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Corporations - Stockholders - Fiduciary Relationship in Sale of Controlling Stock Interest

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COMMENTS

CORPORATIONS—STOCKHOLDERS—FIDUCIARY RELATIONSHIP IN SALE OF CONTROLLING STOCK INTEREST—The sale of controlling blocks of corporate stock is a common commercial phenomenon in this era of increased corporate diversification. Usually the purchaser deals with an agent representing stockholders owning a

numerical majority of the voting stock. But with ever-broadening corporate ownership, coupled with natural apathy and the practical impossibility of obtaining full stockholder vote, control is increasingly falling to minority blocks.¹ This comment is concerned with the duty owed by the controlling stockholders to the non-controlling stockholders when there is a sale of the controlling interest. Recently this question was considered by the United States Court of Appeals for the Second Circuit in *Perlman v. Feldmann*,² and the opinion, reversing the lower court and accompanied by a vigorous dissent by Judge Swan, deserves careful consideration.

I.

While no attempt will be made to analyze all the information presented to the lower court,³ the pertinent facts can be summarized as follows: *F* was dominant stockholder, chairman of the board of directors, and president of *N* Corporation, which produced steel sheet to be sold to manufacturers of steel products. During the conflict in Korea, when steel was in short supply, *F*, acting as agent for the controlling stock interests of *N* Corporation, entered into a sale of this block of stock to *W* Company, a syndicate comprised of end-users of steel who wished to obtain a dependable source of supply in the tight market. The sale price received for this controlling stock exceeded both its market value and its book value.⁴ In times of normal demand for steel, *N* Corporation, because of its old facilities, could compete with more modern mills only in its immediate geographic area, while the purchasing syndicate represented geographically remote end-users. The court held that, while the majority stockholders could normally dispose of their stock without having to account for profits, the fiduciary nature of the majority's relation to the minority required that they share any value received that represented a sale by them of a corporate asset. The asset which the majority was said to have appropriated was the power of the corporation to gain an unusually large premium for its product by controlling the product's allocation in a

¹ The courts do not distinguish between majority control and minority controlling interests, but talk strictly in terms of majority and minority stock. *Perlman v. Feldmann*, (2d Cir. 1955) 219 F. (2d) 173. See Rohlich, "Suits in Equity by Minority Stockholders as a Means of Corporate Control," 81 UNIV. PA. L. REV. 692 (1933).

² (2d Cir. 1955) 219 F. (2d) 173.

³ There were, in all, one hundred and thirty-one findings of fact listed in the first twenty pages of Judge Hincks' opinion. (D.C. Conn. 1952) 129 F. Supp. 162.

⁴ The controlling stock was purchased for \$20 per share, the book value was \$17.03, and the price in over-the-counter sales had been found not to exceed \$12 per share.

time of short supply. The case was remanded to the district court to determine what value the controlling stock would have had, shorn of its appurtenant control over the allocation of the corporation's output. The difference between this figure and the sale price of the stock was to be awarded pro-rata to the minority stockholders of record at the time of the sale.

II.

The majority stockholders are not bound to a fiduciary relationship with the minority merely by virtue of their ownership of stock.⁵ The courts have placed this restriction on the majority only when they have assumed the character of managers, i.e., when they have been speaking for and determining the policies of the corporation.⁶ In taking upon themselves the power and prerogatives of directors, the majority acts for the corporation as a whole, and so are bound by the same fiduciary relation to the minority that directors hold toward all the stockholders.⁷ Thus, when the controlling stockholders deal with the corporation, purchasing from it or selling to it, they have the burden not only to prove the good faith of the transaction but must also establish its inherent fairness as to the corporation.⁸ This is not to be confused with the personal disinterest demanded of the director⁹—the majority stockholders may vote on a contract in which they have a personal interest separate from the corporation if, in their discretion, such a transaction would be in the best interests of the corporation.¹⁰ The fiduciary duty concept is applied only to hold that the majority cannot use their controlling power to injure the corporation or the minority interests.¹¹ Based upon this, there is an undisputed rule that the majority, in exercising their power to control corporate

⁵ *Levy v. American Beverage Corp.*, 265 App. Div. 208, 38 N.Y.S. (2d) 517 (1942).

⁶ *Chounis v. Laing*, 125 W. Va. 275, 23 S.E. (2d) 628 (1942); *Kavanaugh v. Kavanaugh Knitting Co.*, 226 N.Y. 185, 123 N.E. 148 (1919); *Guernsey v. Cook*, 120 Mass. 501 (1876).

⁷ *Allied Chemical & Dye Corp. v. Steel & Tube Co. of America*, 14 Del. Ch. 1, 120 A. 486 (1923).

⁸ *Pepper v. Litton*, 308 U.S. 295, 60 S.Ct. 238 (1939); *Meyerhoff v. Bankers' Securities, Inc.*, 105 N.J.Eq. 76, 147 A. 105 (1929); 16 L.R.A. (n.s.) 892 (1908).

⁹ *Zahn v. Transamerica Corp.*, (3d Cir. 1947) 162 F. (2d) 36; *Irving Trust Co. v. Deutsch*, (2d Cir. 1934) 73 F. (2d) 121, cert. den. 294 U.S. 708, 55 S.Ct. 405 (1935).

¹⁰ *Baker v. Standard Lime & Stone Co.*, 203 Md. 270, 100 A. (2d) 822 (1953); *Bjorngaard v. Goodhue County Bank*, 49 Minn. 483, 52 N.W. 48 (1892); *Chicago Hansom Cab Co. v. Yerkes*, 141 Ill. 320, 30 N.E. 667 (1892).

¹¹ *Lebold v. Inland Steel Co.*, (7th Cir. 1941) 125 F. (2d) 369, cert. den. 316 U.S. 675, 62 S.Ct. 1045 (1942).

business, must act in the interest of all stockholders when making sales of corporate property,¹² and the minority may not be excluded from a fair participation in the profits from the sale.¹³

III.

The general rule as to sale of stock is that every stockholder, including a majority stockholder, is free to dispose of his shares at any time and for any price to which he may agree without being liable to other stockholders, as long as he does not dominate, interfere with or mislead the others in exercising the same rights.¹⁴ However, certain limitations have been imposed upon the holders of majority or controlling interests in favor of the minority.¹⁵ It is constructively fraudulent for the majority to induce the minority to sell its interest, either to a majority stockholder or to a third person, for a great deal less than that received by the majority.¹⁶ The majority cannot fraudulently scheme with a purchaser to depress the value of corporate stock and thus enable the acquisition of the minority interest at less than its value.¹⁷ Nor can the majority remain wholly oblivious to the best interests of the corporation; it may not purposely or negligently sell its control to parties intending to loot¹⁸ or mismanage¹⁹ the corporation. Public policy may also restrain a sale of majority interest where such a sale would create a monopoly or prevent competition.²⁰

The essential thing in these restraints on alienation of majority interests is that the tests applied are those of good faith and reasonable care. Without proof of bad faith, intent to defraud, or negligence on the part of the majority, the minority stockholders have no cause of action merely because of a sale by the majority of

¹² 13 AM. JUR., Corporations §427 (1938). The same rule was applied to sales of corporate assets during dissolution in *Kaye v. Kentucky Public Elevator Co.*, 295 Ky. 661, 175 S.W. (2d) 142 (1943).

¹³ *Southern Pacific Co. v. Bogert*, 250 U.S. 483, 39 S.Ct. 533 (1919); *Soderstrom v. Kungsholm Baking Co.*, (7th Cir. 1951) 189 F. (2d) 1008.

¹⁴ *Roby v. Dunnett*, (10th Cir. 1937) 88 F. (2d) 68; *Barnes v. Brown*, 80 N.Y. 527 (1880); 13 FLETCHER, CYC. CORP. §5805 (1943).

¹⁵ Stickells, "Stockholders' Duty in Sale of Stock," 31 BOST. UNIV. L. REV. 191 (1951).

¹⁶ The test is one of good faith. See 132 A.L.R. 260 (1941).

¹⁷ *Mayflower Hotel Stockholders Protective Committee v. Mayflower Hotel Corp.*, (C.C. D.C. 1948) 173 F. (2d) 416.

¹⁸ *Insuranshares Corp. v. Northern Fiscal Corp.*, (D.C. Pa. 1940) 35 F. Supp. 22, noted in 25 MINN. L. REV. 525 (1941).

¹⁹ See *Hunnewell v. New York Central & H.R.R. Co.*, (C. C. N.Y. 1911) 196 F. 543.

²⁰ *Pennsylvania R. Co. v. Commonwealth*, (Pa. 1886) 7 A. 368; 13 AM. JUR., Corporations §430 (1938).

its controlling interest.²¹ The mere fact that the majority receives a premium price for its stock is no fraud on the minority.²² It is a recognized fact that a controlling interest is of greater value than a minority interest,²³ and certainly investors can take into consideration the value of the power to appoint the management of a corporation.²⁴ One court sums up this matter of price in this way:

"No court could control the prices at which the . . . [majority] . . . stockholders should sell their stock. That obviously was a matter of private contract between the parties thereto. As to such arrangement the minority interests cannot be heard to complain, absent, as we have said, fraud, overreaching, or deceit."²⁵

IV.

In *Perlman v. Feldmann*, the majority stockholders were held liable to the minority because in selling their controlling interest they also sold an asset of the corporation, the proceeds from which they were bound to share. The court concluded that the power to allocate the product in a period of short supply was an asset; this was essential to holding the majority liable. But if this control were viewed simply as any other corporate power inherent in the majority interest, the minority would have a cause of action only if the power were abused,²⁶ and that action would have to be against the new majority of shareholders who abused it, not against the old majority who had sold their control. The minority lost no more through the sale than if the original majority had stayed in control and had, in their discretion, allocated the products of the corporation in a way contrary to the desires of the minority.²⁷ The minority would have had to go along unless they could have shown bad faith or lack of due diligence on the part of the managers.²⁸ Thus, even assuming that the allocation of steel to geographically remote end-users was an abuse of a corporate power

²¹ *Hallenborg v. Cobre Grande Copper Co.*, 200 U.S. 239, 26 S.Ct. 236 (1906); *Adams v. Mid-West Chevrolet Corp.*, 198 Okla. 461, 179 P. (2d) 147 (1947); *Smith v. Gray*, 50 Nev. 56, 250 P. 369 (1926).

²² *Levy v. American Beverage Corp.*, note 5 supra.

²³ *Tryon v. Smith*, 191 Ore. 172, 229 P. (2d) 251 (1951).

²⁴ *Robotham v. Prudential Ins. Co.*, 64 N.J.Eq. 673, 53 A. 842 (1903).

²⁵ *Nelson v. Northland Life Ins. Co.*, 197 Minn. 151 at 156, 266 N.W. 857 (1936).

²⁶ 13 AM. JUR., Corporations §1014 (1938).

²⁷ *Roosevelt v. Hamblin*, 199 Mass. 127, 85 N.E. 98 (1908).

²⁸ *Seagrave Corp. v. Mount*, (6th Cir. 1954) 212 F. (2d) 389; *Hill v. Erwin Mills, Inc.*, 239 N.C. 437, 80 S.E. (2d) 358 (1954); *Kroener v. Pancoast*, 47 R.I. 470, 134 A. 6 (1926); 51 YALE L. J. 1034 (1942).

to the detriment of the minority, the original majority did not abuse this power, and only the purchasers should be liable. Also, no duty should be placed upon the majority to account to the corporation for profits from the sale of their stock simply because they were in a position, due to favorable market conditions, to command a considerable premium above current market prices.²⁹

In deciding that the power to control allocation of the corporate product was an *asset* and not simply a *power*, the court faced the seemingly impossible task of trying to separate the amount of premium received based upon the power to control the corporation in general from the amount received based upon the ultimate power to control distribution. It is also important to note that in future applications of this complicated test, the court must first check the relative supply and demand in the industry, and find that the market for the corporation's product was a seller's market, or else the power to control allocation of a product could hardly be considered a valuable asset. The result in *Perlman v. Feldmann* might well be just, but the court has created an extremely unwieldy doctrine which opens all sales of controlling blocks of stock to the uncertainty that the courts, on hindsight, might decide that part of the control sold was an asset of the corporation, the proceeds from which belonged to all the shareholders equally.

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²⁹ *Stanton v. Schenck*, 140 Misc. 621, 251 N.Y.S. 221 (1931); *Porter v. Healy*, 244 Pa. 427, 91 A. 428 (1914).