behavior by a standard of "fairness" which appears inevitably to offer the incumbents still another mode of access to the corporate till in order to preserve their control. The primary question is whether a prophylactic sanction should be invoked to preclude all such issuance or purchase of stock for the purpose of preserving control. The courts' refusal to provide such a sanction rests on entirely erroneous substantive premises as to corporate suffrage. The Delaware opinions are grounded on the assumption that it is proper for management, and ultimately the courts, to decide in advance that the outsiders will gain control and that the activities contemplated by them will be so harmful from a business standpoint<sup>46</sup> or of such questionable legality<sup>47</sup> as to justify both the economic cost of thwarting their attempt (the issue price to insiders or the expenditure of corporate funds) and the denial to the stockholders of the opportunity to vote on whether they would authorize outsiders to undertake such activities. However, it is one thing to conclude on the basis of the actual conduct of corporate affairs and demonstrated economic results that those in charge have illegally milked the corporation, otherwise misconducted themselves, or managed the enterprise inefficiently and unsuccessfully. It is quite another thing to form such

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interested directors was, in fact, not exonerated. In any event, it is not necessary to underscore the fact that the distinction between "interested" and "disinterested" directors is less than sharp. See 50 CORNELL L.Q. 302, 308-09 (1965).

45. See Bayne, *The Fiduciary Duty of Management—The Concept in the Courts*, 35 U. DET. L.J. 561 (1958). Courts measuring insiders' behavior by trust ideology addressed to the duty of loyalty may proscribe prophylactically conduct which might be supported by a business judgment test. *Seagrave Corp. v. Mount*, 212 F.2d 389, 397 (6th Cir. 1954). Certainly when a fiduciary's motives are challenged as being self-serving, room may not be left for wide business judgment even by "disinterested" directors. Cf. *Fogelson v. American Woolen Co.*, 170 F.2d 660 (2d Cir. 1948).

46. *E.g.*, that the corporation would be adversely affected among its customers if its reputation for high quality products were diluted by association with a purveyor of lower quality products, that, if a controlling interest in the enterprise were acquired by one customer, the latter would be improperly favored and other customers would be scared off, *Kors v. Carey*, 39 Del. Ch. 47, 158 A.2d 136 (Ch. 1960), or that the corporation's mode of marketing its product would be disadvantageously altered, *Mathes v. Cheff*, 41 Del. Ch. 166, 190 A.2d 524 (Ch. 1962).

47. *E.g.*, that the relationship between the controlling person and the corporation might violate the Robinson-Patman and Clayton Acts, *Kors v. Carey*, *supra* note 46, at 50-51, 158 A.2d at 139-40, or that the controlling person might merge the corporation into itself on terms which were less favorable than could be obtained at arm's length, *Martin v. American Potash & Chem. Corp.*, 33 Del. Ch. 234, 92 A.2d 295 (Sup. Ct. 1952).

a conclusion on the basis of predictions by interested witnesses as to what policies outsiders will follow if they get control, and to decide that other possible uses of corporate funds are less desirable than their use to prevent the acquisition of control by persons who *may* commit acts which *may* be unlawful or economically disadvantageous *if* they acquire control.<sup>48</sup>

In fiduciary terms, it is incongruous to vest insiders with any discretion to use the corporate machinery to issue stock to themselves or to use corporate cash to buy its stock in order to increase their proportionate voting power and perpetuate their control. It is not merely that they thus advantage themselves in self-dealing or self-serving transactions; it is equally significant that the propriety of the price paid turns on a relatively flexible estimate of fairness, and that the corporate necessity for such action turns on a no more precisely assessable estimate of the nature, wisdom, and propriety of the future conduct of outsiders. In such kinds of self-dealing—where both the opportunity and the temptation to benefit the trustee are large and where there is no way of assessing effectively whether the beneficiary is deprived of anything—fiduciary ideology suggests a prophylactic prohibition, or at the very least requires the informed consent of the beneficiaries.<sup>49</sup> While corporate considerations often override such strict fiduciary injunctions, no overriding corporate needs are present when the transaction is intended to increase or perpetuate the insiders' control. On the contrary, corporate norms support fiduciary norms in rejecting both the preemptive issuance of stock to insiders and the purchase of corporate stock to preserve control. No corporate ends are served by such conduct other than those said to result from preserving the insiders' control. If such control is sought for private benefit, the preferential increase of the insiders' voting power offends even the narrowest conception of stockholder rights. If control is sought to be retained for the common benefit (to fend off "raiders" who have possibly harmful intentions), such augmentation of insider voting power offends the basic assumption underlying the stockholders' right to

48. *Fenestra, Inc. v. Gulf Am. Land Corp.*, 377 Mich. 565, 141 N.W.2d 36 (1966). It is instructive to compare the charges against the raider made by the incumbents in *Mathes v. Cheff*, for the purpose of justifying their use of corporate cash to beat off the raider with management's own performance in directing the affairs of that company. See *Cheff v. Schnackenberg*, 382 U.S. 917 (1965); 50 CORNELL L.Q. 302, 306 (1965).

49. *Cf. Mosser v. Darrow*, 341 U.S. 267, 273 (1951). It may be noted that to the extent that the "fairness" of the issue or purchase price depends on a prediction that the outsiders will get control and an assessment of what they will do to the corporation if they get control, it is considerably less measurable than the "fairness" of the price paid for goods, or even services, in the typically permitted instances of self-dealing.

vote—that they have the power to determine who is to manage corporate operations for the common benefit.

To be sure, the adequacy of stockholder suffrage as a mode of allocating power over the varied constituencies served or “governed” by a modern, publicly held corporation has been questioned repeatedly.<sup>50</sup> It has been urged that, ideally, stockholders should be given a smaller voice and other constituencies a larger voice in the process by which management is legitimated. But whatever may be the validity of such arguments, there is little to support, and much to oppose, any suggestion that when those in control are challenged by outside stockholders the insiders should be authorized to determine or affect the legitimacy of their own tenure by diluting stockholder suffrage through the exercise of their power over the corporate machinery or assets. By the same token, while the normal ineffectiveness of public stockholders’ votes evidences the dismal, if inevitable, disparity between doctrine and reality with respect to stockholder suffrage even in the case of moderate-sized corporations, it is no cure to permit the incumbents to tighten their long-range grip on control by use of corporate facilities or assets.

Indeed, the erosion of suffrage is underscored when the dilution or curtailment of the vote occurs in the face of a challenge by outsiders which creates one of the few occasions when public investors’ votes are likely to be effective. Organized and potent opposition which can offer a choice to stockholders does not inevitably arise when existing management is inadequate. But application of the pejorative term “raider” to outsiders should not mask the facts that inadequate management invites such opposition and that “raiders” can have the same interest as public investors in enhancing the value of the corporate stock.<sup>51</sup> So long as stockholder voting is the prescribed mode for legitimating management, it is preferable to facilitate opportunities for a stockholders’ choice in such matters, and, therefore, for the governing rules to forbid the use of corporate assets or facilities by insiders to prevent or frustrate the exercise of

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50. See BERLE, *POWER WITHOUT PROPERTY* (1959); MASON, *THE CORPORATION IN MODERN SOCIETY* (1959); REUSCHLEIN, *THE SCHOOLS OF CORPORATE REFORM* (1950); Gower, Book Review of Emerson & Latham, *Shareholder Democracy*, 68 HARV. L. REV. 922 (1954); Manning, Book Review of Livingston, *The American Stockholder*, 67 YALE L.J. 1477 (1958).

51. See MCCARTHY, *ACQUISITIONS AND MERGERS* 257 (1963); MASON, *op. cit. supra* note 50, at 46-72. The later history of the Holland Furnace Company, the corporation involved in *Cheff v. Mathes*, suggests that the public stockholders could not possibly have been any worse off if the raider had acquired control. See 50 CORNELL L.Q. 302, 306 n.29 (1965). See also Barnhill, *The Corporate Raider*, 20 BUS. LAW. 763 (1965). For discussion of a comparable effort to solve the so-called problem of the raider in Britain, see Penrose, *Some Aspects of the Development, Criticism and Control of the Take-Over Bid, Since 1945*, 1964 JURID. REV. 128.

such a choice.<sup>52</sup> Hence, even when it appears probable that the outsiders contemplate unwise or unlawful actions, those in control have no writ to use corporate facilities to impose their benevolent protection, at least if their doing so rests on their own unmeasurable estimate of the future behavior of others and at the same time effectively denies to stockholders the right to express a preference for one management over another.

This suggested prohibition is not inconsistent with the duty which a controlling stockholder may have, when selling his investment, to prevent control from passing to persons whose intent to injure the corporation is, or should be, foreseeable.<sup>53</sup> That obligation exists because the controlling person is getting out of the enterprise and is shifting control by a transaction in which, by definition, the remaining stockholders have no voice. When he thus acts alone he has a duty to guard the interests of the remaining stockholders. However, when they have the opportunity to protect their own interests by the use of their voting power, his fiduciary duty neither requires nor permits him to deny them that opportunity or to dilute their right of choice.

#### 4. *Stockholder Ratification*

A categorical prohibition against the use of corporate assets for the purpose of preserving control would deny to stockholders the power to permit such a use of assets except by unanimous consent. This suggestion is not incompatible with statutes which provide that less than all the stockholders have the power to approve the issuance of stock to insiders or the purchase of stock by the corporation, or that specified majorities of the stockholders may amend the charter, even to the extent of diluting or diminishing their voting power.<sup>54</sup> Such statutory power in a majority to curtail its own voting potential does not necessarily mean that the majority can donate a portion of the minority's interest in the vote to insiders in order to perpetuate the latter's control. In corporate law, as elsewhere, compliance with statutory requirements may be a necessary, but not a sufficient, condition to valid action. Overriding criteria of

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52. This is not to say that public investors have a right, either in fiduciary or in corporate terms, to be offered a contest for control every time a dissident faction appears, or that every control contest is desirable. Indeed, some are costly and some may be injurious to the corporation. But, when outsiders make substantial investments in stock in order to seek control, they are not likely to be merely nuisance claimants. They are presumably raising serious, and possibly substantial, issues.

53. See note 113 *infra*.

54. See, e.g., *Maddock v. Vordone Corp.*, 17 Del. Ch. 39, 147 Atl. 255 (Ch. 1929); *Morris v. American Pub. Util. Co.*, 14 Del. Ch. 136, 122 Atl. 696 (Ch. 1928); Note, 54 HARV. L. REV. 1368 (1941).

"fairness" or "good faith" still have to be met.<sup>55</sup> Informed stockholder approval, even by statutorily prescribed majorities, of an issuance of new stock or a corporate purchase of old stock would presumably not validate such action if the price were so unfair as to amount to a gift of corporate assets to, or for the benefit of, the insiders.<sup>56</sup> Appropriation of a portion of the stockholders' interest in control by altering the amount of outstanding stock to favor the insiders may be no less a gift to them, and consequently it cannot be ratified by less than unanimous, informed stockholder approval. The cases dealing with close corporations recognize this principle quite regularly, perhaps because the relationship between stockholder suffrage and the protection of essential economic interest is apparent in this context since the complainant is likely to have been deprived by the defendants of a significant voice in control and a significant share of the emoluments of control. The tenuousness of the relationship between individual small stockholders' votes and their economic interest in the identity of the management of a publicly held corporation might explain, but cannot justify, the courts' failure to invoke the same requirement of stockholder action in the case of publicly held corporations.

Even if, as has been suggested,<sup>57</sup> it were appropriate to put before stockholders for a majority vote the question of issuing or buying stock to fend off raiders, it may be noted that this appears never to have been done. While federal securities legislation may induce some such submissions, it has not yet required them.<sup>58</sup> More-

55. *E.g.*, *Continental Sec. Co. v. Belmont*, 206 N.Y. 7, 99 N.E. 138 (1912); *Kerbs v. California E. Airways, Inc.*, 33 Del. Ch. 69, 90 A.2d 652 (Sup. Ct. 1952), 34 A.L.R.2d 839 (1954); *Keenan v. Eshleman*, 23 Del. Ch. 234, 2 A.2d 904 (Sup. Ct. 1938); *Remillard Brick Co. v. Remillard-Dandini Co.*, 109 Cal. App. 2d 405, 241 P.2d 66 (Dist. Ct. App. 1952); *Page v. American & British Mfg. Co.*, 129 App. Div. 346, 113 N.Y. Supp. 734 (1908). See also *State ex rel. Waldman v. Miller-Wohl Co.*, 42 Del. 73, 28 A.2d 148 (Super. Ct. 1942). Compare *United Funds, Inc. v. Carter Prods., Inc.*, CCH FED. SEC. L. REP. ¶ 91288 (Md. Cir. Ct., May 16, 1963); cases cited note 14 *supra*. For the literature and cases on the question of a requirement of "fairness" when fundamental changes are submitted for vote by statutory majorities, see Note, 69 HARV. L. REV. 538 (1956).

56. See cases cited note 55 *supra*.

57. See Note, 70 YALE L.J. 308, 318-20 (1962); *McPhail v. L. S. Starrett Co.*, 257 F.2d 388, 394 (1st Cir. 1958); *cf. Krieger v. Anderson*, 40 Del. Ch. 363, 182 A.2d 907 (Sup. Ct. 1962). *But cf. Gilchrist v. Highfield*, 140 Wis. 476, 123 N.W. 102 (1909).

58. Recent decisions under federal securities legislation suggest that disclosure of control aspirations may be a mode of implementing insiders' fiduciary obligations when stock is issued to them. Compare *Ruckle v. Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964), with *McClure v. Borne Chem. Co.*, 292 F.2d 824, 834 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961). See generally Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965); *Israel's, Corporate Purchase of Its Own Shares—Are There New Overtones?*, 50 CORNELL L.Q. 620 (1965); Note, 33 U. CHI. L. REV. 359 (1966). However, in the context of corporate purchase of stock to affect control, there is considerable uncertainty as to the scope, and indeed the meaning of the

over, as a practical matter, if a market purchase program is planned in order to frustrate raiders, advance authority is not likely to be sought from stockholders because to do so would be so time-consuming and would have such an inflationary impact on the price of the stock as to threaten the success of the program. On the other hand, if stockholder approval is sought after the purchases are made on the market, or even before such purchase if the payment of funds is made to buy out the potential raider rather than to buy stock on the market, no issue remains between the raider and the old management to submit to the stockholders.<sup>59</sup> The intrinsic limitations on the kind of information which would be disclosed in any solicitation of proxies to obtain approval of such corporate expenditures suggest that an informed vote could not be had on the question. Hence there is no basis for depriving stockholders of the more conventional opportunity to choose the management they prefer by substituting therefor contests over whether to authorize a corporation's issuance or purchase of its stock for the purpose of perpetuating the incumbents' control.<sup>60</sup>

disclosure requirement, except perhaps for the proxy regulations. See *Studebaker Corp. v. Allied Prods. Corp.*, 256 F. Supp. 173 (W.D. Mich. 1966). Whatever may be the insiders' duty of disclosure to the sellers, federal securities legislation appears to have created no comparable duty to the corporation and its remaining (*i.e.*, non-selling) stockholders when insiders cause the corporation to buy in its stock. *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964); *Carliner v. Fair Lanes, Inc.*, 244 F. Supp. 25 (D. Md. 1965); *Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965). To find a duty of disclosure to the corporation and its remaining stockholders in the federal securities legislation raises myriad other problems. Recognition of some of the difficulties involved is explicitly given in the brief of the SEC (p. 14) in *O'Neill v. Maytag*, where, in arguing that insiders should be required to disclose their purpose to affect control when they cause a corporation to repurchase its securities at a price which is alleged to be too generous to the sellers, the Securities and Exchange Commission has stated:

Where, . . . persons who represent a corporation in a securities transaction participate with the other party to that transaction in a scheme to defraud their corporation, it is not entirely clear what disclosures and to whom would suffice to eliminate the fraud. The question may be largely academic since normally concealment of a scheme to defraud from those in a position to do anything about it is of the essence of the scheme. In any event, it seems unnecessary to consider this question here since, at least at the present stage, there is no suggestion that the alleged fraud was disclosed to anyone not a party to the alleged scheme.

59. See Note, 70 *YALE L.J.* 308, 318-19 (1962).

60. A contest between outsiders and insiders over approval of the issuance or purchase of stock, see, *e.g.*, N.C. GEN. STAT. § 55-52(c) (1965), might not present to the stockholders the same issues as a contest for office. Thus, recently the management of Loews, Inc., sought stockholder approval for a "package" transaction consisting of a 2-for-1 stock split and an authorization of additional shares which management might use to purchase diversified properties from friendly sellers and at the same time strengthen its control. See note 34 *supra*. The dissidents, challenging the management's efforts thus to acquire additional potential support, were hampered by the fact that the vote for creation of additional stock was to be cast as part of a vote for a stock split which most stockholders would find highly attractive. Apart from the possibility of thus confusing voters or slanting the vote, the fact that the timing of such a vote would be within the control of the incumbents would presumably favor them.

### 5. Injuries and Remedies

When a corporation is caused to repurchase its stock in order to preserve insiders' control, challenges of the repurchase present not only the problem of establishing a wrong,<sup>61</sup> but also the problem of prescribing a remedy.<sup>62</sup> The complaint generally alleges economic injury to the corporation resulting from an expenditure of funds which is claimed to be unlawful in purpose and therefore wasteful, and economic relief is thus generally sought.<sup>63</sup> As we have noted, the courts have posed the question in terms of whether the expenditure is economically justifiable and have tested the propriety of the insiders' conduct by the business judgment standard.<sup>64</sup> If, by the application of that test, no overall economic injury is found, the courts are hard put to recognize, or to fashion relief for, the residuary claim that the public investors' voting power has been altered to their disadvantage.<sup>65</sup> Adherence to the notion that it is the insiders' loyalty rather than their business judgment which is challenged, and which they must vindicate, would facilitate the use of suggested economic remedies.<sup>66</sup> While such remedies may not

61. The fact that the complainant is simply a small investor who has not himself been deprived of control has been deemed sufficient to deprive him of standing in cases involving public corporations. See *Kors v. Carey*, 39 Del. Ch. 47, 57, 158 A.2d 136, 142 (Ch. 1960); *Yasick v. Wachtel*, 25 Del. Ch. 247, 17 A.2d 309 (Ch. 1941). *But cf.* *Healy v. Geilfuss*, 37 Del. Ch. 502, 510-11, 146 A.2d 5, 10 (Ch. 1958), *appeal dismissed*, 40 Del. Ch. 26, 172 A.2d 574 (Sup. Ct. 1959); *Matter of Caplan*, 20 App. Div. 2d 301, 246 N.Y.S.2d 913, *aff'd*, 14 N.Y.2d 679, 198 N.E.2d 908 (1964).

62. The problem of an appropriate remedy is generally not serious in the case of issuance of stock to insiders, since either cancellation of the stock or rescission are readily available remedies. See, e.g., *Sachs v. Seminole Oil & Gas Corp.*, 38 Del. Ch. 246, 150 A.2d 20 (Ch. 1959); *Andrew v. Albert & J. M. Andersen Mfg. Co.*, 325 Mass. 343, 90 N.E.2d 541 (1950); *Glenn v. Kittanning Brewing Co.*, 259 Pa. 510, 103 Atl. 340 (1918); *Floor v. Johnson*, 114 Utah 313, 322-24, 199 P.2d 547, 551-52 (1948).

63. See, e.g., *Mathes v. Cheff*, 41 Del. Ch. 166, 167-69, 190 A.2d 524, 525 (Ch. 1963); *Propp v. Sadacca*, 40 Del. Ch. 113, 114-16, 175 A.2d 33, 34 (Ch. 1961); *Kors v. Carey*, 39 Del. Ch. 47, 50-51, 158 A.2d 136, 138 (Ch. 1960); *Healy v. Geilfuss*, 37 Del. Ch. 502, 510-11, 146 A.2d 5, 10 (Ch. 1958); *Lawrence v. Decca Records, Inc.*, 27 Misc. 2d 445, 203 N.Y.S.2d 225 (Sup. Ct. 1960). Compare *Cummings v. United Artists Theatre Circuit, Inc.*, 237 Md. 1, 204 A.2d 795 (1964).

64. See notes 42 & 44 *supra* and accompanying text.

65. See, e.g., *Martin v. American Potash Co.*, 33 Del. Ch. 234, 92 A.2d 295 (Sup. Ct. 1952); *Lawrence v. Decca Records, Inc.*, 20 Misc. 2d 424, 195 N.Y.S.2d 431 (Sup. Ct. 1959). Compare *Healy v. Geilfuss*, 37 Del. Ch. 502, 146 A.2d 5 (Ch. 1958). In *Kors v. Carey*, 39 Del. Ch. 47, 158 A.2d 136 (Ch. 1960), the corporation profited by purchase of its stock in view of a later price rise, even though the purchases were made at prices in excess of the market price at the time of purchase. See also *Cheff v. Mathes*, 41 Del. Ch. 494, 502-03, 199 A.2d 548, 553 (Sup. Ct. 1964).

66. See Note, 70 YALE L.J. 308, 317-18 (1960). As the facts in the Delaware cases suggest, generally more will have been paid by the corporation in purchasing its stock than a willing buyer would have paid a willing seller on the public market. See *Mathes v. Cheff*, 41 Del. Ch. 166, 190 A.2d 524 (Ch. 1963); *Bennett v. Propp*, 41 Del. Ch. 14, 187 A.2d 405 (Sup. Ct. 1962); *Kors v. Carey*, *supra* note 65. This excess is a minimum measure of the economic cost to the corporation of the insiders' desire to retain control for themselves. To that extent at least, compliance with fiduciary stan-

re-establish the prior balance of voting power in particular cases, they are likely to have a deterrent effect in the generality of cases.

But even if the challenge seeks only to vindicate political claims, that is, to rectify the contraction of the public stockholders' voting power rather than to recoup for economic injury, there is no reason to dismiss the challenge. An insider is no less in violation of his fiduciary duties when he curtails the stockholders' interest in the mobility of control arrangements than when he inflicts demonstrable economic harm. And, political remedies are available. Although courts are reluctant to remove directors for abuse of their office, and often are said to be powerless to do so in the absence of statutory power, statutes in some states authorize such removal,<sup>67</sup> and common law decisions suggest, even if they rarely hold, that such power exists, at least in the case of fraud.<sup>68</sup> Moreover, the failure to disclose in proxy materials that a corporation's issuance or purchase of its stock is to be made or has been made in order to avoid a contest or to enable management to prevail in a contest may be sufficiently misleading so as to constitute a violation of the Securities Exchange Act and the proxy regulations. An election in which proxies so obtained are used is sufficiently tainted so as to justify removal from office of those elected.<sup>69</sup> There is certainly a legitimate basis for urging that directors who so acquire their tenure hold it no more properly than do persons who have purchased office or have corrupted stockholders' votes, and that therefore the directors should be removed and declared ineligible while a new election is conducted.<sup>70</sup> To be sure, such removal would not restore to the public stockholders the potential for change repre-

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dards would require them to make the corporation whole, even if, as in *Kors v. Carey* and *Cheff v. Mathes*, the stock subsequently increased in price. Another suggested economic remedy is to cause the insider to purchase the stock from the corporation at a price equal to the price theretofore paid by the corporation or the market price at the time when the insider must purchase, plus interest, whichever is higher.

67. See BALLANTINE, CORPORATIONS § 187, at 438-39 (1946 ed.); 2 FLETCHER, CYCLOPEDIA OF CORPORATIONS § 358 (1954); e.g., CAL. GEN. CORP. LAW § 811; N.Y. BUS. CORP. LAW § 706(d). See also Investment Company Act § 36, 54 Stat. 841 (1940), 15 U.S.C. § 80a-36 (1964).

68. See *Brown v. North Ventura Road Dev. Co.*, 216 Cal. App. 2d 227, 232, 35 Cal. Rptr. 568, 571 (Dist. Ct. App. 1963); *California Fruit Growers Ass'n v. Superior Court*, 8 Cal. App. 711, 97 Pac. 769 (Dist. Ct. App. 1908); *Nahikian v. Mattingly*, 265 Mich. 128, 135, 251 N.W. 421, 424 (1933); *Hollander v. Breeze Corp.*, 131 N.J. Eq. 585, 26 A.2d 507 (Ch. 1941), *aff'd*, 131 N.J. Eq. 613, 26 A.2d 522 (Ct. Err. & App. 1942).

69. See Loss, *The SEC Proxy Rules in the Courts*, 73 HARV. L. REV. 1041, 1072-83 (1960). Action by a private stockholder under *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964), may be the means for seeking such redress.

70. *Wyatt v. Armstrong*, 186 Misc. 216, 59 N.Y.S.2d 502 (Sup. Ct. 1945). The power of courts to review corporate elections has been invoked in related contexts. *Sachs v. Seminole Oil & Gas Corp.*, 38 Del. Ch. 246, 150 A.2d 20 (Ch. 1959); *Floor v. Johnson*, 114 Utah 313, 322-24, 199 P.2d 547, 551-52 (1948).



sented by the outsiders who were eliminated by a controlling stockholder, and it might not even restore the control arrangements which have been altered. Indeed, there may be little stimulus for a stockholder to seek to vindicate merely his political rights if no economic remedy is available.<sup>71</sup> But judicial sterility in creating remedies should not be an added deterrent to the stockholder.

### B. *Use of Corporate Funds in Proxy Solicitations*

The fiduciary and corporate considerations which suggest the impropriety of the issuance of stock to insiders, or of the use of corporate funds to purchase stock in order to preserve the incumbents' control are also relevant to the expenditure of corporate funds to solicit proxies on behalf of management. To be sure, such a use of corporate funds is presumably designed to furnish, rather than to deny, the stockholders the opportunity to exercise their suffrage. In addition, such expenditures in proxy contests do not permanently alter the voting structure; they merely help to preserve the incumbents' control in a particular election. Nevertheless, control so preserved is more likely to be continuous than merely temporary, and such a use of corporate funds thus effectively curtails, rather than enlarges, stockholders' opportunities to choose management.

These realities are not altered by the judicially created doctrine which purports to confine the insiders' use of corporate funds in proxy solicitation to the illumination of questions of "policy" (which presumably serves the good of all stockholders), and which denies such a use of funds when only questions of "personnel" are at issue.<sup>72</sup> This distinction between issues of "policy" and issues of "personnel" has been recognized by the courts, even as they have invoked it, to be a virtually useless device for separating permissible from impermissible corporate expenditures.<sup>73</sup> Such expenditures have rarely, if ever, been disallowed on the ground that the dispute

71. Derivative litigation which offers little hope of any immediate cash return is hardly likely to be undertaken, even by a substantial stockholder.

72. *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 20 Del. Ch. 78, 81, 171 Atl. 226, 227 (Ch. 1934); *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 309 N.Y. 168, 128 N.E.2d 291 (1955); *Grodetsky v. McCrory Corp.*, 267 N.Y.S.2d 356, 49 Misc. 2d 322 (Sup. Ct. 1966). See generally authorities collected in ARANOW & EINHORN, *PROXY CONTESTS FOR CORPORATE CONTROL* chs. 20-22 (1957). As the authors indicate, the outer limits of permissible expenditures are unclear, largely because of the uncertainty as to whether the premise on which expenditures are authorized is (1) only to enable stockholders to be informed with respect to the matters at issue; or (2) also to permit them to be persuaded to vote for one side or the other.

73. *Steinberg v. Adams*, 90 F. Supp. 604, 608 (S.D.N.Y. 1950); *Hall v. Trans-Lux Daylight Picture Screen Co.*, *supra* note 72, at 81, 171 Atl. at 227; see ARANOW & EINHORN, *op. cit. supra* note 72, ch. 21. *But cf. Cullom v. Simmonds*, 285 App. Div. 1051, 139 N.Y.S.2d 401 (1955).

is purely a matter of "personnel."<sup>74</sup> Hence, notwithstanding ambiguities in some of the decisions, any detached assessment of the law in operation impels the conclusion that insiders are in fact allowed to use corporate money and facilities in proxy solicitation to protect their own access to the private emoluments of control, even though the "rule" by which this result is achieved does not contemplate, and indeed purports to prohibit, such use.

Strict fiduciary standards would categorically preclude insiders from spending corporate funds to perpetuate their power, whether they are deemed fiduciaries for stockholders alone or for several constituencies. And as a corporate matter, the fact that a proxy contest is over issues of policy does not, a priori, justify the use of corporate funds by management to solicit proxies for itself in order to legitimate its control. It would be equally reasonable to forbid corporate funds from being used in a campaign to preserve control and to require those whose economic interests are presumably most affected by the adoption of one policy rather than another—*e.g.*, the stockholders—to use their own funds to underwrite the proxy campaign. In any event, it is theoretically possible to require relevant information to be furnished to stockholders without at the same time soliciting proxies,<sup>75</sup> although, practically, the relevant information is likely to favor management. But apparently in recognition of the public stockholders' limited financial interest in relation to the cost of proxy solicitation and in deference to the need to raise a quorum,<sup>76</sup> courts have accepted the notion that, in both

74. The unlikelihood of any such disallowance is increased by the New York decisions placing the burden of proof on the outside challenger, which makes it virtually impossible for an insider's expenditures to be found improper. See *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 309 N.Y. 168, 128 N.E.2d 291 (1955).

75. Compare Securities Exchange Act § 14(c), 78 Stat. 570 (1964), 15 U.S.C. § 78n(c) (1964); SEC Reg. 14A, Schedule 14A, 17 C.F.R. §§ 240.14a-10, -11 (1964, Supp. 1966). Commentators and others have suggested that even if proxies are solicited, the materials to be sent to stockholders should be rigidly confined to relevant factual information, and that expenditures for persuading as distinct from informing should be disallowed. See Emerson & Latchman, *Proxy Contest Expenses and Shareholder Democracy*, 4 W. RES. L. REV. 5 (1952); Friedman, *Expenses of Proxy Contests*, 51 COLUM. L. REV. 951, 954-55 (1951); cf. *Rosenfeld v. Fairchild Engine & Airplane Corp.*, *supra* note 74, at 176-87, 128 N.E.2d at 295-301 (Van Voorheis, J., dissenting); *Lawyers Advertising Co. v. Consolidated Ry. Lighting & Refrigerating Co.*, 187 N.Y. 345, 80 N.E. 199 (1907). It may be noted, however, that such relevant information will undoubtedly be cast in a form which favors management so that the incumbents will inevitably derive substantial advantage from the use of corporate funds and facilities to circulate such information.

76. See EMERSON & LATCHMAN, *SHAREHOLDER DEMOCRACY* 141 (1954); LIVINGSTON, *THE AMERICAN STOCKHOLDER* (1958). It may be noted, however, that recently the Court of Appeals for the Second Circuit has suggested "that in contests for control the management has a role to play as such and not merely insofar as the managers are stockholders," so that it is entitled to use corporate funds to perpetuate itself in order to frustrate outside stockholders' desires. *Studebaker Corp. v. Gittlin*, 360 F.2d 692, 695 (2d Cir. 1966).

management controlled and stockholder controlled enterprises, corporate funds may properly be used to solicit management proxies on matters of policy. Here, as elsewhere, fiduciary considerations have yielded to alleged corporate needs—the assumed desirability, if not the demonstrated necessity, of sending proxy solicitation materials to stockholders in order that they be fully informed on matters of corporate policy with respect to which they have the right to vote.<sup>77</sup>

The factors which are felt to justify the overriding of strict fiduciary injunctions against permitting insiders to use corporate assets for their own benefit suggest narrow limits to insiders expenditures which, as we have noted, courts do not appear to find easily enforceable. But, whether or not such limits are enforced, the same factors suggest that the inevitable advantages accruing to insiders from such access to corporate funds should be diluted, if they cannot be entirely offset, by facilitating the expression of the views of those opposing the incumbents. When rigid fiduciary restrictions are relaxed to permit insiders to deal with their corporations, stockholder protection demands full disclosure and “fair” terms. Similarly, giving insiders access to corporate funds to solicit proxies on matters of “policy” requires making available equal access to such funds and facilities for those challenging management on matters of “policy.”

The case law is sparse in this area and does not extend beyond suggesting that successful insurgents (possibly only with stockholder approval) and unsuccessful incumbents may be reimbursed from the corporate till.<sup>78</sup> Moreover, to conclude that such reimbursement is a permissible corporate expenditure is not to say that it is a right of the recipients.<sup>79</sup> No statement or holding by a court or the Securities and Exchange Commission has yet gone as far as the proposals by commentators that “meritorious” but unsuccessful insurgents should be reimbursed, not merely as a privilege, but as a matter of right.<sup>80</sup> Nevertheless, such reimbursement would be con-

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77. The New York Stock Exchange requires listed companies to agree to solicit proxies for all meetings of stockholders and therefore to furnish the information required under § 14 of the Securities Exchange Act in proxy soliciting material. *NEW YORK STOCK EXCH., COMPANY MANUAL* § A-134 (1953).

78. *Steinberg v. Adams*, 90 F. Supp. 604 (S.D.N.Y. 1950); *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 309 N.Y. 168, 128 N.E.2d 291 (1955); *cf. Cullom v. Simmonds*, 285 App. Div. 1051, 139 N.Y.S.2d 401 (1955).

79. *Cf. Grodetsky v. McCrory Corp.*, 267 N.Y.S.2d 356, 49 Misc. 2d 322 (Sup. Ct. 1966).

80. Indeed, at least one case has rejected such a view, *Phillips v. United Corp.*, 5 SEC Jud. Dec. 445, Civ. No. 40-497 (S.D.N.Y. 1947), *appeal dismissed*, 171 F.2d 180 (2d Cir. 1948). See also *Grodetsky v. McCrory Corp.*, *supra* note 79. *But see, Campbell v.*

sistent with, if it is not compelled by, the basic notion that if stockholders should underwrite the expense of receiving management's views, they should also pay the cost of circulating the opposition's views because such views are no less relevant than are management's to the choice which stockholders are entitled to make in a contest over control.

Uprisings of small stockholders are not a predictable result of giving outsiders contesting control access to corporate funds, even if it were desirable to encourage such attempts at Jeffersonian democracy in corporate enterprise. At best, opposition will succeed only where it originates with relatively large aggregations of capital. Such stockholder voting arrangements may not be the wisest mode for determining where corporate power shall reside, and they certainly do not offer the most effective method of assuring management responsibility. But so long as stockholder suffrage provides the predominant machinery for effectuating such purposes, and so long as it remains impossible to deny management access to the corporate till in order to favor itself—however lightly<sup>81</sup>—in the solicitation of votes, the advantages of such self help can at least be mitigated by also making that source available to outside opposition.<sup>82</sup>

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Loew's, Inc., 36 Del. Ch. 563, 134 A.2d 852 (Ch. 1957); Emerson & Latcham, *Proxy Contest Expenses & Shareholder Democracy*, 4 W. RES. L. REV. 5, 15-17 (1950); Friedman, *supra* note 75. See also authorities discussed in ARANOW & EINHORN, *op. cit. supra* note 72; FEUER, PERSONAL LIABILITIES OF OFFICERS AND DIRECTORS 119-21 (1961). Compare the suggestion that management proxy materials carry nominations made by outside stockholders. Caplin, *Proxies, Annual Meetings and Corporate Democracy, The Lawyer's Role*, 37 VA. L. REV. 653 (1951).

81. See note 75 *supra*.

82. Whether the availability of such a subsidy would unduly drain the corporate treasury or otherwise injure the corporation or the attractiveness of its stock for investors depends largely upon the kinds of contestants who would be eligible for the subsidy and the kinds of contests in which the participants would be eligible for the subsidy. Proxy contests are not ipso facto beneficial to public investors. And not all initiators of proxy contests seek the common good. On the other hand, more is involved than simply initiating a derivative suit or offering a proposal to be included in management's proxy statement. It is unlikely that mere nuisance contests will be started, particularly if funds must first be spent, if judicial or administrative approval must be obtained before there is reimbursement, or if not all contestants may automatically expect reimbursement from the corporation. Development of suitable criteria of eligibility for subsidy undoubtedly presents knotty problems, particularly since the opposition need not be confined to a single group, but may be splintered. But several feasible suggestions have been made for such criteria and for their implementation by the Securities and Exchange Commission. See EMERSON & LATCHAM, SHAREHOLDER DEMOCRACY 142 (1954); Emerson & Latcham, *Proxy Contest Expenses and Shareholder Democracy*, 4 W. RES. L. REV. 5 (1952); Friedman, *supra* note 75; Note 61 YALE L.J. 229 (1952). The difficulty of drawing an appropriate line is certainly not of sufficient magnitude to preclude a rule authorizing subsidization of meritorious, if unsuccessful, opposition.

C. *Indemnification for Litigation Expenses*  
*Incurred in Contests for Office*

Somewhat different from the problems generated by the use of corporate funds in proxy contests are the issues raised by the use of corporate funds to indemnify or reimburse directors and others for the cost of litigation challenging their right to hold office or pressing others' claims to office. Little judicial light illuminates this area. In the absence of statute or corporate by-law, a few courts have either declined to authorize reimbursement when there was no demonstrable pecuniary benefit to the corporation, or have tended to invoke a distinction between the personal interests of the litigants in the controversy and the corporate interest in the integrity of its internal processes.<sup>83</sup> This distinction is reminiscent of the distinction between personnel and policy which is invoked in measuring the propriety of the expenditures of corporate funds in proxy contests, but it is even less tenable as a tool for separating permissible from impermissible reimbursement for the costs of litigating title to office than it is as a measure of the legitimacy of proxy contest expenses.<sup>84</sup> Hence it is not surprising that the distinction is ignored in those decisions which suggest that reimbursement from corporate funds (pursuant to indemnification statutes, contracts, or other arrangements) can be offered to directors who prevail in the litigation challenging their status,<sup>85</sup> and to outsiders successfully litigating their right to office.<sup>86</sup>

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83. See, e.g., *Burley Tobacco Co. v. Vest*, 165 Ky. 762, 178 S.W. 1102 (1915); *Schindel v. Brenauer*, 136 N.J. Eq. 94, 40 A.2d 631 (Ct. Err. & App. 1945); *Hull v. Enoch Morgan Sons*, 2 N.Y. City Ct. Rep. 69 (1884). See also *Reifsnyder v. Pittsburgh Outdoor Advertising Co.*, 405 Pa. 142, 147-49, 173 A.2d 319, 322 (1961); Comment, *Corporate Responsibility for Litigation Expenses of Management*, 40 CALIF. L. REV. 104, 109 (1952); cases collected in Annots. 39 A.L.R.2d 580 (1955); 152 A.L.R. 909 (1944).

84. A controversy over title to corporate office is addressed to legal questions concerning the functioning of the corporate elective process rather than the wisdom of particular policies or the competence or integrity of particular personnel. See notes 87 & 88 *infra*.

85. See *Essential Enterprises Corp. v. Automatic Steel Prods., Inc.*, 39 Del. Ch. 371, 164 A.2d 437 (Ch. 1960), 75 HARV. L. REV. 623 (1962), relying upon a statutory and by-law right to indemnification. Compare *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 20 Del. Ch. 78, 87-88, 171 Atl. 226, 230 (Ch. 1934); *Central Shorewood Bldg. Corp. v. Saltzstein*, 245 Wis. 138, 13 N.W.2d 525 (1944).

86. See *Richman v. DeVal Aerodynamics, Inc.*, 40 Del. Ch. 548, 185 A.2d 884 (Ch. 1962); *Mencher v. Sachs*, 39 Del. Ch. 366, 164 A.2d 320 (Sup. Ct. 1960); *Runswick v. Floor*, 116 Utah 91, 100, 208 P.2d 948, 953 (1949), all involving corporate elections plus a determination that certain corporate action affecting control (such as issuance of stock to insiders or their friends, or entry into management contracts) should be altered or stayed. The Delaware decisions imply that the recipient's right to reimbursement (if not also the corporation's right to proffer it) rests on the benefits conferred upon the corporation by the judicial resolution of the collateral issues. See also

Whether corporate payment of such litigation expenses is as incompatible with fiduciary standards as is payment of management's expenses in proxy contests, corporate considerations would more easily support a conclusion favoring such payments in the former case than in the latter. Concern with validating the corporate electoral process and with legitimating its office holders<sup>87</sup> offers reasons to permit the corporation (as distinguished from the supporting stockholders) to pay management's litigation expenses, reasons which are lacking for its payment of the cost of management's proxy solicitations.<sup>88</sup> Moreover, interest in the legitimacy of corporate office argues for also indemnifying the unsuccessful incumbents<sup>89</sup> and the challengers, so long as they have put forward "meri-

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Bosch v. Meeker Co-op. Light & Power Ass'n, 257 Minn. 362, 101 N.W.2d 423 (1960); In the Matter of Caplan (Lionel Corp.), 20 App. Div. 301, 246 N.Y.S.2d 913 (Sup. Ct. 1964), *aff'd*, 23 App. Div. 2d 655, 257 N.Y.S.2d 644 (1965); Allen v. Chase Nat'l Bank, 180 Misc. 259, 40 N.Y.S.2d 245 (Sup. Ct. 1942); Note, 48 CALIF. L. REV. 843 (1960); cases collected in Annot. 39 A.L.R.2d 580, 587-88 (1955).

87. See *Essential Enterprises Corp. v. Automatic Steel Prods., Inc.*, 39 Del. Ch. 311, 378-79, 164 A.2d 437, 441-42 (Ch. 1960); *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 20 Del. Ch. 78, 88, 171 Atl. 226, 230 (Ch. 1934). *But cf.* note 83 *supra*.

88. *Cf.* *Hall v. Trans-Lux Daylight Picture Screen Corp.*, *supra* note 87, at 88, 171 Atl. at 230. In proxy contests, the assumption is that essentially political or policy questions are being debated and that the stockholders are required to subsidize such a debate in order to be able to vote more intelligently. However, in litigation over tenure of office, no money is being expended for the purpose of informing stockholders with respect to any action they should take. The expenses are undertaken to inform the court and to enable it, rather than the stockholders, to act correctly in resolving legal questions. Indemnification or reimbursement of contestants for their costs in such litigation is more aptly analogized to payment of costs of parties to litigation producing a benefit for the corporation. The concept "benefit" embraces not merely the creation of a trust fund or pecuniary benefit, but also the effectuation of the corporate processes of election and the legitimizing of the occupants of corporate office. See Hornstein, *The Counsel Fee in Stockholder's Derivative Suits*, 39 COLUM. L. REV. 784, 799 n.100 (1939), for cases authorizing compensation for non-pecuniary benefits. Compare *Bosch v. Meeker Co-op. Light & Power Ass'n*, 257 Minn. 362, 101 N.W. 423 (1960); *Martin Foundation, Inc. v. Phillips-Jones Corp.*, 204 Misc. 120, 123 N.Y.S.2d 222 (Sup. Ct. 1953), *modified*, 283 App. Div. 729, *aff'd*, 306 N.Y. 972, 120 N.E.2d 229 (1954); Note, 48 CALIF. L. REV. 843 (1960). Cases are collected in 39 A.L.R.2d 580, 587-88 (1955).

89. Loss of such litigation is most likely to be on non-negligence, non-fault grounds when there is a contested election or an effort to remove a director without cause. It is doubtful that the indemnity would apply if the directors' claims to offices are based on what is found to have been their misconduct, see *Bailey v. McLellan*, 159 F.2d 1014 (1st Cir. 1947); *Chabot & Richard Co. v. Chabot*, 109 Me. 403, 84 Atl. 892 (1912), or are frivolous, since such claims could be deemed to be wrongfully or negligently asserted, and therefore to disentitle the directors to indemnity, *cf.* *Essential Enterprises Corp. v. Dorsey Corp.*, 40 Del. Ch. 343, 355-57, 182 A.2d 647, 655 (Ch. 1962); WASHINGTON & BISHOP, *INDEMNIFYING THE CORPORATE EXECUTIVE* 15-16 n.24 (1963). Certainly, a director who is unsuccessful in meritorious litigation over his tenure of office is no less entitled to reimbursement for his expenses than is a trustee for expenses incurred in litigation over the propriety of his conduct, as long as his actions do not constitute active misconduct or actual fraud. *In re Carter's Estate*, 6 N.J. 426,

torious"<sup>90</sup> contentions. To be sure, the language of most statutes, by-laws, and contracts providing for indemnification may not cover challengers who were not directors or officers when they incurred the expenses for which they seek reimbursement.<sup>91</sup> Nevertheless, the cases intimate that successful challengers may properly cause the corporation to reimburse them or may request the court to make appropriate compensation to them on grounds other than a statutory or contractual right to indemnification.<sup>92</sup> Occasionally, in cases involving close corporations, the courts have allowed all parties to be reimbursed for the costs of litigation challenging tenure of office, at least when the losing party was not entirely unsuccessful.<sup>93</sup> Compensation to successful or partly successful challengers or incumbents rests on the same principles which permit compensation of counsel for plaintiffs in derivative litigation brought for the collective benefit of all stockholders.<sup>94</sup> Even when the challenger or incumbent is not at all successful, if his claims were meritorious so that factual problems and legal issues of significance to corporate suffrage or control were resolved, the grounds that support payment of "watchdog" compensation to unsuccessful contenders in many reorganization proceedings<sup>95</sup> suggest compensating him in contests for office irrespective of such rights as he may have under indemnification statutes or by-laws.

In sum, if fiduciary considerations are not weighty enough to preclude the use of corporate funds on behalf of management in proxy contests or to reimburse incumbents in litigation over contest results, the corporate considerations thus impelling the relaxation of fiduciary commands suggest that the same source of funds be made available to outsiders in order to offset the advantages of such relaxation.

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446, 78 A.2d 904, 915 (1951); *Behrman v. Egan*, 31 N.J. Super. 95, 106 A.2d 36 (Ch. 1953), *modified*, 16 N.J. 97, 106 A.2d 284 (1954).

90. The determination of when claims are sufficiently "meritorious" to justify reimbursement of expenses presents fewer difficulties than does the determination of when unsuccessful opposition in proxy contests may appropriately be reimbursed, since assessment of compensable litigation expenses turns on much narrower inquiries—inquiries into the merits of legal claims and facts relevant thereto—which are within the daily competence of courts and administrative agencies.

91. See *Essential Enterprises Corp. v. Automatic Steel Prods., Inc.*, 39 Del. Ch. 371, 378-79, 164 A.2d 437, 441 (Ch. 1960); *WASHINGTON & BISHOP, op. cit. supra* note 89, at 17-18.

92. See note 86 *supra*.

93. *Marron v. Wood*, 55 N.M. 367, 233 P.2d 1051 (1951); *cf. Grant v. Hartman Ranch Co.*, 193 Cal. App. 2d 497, 14 Cal. Rep. 531 (1961).

94. See note 88 *supra*.

95. *In re United Corp.*, 119 F. Supp. 524, 532-33 (D. Del. 1954); *In re Engineers Pub. Serv. Co.*, 116 F. Supp. 930 (D. Del.), *aff'd*, 221 F.2d 708 (3d Cir. 1953).

## II. USE OF INSIDERS' RESOURCES TO AFFECT CONTROL

A. *Purchase of Stock by Insiders from Outsiders or on the Market*

Apart from efforts to affect control by using corporate assets or facilities in which other stockholders have an interest, insiders may also seek to use their own resources to protect their control, such as by purchasing stock on the open market, or from outsiders who are seeking to take over, or from other insiders who are leaving. Are such purchases, which do not involve either self-dealing or self-serving transactions utilizing corporate assets but which do involve a unilateral alteration of relative voting power, governed by fiduciary standards? Do the buyers or the sellers owe any obligation to the other participants in the enterprise which would restrict them in dealing freely with stock in a manner affecting control?

While few cases have considered these questions, those which have decided or discussed the issues suggest negative answers, at least insofar as the insider-purchasers' obligations are concerned. In cases involving publicly held corporations, the subject has been mentioned only in passing, with the suggestion that, despite whatever doubts may exist about the use of corporate funds for such purposes, individual funds are freely usable.<sup>96</sup> In cases involving close corporations, although there are occasional intimations to the contrary,<sup>97</sup> the purchase or sale of stock to affect the balance of control is not generally actionable in suits brought by other stockholders, including those against whom the balance has been shifted.<sup>98</sup> Whatever obligations of disclosure insiders may have to

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96. *Mairs v. Madden*, 307 Mass. 378, 30 N.E.2d 242 (1940); see *Mathes v. Cheff*, 41 Del. Ch. 166, 190 A.2d 524 (Ch. 1963); *Kors v. Carey*, 39 Del. Ch. 47, 158 A.2d 136, 140 (Ch. 1960); *Trevor v. Whitworth*, 12 App. Cas. 409, 417, 436 (1887).

97. See *Kelley v. 74 & 76 W. Tremont Ave. Corp.*, 4 Misc. 2d 533, 151 N.Y.S.2d 900 (Sup. Ct. 1956), *modified and aff'd*, 3 App. Div. 2d 821, 162 N.Y.S.2d 825 (1957), *aff'd*, 3 N.Y.2d 973, 146 N.E.2d 795 (1957); cf. *Opdyke v. Kent Liquor Mart, Inc.*, 40 Del. Ch. 316, 181 A.2d 579 (Sup. Ct. 1962); *Faraclas v. City Vending Co.*, 232 Md. 457, 194 A.2d 298 (1963).

98. *Dacovich v. Canizas*, 152 Ala. 287, 294, 44 So. 473, 475 (1907); *Guaranty Laundry Co. v. Pulliam*, 198 Okla. 667, 181 P.2d 1007 (1947); *Howell v. McCloskey*, 375 Pa. 100, 99 A.2d 610 (1953); see *Yax v. Dit-Mco, Inc.*, 366 S.W.2d 363 (Mo. 1963); cases collected in Annot., 2 A.L.R.2d 745, 753-72 (1948); cf. *Brown v. Dolese*, 38 Del. Ch. 471, 154 A.2d 233 (Ch. 1959), *aff'd*, 39 Del. Ch. 1, 157 A.2d 784 (Sup. Ct. 1960). *Boss v. Boss*, 200 A.2d 231 (R.I. 1964), and *Dupont v. Dupont*, 256 Fed. 129, 175 (3d Cir. 1919) suggests that stockholders can vote their stock for the corporation not to buy, in order for them to be able to buy personally. Compare *King Mfg. Co. v. Clay*, 216 Ga. 581, 118 S.E.2d, 581 (1961); *Llewellyn v. Queen City Dairy, Inc.*, 187 Md. 49, 48 A.2d 322 (1946) (holding that a corporation has no interest in purchases of its stock by insiders for purposes of acquiring or retaining control); *Vulcanized Rubber & Plastics Co. v. Scheckter*, 400 Pa. 405, 162 A.2d 400 (1960).



sellers<sup>99</sup> or whatever restrictions their fiduciary role may impose upon their freedom to use corporate assets to seek to affect control, the governing decisions do not oblige them to refrain from using their own assets to enhance or preserve their control status by arm's length purchases from third persons.

Where close corporations are involved, there is a substantial basis for questioning a rule which leaves a fiduciary free to use his own funds to affect adversely others' interest in control by buying the stock of departing co-venturers. As we have noted, the economic interest of the participants in close corporations tends to be concentrated in sharing the private emoluments of control, and the participants are not free to escape from a control group which they dislike or suspect by merely selling their stock in a public market. Hence, deprivation of a share in control, or even alteration of prevailing control arrangements, may constitute injury no less significant than that which occurs when publicly held corporations are operated so as to benefit the insiders at the expense of the public investors.<sup>100</sup> In such circumstances, it is of doubtful relevance to distinguish between insiders' pre-emption of control by purchase of stock from third parties and by purchase from the corporation, although there is self-dealing in the latter case, whereas there is no self-dealing in the former. The interest of the remaining stockholders in the preservation of previously prevailing control arrangements suggests a classic conflict of interest for the insider who seeks to take advantage of the departure of some participants without offering the remaining stockholders an opportunity to share in the purchase of the stock of those leaving. Similar considerations may affect the seller's freedom to act without offering an opportunity to all participants to purchase his stock, whether he is selling a block of stock which gives control to one group of existing participants or selling control to a stranger. Such sales pose a danger to the other stockholders which is comparable to the dangers created by the sale of control of a public corporation to purchasers who are likely to damage the interests of the surviving stockholders. To the extent that the seller of stock in a close corporation knows or should know the significance of his disposition, there is good reason to hold

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99. See *Helms v. Duckworth*, 249 F.2d 482 (D.C. Cir. 1957); *Broffe v. Horton*, 172 F.2d 489, 494 (2d Cir. 1949); *Sher v. Sandler*, 325 Mass. 348, 90 N.E.2d 536 (1950); Fleischer, "Federal Corporation Law": *An Assessment*, 78 HARV. L. REV. 1146 (1965); Note, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120 (1950).

100. 1 O'NEAL, CLOSE CORPORATIONS, 120-21 (1958); Comment, *Sales of Corporate Control at a Premium: An Analysis and Suggested Approach*, 1961 DUKE L.J. 554, 561-63.

him to standards comparable to those applied in the sale of control of a publicly held corporation.<sup>101</sup> Hence, extension of fiduciary standards to prevent such shifts of control, even when effected only by the use of the insiders' own resources, seems both fairer and more useful than is the present attitude of the courts.

The "privacy" of the corporation and the resultant possibility that the parties could protect themselves against such alterations by making contractual arrangements do not require a different conclusion. The law of trusts and of agency created fiduciary duties to protect beneficiaries against conduct with respect to which the settlor or principal might have contracted, but failed to do so. The fiduciary relationship among partners, which offers a more apposite analogy to the corporate situation,<sup>102</sup> similarly suggests that the participants are not left solely to contractual protection against the efforts of one of them to advantage himself over the others. Indeed, as we have noted, it is in the case of the close corporation that the courts most often prescribe fiduciary protection against the use of corporate assets to affect control, although the very privacy of the enterprise would have permitted the parties to provide against that contingency by contract.<sup>103</sup> This is not to say that the stockholders of an essentially private venture should be unable to waive such protection. But it is to suggest that unless they knowingly do so, the freedom of insiders to buy stock in order to acquire or strengthen their control in close corporations should be subject to more restriction than courts have heretofore imposed upon it.<sup>104</sup>

In the case of public corporations, however, a different set of

101. See *Low v. Wheeler*, 208 Cal. App. 477, 24 Cal. Rptr. 538 (Dist. Ct. App. 1962); 1961 DUKE L.J. 554, 561-63; cf. *Zweifach v. Scranton Lace Co.*, 156 F. Supp. 384, 397 (M.D. Pa. 1957). But cf. *Lank v. Steiner*, 213 A.2d 848 (Del. Ch. 1965).

102. Compare *Kelly v. Delaney*, 136 App. Div. 604, 121 N.Y. Supp. 241 (1910), *aff'd*, 205 N.Y. 618 (1910), with *Low v. Wheeler*, *supra* note 101. See also *Helms v. Duckworth*, 249 F.2d 482 (D.C. Cir. 1957); *Funk v. Spalding*, 74 Ariz. 219, 246 P.2d 184 (1952); cf. Conway, *The New York Fiduciary Concept in Incorporated Partnerships and Joint Ventures*, 30 FORDHAM L. REV. 297 (1961). Since partnerships are more readily terminable at the will of minority participants than are corporations, the need for fiduciary protection against shifts in control in the absence of contract may be greater in the corporate case. To the extent that use of the corporate form may restrict the contractual freedom of the participants to alter the statutory norms governing corporate operations, there may be further reason for the fiduciary umbrella to be extended to cover areas against which the parties have failed to contract. In any event, the social and economic considerations which seek liquidity or investment freedom for stock of public corporations do not preclude deference to fiduciary restrictions in assessing the propriety of shifts of control of private corporations.

103. See notes 14-28 *supra* and accompanying text.

104. Stockholder pooling agreements to stabilize control among less than all the stockholders present similar, but not identical, problems, as do purchases by one insider of another's stock in order to freeze out a third. Fiduciary considerations also limit the validity and enforceability of such agreement. See Bradley, *Toward A More Perfect Close Corporation*, 54 GEO. L.J. 1145 (1966).

problems is presented. To be sure, fiduciary ideology should oppose a rule which authorizes an insider to alter disadvantageously the public stockholders' interest in control or which permits a fiduciary, even with his own resources, to buy off some of his beneficiaries, thus impeding the others from exercising such rights as they would otherwise have to oust him. On the other hand, the public investors' economic interest in control is more indirect than that of investors in close corporations. We have noted that this relative remoteness of the public stockholders' economic interest should not leave insiders of public corporations any freer than insiders of close corporations to use corporate assets to alter the voting arrangements so as to strengthen their control.<sup>105</sup> But a different question arises when they use only their own assets or resources.

The principal significance of the public stockholders' voting power is to permit them to participate in determining which set of strangers shall manage corporate affairs, and, possibly, which general business policies will be followed. Public investors are best served when they have a choice in making these determinations. But to facilitate such a choice requires rules which leave outsiders free to use their own resources to try to acquire the amount of stock which they deem necessary to enable or to encourage them to contest control. Public stockholders and the other constituencies governed by the modern corporation run the risk that outsiders whose competence, policies, or integrity they justly suspect can buy enough stock to give them control with or without a proxy contest.<sup>106</sup> On that premise, comparable freedom to acquire stock must be available for insiders when they seek to use only their own resources in arm's length transactions to protect or strengthen their control. The mere fact that they are incumbents hardly suggests that they are less desirable as managers than those who would oust them. While the public stockholders may effectively be denied choice if insiders buy up enough stock with their own funds to preserve their position, the risk of such denial must be taken as part of the cost of permitting outsiders to attempt to acquire controlling stock.<sup>107</sup> In short, the public stockholders' interest in having a choice of management or in the mobility of control is, by defini-

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105. See notes 47-50 *supra* and accompanying text.

106. See *Fenestra v. Gulf Am. Land Corp.*, 377 Mich. 565, 608, 141 N.W.2d 36, 55-56 (1966).

107. The premises on which privately held corporations operate effectively preclude such a choice. There is no public market for their stock, and outsiders are not therefore readily able to enter the corporation. Moreover, the participants in a privately held corporation do not seek a wide choice of managers. They are more likely to be interested in the arrangements among those participating than in attracting outsiders.

tion, subject to such curtailment as others can afford to cause by purchasing stock. So long as outside challengers are not obliged to confine their purchases to only enough stock to force the insiders to engage in a proxy contest, the fiduciary position of insiders should not deny them equal freedom to purchase stock for control purposes; indeed, the interests of the remaining investors in the enterprise require that insiders should have such freedom. Assuming adequate disclosure,<sup>108</sup> not the least of the virtues of competition between insiders and outsiders seeking control is the option thus given to public investors to get out of the enterprise at prices reflecting the contestants' optimistic estimates of the value of control.

If the public investors' interest suggests that neither insiders nor outsiders should be categorically precluded from buying up stock in the market when competing for control, the question may still be asked whether any fiduciary restrictions operate when the former buys out the latter in order to retain control. The same considerations that impel facilitating outsiders' legitimate efforts to seek control argue against erecting any obstacles to their abandoning the pursuit of it. The magnitude of the expense and the scope of the difficulties facing those who challenge incumbents for control of public corporations needs no elaboration beyond noting that those factors undoubtedly account for the infrequency of such challenges. If any significant restriction were imposed upon the right of persons undertaking such a campaign to quit for any reason or

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108. Consideration of the interests of the stockholders who *sell* to insiders and to outsiders buying stock in the market, as distinguished from the interest of the corporation and its remaining stockholders, suggests some restraints on both insiders and outsiders seeking to purchase stock in the market for purposes of control, see note 99 *supra*, but poses a host of problems which are beyond the scope of this paper. The notion that an insider's bargaining advantages in securities dealings with outside investors should be offset by disclosure of relevant facts affecting value when he buys their stock may require him to disclose not merely his identity as a purchaser, but his purpose to acquire or strengthen his control position, since both his purpose to affect control rather than merely to increase his investment and the possibility of a contest are relevant facts which will have an impact on the possible price which buyers may ask. Similar considerations may apply no less compellingly to the outsider who is seeking control, at least at some point in his process of acquisition of stock or preparation for a contest, see *Hughes v. Treat*, 22 S.E.C. 623 (1946), such as (a) when he becomes subject to § 16(a) of the Securities Exchange Act, *cf.* *Chicago So. Shore & So. B. R.R. v. Monon R.R.*, CCH FED. SEC. L. REP. (Transfer Binder, 1964-66) ¶ 91525 (N.D. Ill. 1965); (b) when he acquires 5% of the outstanding stock, see S. 2731, 89th Cong., 1st Sess. (1965); SEC Memorandum to Senate Committee on Banking and Currency on S. 2731; or (c) when he seeks to solicit proxies, *Studebaker Corp. v. Allied Prods. Corp.*, 256 F. Supp. 173 (W.D. Mich. 1966). Determining the items of information which outsiders or insiders should be required to disclose requires a balancing of actualities and possibilities to arrive at a prescription which will neither improperly conceal relevant information nor run up the price of the stock on uncertain expectancies. And finally, there is the host of problems created by the outsider's decision to abandon the control contest and sell out on the market at prices which may be inflated by reason of prior purchases in preparation for the control contest.

at any time, there would undoubtedly be even fewer attempts to divest incumbents of control. Whether these considerations justify permitting receipt of a premium, if indeed a premium is identifiable,<sup>109</sup> by the outsider without his having to account therefor is a nice question. To the extent that the "premium" is paid merely to enable him to recoup his investment, it is arguable that such a payment should not be discouraged, at least in the absence of evidence that the outsider is selling more than the termination of a potential contest over the direction that corporate affairs should take. To put the matter in more conventional terms, outsiders selling out to insiders at a premium may not be sufficiently in a control position to be held to the fiduciary obligations of those who sell control, which includes the actual power to exploit the enterprise. The crucial question is, even if outsiders abandoning a control attempt may freely sell their stock for a higher price per share than public investors can receive, should insiders be permitted to pay such a premium to procure abandonment of a potential control contest? This question invites inquiries comparable to those generated by the question whether a premium may be received by an insider for selling control, even if the answers may not be the same.<sup>110</sup>

### B. Sales of Control

The inquiries are somewhat different here than when insiders purchase stock, for the obvious reason that when insiders sell control and thus sever their connection with the business, there is lacking the concern with its future prosperity which they are likely to have when they remain with the enterprise. That difference suggests that

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109. When outsiders purchase stock in quantity in contemplation of a proxy contest, the almost inevitable consequence is to raise the market price of the stock. *Cf.* *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1963). Presumably that price, although in a sense artificially inflated, does not embody a premium, and sale at that price would present no problem.

110. One basis for the difference may be that the incumbents' retention of control leaves the public investors subject to risks of private exploitation by the same persons who were in control when they originally invested, whereas sale of control exposes them to different, if not necessarily greater, risks of such exploitation. The capitalized value of such potential private exploitation is not being sold to strangers, even if something is being paid by the incumbents to retain it. Such justification as may exist for insisting that all stockholders receive a share of that value when it is sold, see note 124 *infra*, is lacking when it is merely retained. From another point of view, insiders may be deemed less likely to have to pay an "excessive" amount as a premium to retain their existing control than an outsider would have to pay to buy control, so that the likelihood and extent of the enterprise being exploited in order to recoup the premium may be less in the former case. Moreover, there may be considerably more difficulty in enforcing a rule which either requires the outsider (who has not sold actual control) to distribute the premium to the other stockholders, *cf.* *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1963), or in justifying a rule which requires the insider to offer to buy all other stock at the price he paid for the outsider's stock.

when insiders seek to dispose of control, even more than when they seek to preserve it, the remaining stockholders' legitimate interest in how control is shifted justifies limiting the insiders' freedom of action.<sup>111</sup> The extent of these limits has been the subject of exhaustive discussion,<sup>112</sup> to which little can be added here.

It may be noted, however, that certain of the notions found in the decisions on insiders' use of corporate assets to retain control reappear in the discussions of the sale of control. Thus insiders' obligations when disposing of stock control require, at a minimum, that they not sell out to persons whom they know, or have reason to know, will "loot" or "milk" the enterprise.<sup>113</sup> This obligation reflects the traditional duty of care, which is no less applicable when control is sold than when control is exercised in managing the corporation; indeed, it exists whether or not a premium or extra com-

111. The stockholder's interest is somewhat different when the insiders are selling control in the form of office or directorship than when control is in the form of stock ownership. Representational control, alone, is not salable at all because the seller doesn't "own" it in any sense. Control resulting from stock ownership (e.g., because of the size of the block or because it is coupled with access to the proxy machinery) may be sold along with the stock, but the question of restrictions or limitations on the seller then arises. See Berle, *The Price of Power: Sale of Corporate Control*, 50 CORNELL L.Q. 628 (1965); cf. *Essex Universal Corp. v. Yates*, 305 F.2d 572 (2d Cir. 1962).

112. Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965); Bayne, *A Philosophy of Corporate Control*, 112 U. PA. L. REV. 22 (1962); Berle, *The Price of Power: Sale of Corporate Control*, 50 CORNELL L.Q. 628 (1965); Greene, *Directors' Surrender of Office for Pecuniary Consideration*, 28 U. CINC. L. REV. 380 (1959); Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986 (1957); Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956); Katz, *The Sale of Corporate Control*, 38 CHI. BAR REC. 376 (1957); Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725 (1956); Weisbrod, *Trading in Business Ownership*, 1954 U. ILL. L.F. 465, 477-79; Comment, *Sales of Corporate Control and the Theory of Overkill*, 31 U. CHI. L. REV. 725 (1964); Comment, *Sales of Corporate Control at Premiums? An Analysis and Suggested Approach*, 1961 DUKE L.J. 554; Note, *The Sale of Control: The Berle Theory and the Law*, 25 U. PITT. L. REV. 59 (1963).

113. Because the cases invariably involve the receipt by the seller of some special reward from the buyer, they do not test the duty of care which exists without regard to whether the insider is receiving any special reward. The opinions purport to rest on the "fraudulent" conduct of the seller in "conspiring" with the buyer for his own benefit, but occasionally they also refer to his negligence or even wilful misconduct, and intimate that his conduct is to be judged by his obligation to exercise care without regard to whether he is receiving any special reward and that he is liable for the injury caused rather than merely accountable for any premium he received. See *Insuranshares Corp. v. Northern Fiscal Corp.*, 35 F. Supp. 22, 28, (E.D. Pa. 1940); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622, 652-53 (Sup. Ct.), 30 N.Y.S.2d 755 (Sup. Ct. 1941); *Dale v. Thomas H. Temple Co.*, 186 Tenn. 69, 208 S.W.2d 344 (1948). Compare Bayne, *The Sale of Corporate Control*, 33 FORDHAM L. REV. 583 (1965).

The duty of care is deemed to exist in spite of the fact that the insider may be selling not merely corporate office, but a substantial investment interest of his own. Possession of control—even if represented by a substantial investment interest—restricts the freedom of the possessor when he manages the enterprise, and similarly, it impairs his freedom to dispose of his own stock because, by reason of its embodying control, it is not merely his property. See Berle, *supra* note 112.

pensation is received for such a sale. However, when insiders sell control at a premium, they sharpen, if they do not actually create, a conflict of interest between themselves and the remaining stockholders, so that more than the duty of care or of exercising sound business judgment is involved. The conflict between the insiders' interest in the premium and the risk to which they subject the other stockholders—the risk that the buyer will fail in his conduct of the corporate business or will exploit the enterprise for his personal benefit—activates the fiduciary duty of loyalty as well as the duty of care.

In recent years, the issue has been cast in terms of whether the sellers should be required, by analogy to traditional trustees' obligations, prophylactically to forego the special payment reflected in the premium, whether or not harm or likelihood of harm is demonstrated to result from the sale.<sup>114</sup> On the one hand, it has been suggested, by commentators more than by courts that the insiders must forego such premiums either by making available to all stockholders (including themselves) an equivalent prorated offer<sup>115</sup> or by accounting for any premiums realized.<sup>116</sup> On the other hand, there is the position which is rooted more in the duty of care than of loyalty and which has support among judicial as well as academic authorities, that the seller should be accountable only when he has failed to exercise appropriate care in the choice of a purchaser, that is, when he has sold to a purchaser who he knew, or should have known, would be likely to exploit unlawfully the private emoluments of control.<sup>117</sup> In short, in dealing with the sale of control at a premium as with efforts to preserve control, the notion is that the insiders' responsibility should turn on whether the motives or intentions of those seeking control are, or are likely to be, directed more to the common good than to private exploitation of the enterprise and whether the seller has exercised sufficient care in ascertaining those motives or intentions. Despite the thoughtful prescription recommended for determining whether private advantage is sought or appropriate care in selecting the purchaser is exercised in any particular case,<sup>118</sup> experience with comparable criteria for legitimating uses of corporate assets or facilities to preserve con-

114. See *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955), *cert. denied*, 349 U.S. 952 (1955); *Krieger v. Anderson*, 40 Del. Ch. 363, 182 A.2d 907 (Sup. Ct. 1962); *cf.* *SEC v. Insurance Sec., Inc.*, 254 F.2d 642 (9th Cir. 1958). See also authorities cited *supra* note 112.

115. See *Andrews*, *supra* note 112.

116. See *Jennings*, *supra* note 112; *Leech*, *supra* note 112.

117. See *Hill*, *supra* note 112; *Katz*, *supra* note 112.

118. See *Hill*, *supra* note 112, at 1019-28.

trol suggests pointedly that appropriate care will generally be found to have been exercised. Indeed, due care probably will be found no less often than the exercise of permissible business judgment has been found in stock purchase cases.<sup>119</sup> However, in traditional fiduciary analysis, the duty of loyalty rather than that of care is the focal point of inquiry, and decision would not turn on the fiduciary's motivation or on the distinction between "personnel" and "policy"; nothing less than the informed consent of the other stockholders could justify sale of control at a premium. The question which remains is whether corporate considerations impel dilution of the fiduciary norm.

In answer to that question, it has been suggested that a categorical denial of the premium to potential sellers will erode their incentive to transfer control and that, as a consequence, public stockholders and the public at large will be injured because discontented and inefficient management will remain in control, while aggressive and imaginative new forces will be prevented from buying control. The argument is that the increased likelihood of transfers of control resulting from permitting premiums to be received is so beneficial to public stockholders and so independently desirable for the economy as to preclude the categorical denial of premiums and to justify the risk of occasional unapprehended purchases by persons seeking the private emoluments of control. But these propositions are not self-evident, even though it may be assumed that a controlling group which has decided that it can find a better investment opportunity elsewhere is not likely to offer the enterprise optimal management and direction, and although it may be true that to permit that group to receive a premium will provide an added inducement to sell control. Whether it will induce more than a few occasional additional sales than would otherwise occur remains largely speculative. So too does the answer to the question whether groups which are otherwise satisfied to retain control will be stimulated to sell if they are offered a premium of a size likely to reflect only sound investment intentions and not the predatory designs

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119. The inability of the courts to distinguish readily between motives of personal gain and motives of public good in such circumstances is illustrated not only in the stock purchase cases, but also in the proxy contest cases. There is no reason to believe that the courts will be any more skillful or zealously motivated when dealing with the sale of control. Indeed, those commentators favoring a selective prohibition recognize the difficulty of enforcing the distinction, and they conclude that this difficulty will leave counsel for a potential seller uncertain and therefore will deter sales. To minimize that difficulty, it has been suggested that the burden of proof should be allocated in the interest of increasing freedom to sell control. See Hill, *supra* note 112, at 1025-28.



of the offeror.<sup>120</sup> No empirical evidence, from the business community or elsewhere, has been offered in support of the benefits claimed to result from thus facilitating sales of control.

To be sure, no such evidence has been offered to the contrary. And, in any particular case a buyer may not, merely because he pays a premium to a seller, be more interested in private exploitation of the enterprise than he is in enhancing its value for the benefit of all the investors. However, as the litigated cases suggest and as the commentators have pointed out, the likelihood of injury to other stockholders from buyers who will seek to recoup their premium, or otherwise seek the personal advantages of control, is not remote.<sup>121</sup> It also should be noted that transfer of control may, and not infrequently does, disrupt management and, to some extent, operating efficiency.<sup>122</sup> Therefore, the consequences of such a transfer, even without regard to the problem of private exploitation, are not likely to be beneficial to the other investors in the enterprise unless the purchasing group offers executive and managerial qualities which are superior to those offered by the selling group. But the selling

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120. Those questions, it may be noted, are addressed to whether the receipt of a premium will increase the likelihood of the seller selling, and not to the nature or intentions of the buyers. So far as the buyers are concerned, the necessity to pay a premium may—although it need not—stimulate predatory designs. On the other hand, a rule which discourages payment of a premium by a buyer to “inside” sellers need not discourage buyers, and is not likely to discourage buyers who do not have predatory designs. Whatever may be a buyer’s talents or motives and whatever may be his reasons for paying a premium for a control block of shares rather than buying all the stock at market prices, they do not hinge on buying shares only from the owner of a control block. The buyer’s reasons for buying a control block can be substantially met by supplying him with a block of shares to which all stockholders have been given an opportunity to contribute as well as by allowing him to purchase from a single seller. Andrews, *supra* note 112. To be sure, there will be added expense and there may be an occasional hitch to a successful tender solicitation, even when backed by a firm offer from the holder of a control block, but neither is apt to affect significantly the willingness of potential buyers to buy. There may also be some impact on a potential buyer’s willingness to pay a premium if he knows he will be governed by a rule which denies his right to sell freely at a premium. See Comment, *Sale of Corporate Control*, 19 U. CHI. L. REV. 869, 872 (1962). But experience does not suggest that men who seek to buy control either are motivated by a desire to sell it at a premium or would be discouraged by a rule which forbade them from selling at a premium—*i.e.*, at a price in excess of the higher market price which they expect to create for all the stock. FTC, REPORT ON CORPORATE MERGERS AND ACQUISITIONS 103-42 (1955).

121. See *Essex Universal Corp. v. Yates*, 305 F.2d 572, 581 (2d Cir. 1963) (Friendly, J., concurring); Andrews, *supra* note 112, at 517-45; Jennings, *supra* note 112, at 14-19. While buyers who seek to acquire control through market purchases are likely in effect to pay no smaller a premium and to have no less a desire to recoup it, a market purchase program creates a market in which public investors may sell out at a price reflecting the outsiders’ estimate of control value. See text accompanying note 108 *supra*. Moreover, to the extent that such seekers after control need the assistance of public stockholders to wrest control from the incumbents, they will presumably offer a program for the conduct of corporate affairs which will appeal to public investors’ self-interest.

122. See Andrews, *supra* note 112.

group is under no duty to find or even to seek such a buyer.<sup>123</sup> Hence, even apart from whether the premium should be shared on the theory that the "asset" for which it is being paid is an asset belonging to the corporation or to all stockholders rather than just to the sellers,<sup>124</sup> it is difficult to see why rigorous fiduciary standards should be diluted when such a dilution may expose public investors to the risks connected with sales at a premium. Certainly before diluting those standards as substantially as has been suggested, some imperative need for allowing a controlling stockholder to sell at a premium should be shown, or some empirical evidence should be offered to establish that controlling groups are likely to sell out more readily to economically desirable purchasers if they are permitted to receive a premium, or that there is some over-all social or economic need so to encourage transfers of control of publicly held corporations. No such evidence has been offered, nor has such a need been demonstrated.

### III. CONCLUSION

Because functional considerations do, and should, qualify the operation of fiduciary ideology in the corporate field, it has been suggested that elimination of fiduciary terminology from the discussion of insiders' obligations might clarify analysis and facilitate the application of realistic jurisprudence.<sup>125</sup> However, the fiduciary creed is itself rooted in functional ground—albeit in somewhat different soil for partnerships and close corporations than for publicly held corporations. The temptation to abuse the power which a fiduciary is given over the property of others is no less present in corporate transactions than in the administration of express trusts. The remoteness of the insider from his principals in publicly held corporations as well as the difficulty of measuring the "fairness" or "justifiability" of his behavior when he deals with corporate con-

123. Hence, a rule permitting the seller to receive a premium will not increase the likelihood of his seeking or finding a desirable buyer. On the other hand, a rule requiring a pro rata offer by a buyer would leave a seller with a substantial investment in the enterprise and therefore make him more likely to examine the qualifications and intentions of the buyer than he otherwise is required by law to do or is likely in fact to do. See Andrews, *supra* note 112.

124. See Berle, *supra* note 112. The elastic scope which the law gives to those in control to exploit the enterprise for their private benefit has been noted. See notes 5 & 6 *supra*. It is only when the potential for such exploitation (which insiders may be allowed to enjoy unchallenged, if not legitimately, while they are incumbents) is capitalized and sold that the public investors have any opportunity to share in its proceeds. Such potential is no less a corporate asset because its value is not required to be shared prior to its capitalization and sale.

125. See Kaplan, *Conflicts of Interest in Corporations*, UNIVERSITY OF CHICAGO LAW SCHOOL, CONFERENCE ON CONFLICT OF INTEREST (Conference Series No. 17) 34, 52-54 (1964).

trol suggest the kind of inability to police the insider which generated the prophylactic restrictions on trustees and agents. Hence, while relaxation of such restrictions may be required in the corporate setting, particularly where publicly held corporations are involved, a showing of necessity or overriding public interest should be a prerequisite to a such relaxation in any particular context. Moreover, even when it is thus found necessary or desirable to risk occasional unapprehended abuses which the more rigid fiduciary restrictions are aimed at preventing, it is not also necessary to adopt standards to measure, or sanctions to enforce, "fairness" or "justifiability" which effectively permit such abuses.

Courts have generally given little or no weight to these considerations when dealing with insider transactions designed to affect the control of publicly held corporations, whether the transaction involves a corporation's issuance or purchase of its own stock, the solicitation of proxies on behalf of management, or the sale of control. Thus, when the categorical prohibition has been rejected as a measure of the insider's duty, courts have tended to place the burden of proving unfairness or absence of justification on those who would challenge insiders' self-dealing and to measure the propriety of insiders' efforts to alter or preserve control for their own advantage by relying on the distinction between motives of common good and motives of private benefit. Doubtful as may be the validity of the need felt by courts or suggested by commentators to relax the more rigid fiduciary standards in most of the above contexts, the substitute standards which have been offered are even less defensible. They afford no effective protection against conceded, as well as likely, abuses by insiders seeking to dilute outsiders' voting power, to enhance their own power, or to realize on the value of control.