May the owner of a controlling block of corporate shares sell his holding when an opportunity to sell at the same price is not given to the other shareholders? If he does so, must he account to the corporation or to the other shareholders for the part of the proceeds which represent the "control premium"? These questions are ably discussed in recent law-review articles by Professor Richard W. Jennings (44 Calif. L. Rev. 1) and Professor Noyes Leech (104 U. of Pa. L. Rev. 725). These articles marshal evidence of a trend restricting the freedom of controlling shareholders to sell their shares. Professor Jennings supports the flat rule that when control is sold all shareholders should have an opportunity to sell on the same terms. In this paper I wish to examine the grounds for such a rule and to indicate why I believe them unsatisfactory.

To clear the way for a consideration of the central question, it is necessary first to refer to three theories upon which relief may be given against the seller in certain special situations.

Sale of office.—Corporate officers or directors may not retain sums paid to induce them to resign or to aid others in becoming their successors. This rule was developed in cases where no sale of shares was involved, but it has been invoked also where an agreement for sale of controlling shares required the seller to facilitate the buyer's gaining control of the board by causing successive resignations of directors and substitution of nominees of the buyer. It is argued that this constitutes a sale of directorships as well as shares, and the argument has added force if an identifiable part of the consideration seems to have been paid for thus procuring the election of new directors.

Such a case was Porter v. Hedly, 244 Pa. 427 (1914), in which a uniform price per share was offered to majority and minority holders alike, but with a separate "control fund" paid to the defendants (and not distributed among them according to stock ownership). The court required the defendant to account for the "control fund," and the opinion shows the danger of a separate allocation of consideration for control. It is reasonable to infer, however, that the consideration was separated in this manner because the buyer was planning to represent minority shareholders that the majority had accepted the same price for their shares. Such misleading statements were actually made, and the recovery might well have been given on the ground that the minority were improperly induced to part with their shares. This ground is discussed below.

However, in cases where no special abuse was involved, the convenient arrangement for transfer of control by resignation and filling of vacancies has not been held to require the seller to account for a portion of the price on the theory that corporate offices have been sold.

Inducing sale by minority.—In some of the cases requiring accounting for the premium, the sellers were directly implicated in representations or suggestions made to the minority that the price offered to them was the same as that which the majority were receiving. This was the situation in Dunnett v. Am., 71 F. 2d 912 (C.A. 10th, 1934). Here recovery was given to shareholders who relied upon a communication which invited the interpretation that all shareholders were treated equally. The court also spoke of the sale of the controlling shares as a "corporate transaction" analogous to a sale of assets, in which shareholders would participate equally. The actual ground of the decision is clearly shown, however, in the fact that the court denied recovery to shareholders who made no showing of reliance upon the misleading communication. In a related case it was later pressed upon the court that its "corporate transaction" theory would justify recovery on behalf of all shareholders. The court rejected this argument, however, and again refused relief to shareholders who were not misled. Roby v. Dunnett, 88 F. 2d 68 (C.A. 10th, 1937).

Negligent sale to irresponsible buyer.—In another group of cases liability has been imposed where controlling shares were sold to persons who later looted the corporation and where the sale was made under circumstances putting the seller on notice of the probability of such injury. The leading cases involved investment companies which are subject to peculiar danger because of the liquidity of their assets. Insurershares Corp. v. Northern Fiscal Corp., 35 F. Supp. 22 (E.D. Pa., 1940), 42 F. Supp. 120 (1941). Gerdes v. Reynolds, 28 N.Y.S. 2d 622, 30 N.Y.S. 2d 755 (Sup. Ct., 1941). In these cases the high prices offered and the buyer's apparent haste to secure control of the assets were circumstances held to put the sellers on notice. In this situation liability is justified on general tort principles. The freedom

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The Sale of Corporate Control

Summary of a Lecture before the Chicago Bar Association

By WILBER G. KATZ
James Parker Hall Professor of Law, The University of
of Chicago Law School

May the owner of a controlling block of corporate shares sell his holding when an opportunity to sell at the same price is not given to the other shareholders? If he does so, must he account to the corporation or to the other shareholders for the part of the proceeds which represent the "control premium"? These questions are ably discussed in recent law-review articles by Professor Richard W. Jennings (44 Calif. L. Rev. 1) and Professor Noyes Leech (104 U. of Pa. L. Rev. 725). These articles marshal evidence of a trend restricting the freedom of controlling shareholders to sell their shares. Professor Jennings supports the flat rule that when control is sold all shareholders should have an opportunity to sell on the same terms. In this paper I wish to examine the grounds for such a rule and to indicate why I believe them unsatisfactory.

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Mr. Justice Burton greeting other members of the Bench. Left to right: Judge F. Ryan Duffy and Judge H. Nathan Swain, JD '16, of the U.S. Court of Appeals (Seventh Circuit); Judge Elmer J. Schnackenberg, JD '12, of the same court; Judge Julius Hoffman, of the U.S. District Court; and Judge Hugo Friend, JD '08, of the Illinois Appellate Court.
Lectures on Eminent Lawyers

The series of lectures on eminent members of the Bar which The Law School is sponsoring, and which began with Mr. Tappan Gregory’s lecture on “Stephen Strong Gregory,” was continued during the Winter Quarter. Mr. John C. Slade, of Winston, Strawn, Smith and Patterson, spoke on “Silas H. Strawn.” Mr. Slade was a partner of the late Mr. Strawn for many years and as such was uniquely qualified to present a balanced portrait of Silas Strawn’s great contribution, both to the Bar and to society generally. Mr. Slade’s address will be found elsewhere in this issue of the Record.

Prior to the lecture, which was presented in Breasted Hall, the Faculty was host at a dinner in Mr. Slade’s honor in the Quadrangle Club.

The next lecture in the series will be delivered by Mr. Henry F. Tenney, JD ’15, of Tenney, Sherman, Bentley and Guthrie, Chicago. Mr. Tenney will speak on his father, Horace Kent Tenney, in Breasted Hall, Fifty-eighth Street and University Avenue, on Monday, April 22, at 8:30 P.M.

Katz—

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of controlling shareholders to sell their shares does not include freedom to sell to one known to be intending to loot the corporation. Furthermore, general principles of negligence may be invoked if reasonable inquiry has not been made in the face of circumstances which would suggest to a reasonable man the likelihood of such intentions.

In these cases recovery is measured by the loss to the corporation, although in the Gerdes case the court also required accounting for the excessive portion of the sale price as a separable consideration for sale of control.

There are two other cases imposing liability on sellers of control which are more difficult to classify and which arguably afford some basis for a broader rule of liability. The first of these is Commonwealth T. I. & T. Co. v. Seltzer, 227 Pa. 410 (1910). The defendant was president of a hotel corporation; he had no substantial stockholding and was approached by interests desiring to purchase the corporate property. Although knowing that “his company was willing to sell,” he led the outsider to believe that the property was not for sale and then formed a plan to acquire the controlling shares and sell them to the outsider at a profit. It was part of the plan that the purchaser would then acquire the corporate property. This plan was carried out with the help of the co-defendant director. The defendants remained corporate officers after the resale of the shares and acted as such in the sale of the corporate property. The price paid for the property was “not found to be inadequate.” The defendants were required to account to the plaintiffs (apparently shareholders who did not sell out) for the fraction of their profits allocable to the plaintiffs’ shares.

The court’s theory was that the defendants had violated their duties as officers by making a profit in connection with the sale of corporate property; the stock transactions were viewed as mere devices to appropriate a part of the consideration for the property. The relief was given “on the peculiar facts” of the case, with “full and express recognition of the general rule that a stockholder, even though he be one of the managing officers . . ., has the right to buy and sell its stock and to keep any profits which he may thus acquire.”

Suppose, however, that the defendants had owned the controlling shares from the outset and that they had frankly rejected the offer for the corporate assets in order to realize more through the sale of their shares at a premium. Would they be required to account? No confident answer can be drawn from the Seltzer opinion.

The other case which is difficult to classify is Perlman v. Feldman, 129 F. Supp. 162 (D. Conn., 1952), 219 F. 2d 173 (C.A. 2d, 1955). Here a 37 per cent block of shares of Newport Steel Corporation was sold in 1950 to a group of industrial users of steel at $20 per share when recent market sales had not exceeded $12. The purchasers were concededly interested in securing supplies of steel in the right Korean war market. Steel price levels were being maintained by voluntary “controls,” but steel companies, including Newport, had found ways to realize advantages in allocating their production, including interest-free loans from customers. The plaintiffs contended that the defendant’s sale constituted an appropriation of the value of these advantages. The district court dismissed the action after trial, but the court of appeals reversed (Swan, J., dissenting). The court said:

We do not mean to suggest that a majority stockholder cannot dispose of his controlling block of stock to outsiders without having to account to his corporation for profits or even never do
this with impunity when the buyer is an interested customer, actual or potential, for the corporation’s product. But when the sale necessarily results in a sacrifice of this element of corporate good will and consequent unusual profit to the fiduciary who has caused the sacrifice, he should account for his gains. So in a time of market shortage, where a call on a corporation’s product commands an unusually large premium, in one form or another, we think it sound law that a fiduciary may not appropriate to himself the value of this premium.

This passage suggests that the case was treated as analogous to the looting cases. The court could say that sale of control to a potential customer under conditions of shortage resulted necessarily in a sacrifice of corporate good will only if it assumed that the new management would not allocate production in accordance with the best interests of the corporation and would thus violate its fiduciary duty of loyalty. No reference was made to the looting decisions, however, and this may possibly reflect a desire to make the opinion serviceable as an entering wedge for a broader rule of liability.

The foregoing is a summary of the principal cases imposing restrictions upon sales of controlling shares. In none of these cases does the opinion argue for a broad rule that the same offer must be made to all shareholders, and many of the opinions expressly reject this rule. Furthermore, there are a number of decisions (in addition to the Dunnett cases) in which the court refused to make the seller account for a premium. Levy v. American Beverage Corp., 38 N.Y.S. 2d 517 (1st Dept., 1942), Tryon v. Smith, 191 Ore. 172 (1951).

The view that controlling shares may have a legitimate premium value is also illustrated by the decision of the House of Lords in Short v. Treasury Commrs., [1948] A. C. 534. Here the government had taken all the shares of a corporation under Defense Regulations requiring the payment of “not less than the value . . . as between a willing buyer and a willing seller.” Holders of relatively small blocks of shares objected to the price offered (20s. 3d.), which was based upon stock-market quotations. They contended that the price should have been determined by valuing the entire enterprise and dividing by the number of shares. The arbitrator found that on such a basis each share would have been worth 41s. 9d. This contention, however, was rejected. Lord Uithwatt said:

If some one shareholder held a number of shares sufficient to carry control of the company, it might well be that the value proper to be attributed to his holding under the regulation was greater than the sum of the values that would be attributed to the shares comprised in that holding if they were split between various persons. The reason is that he has something to sell—control—which the others considered separately have not. The contention of the appellant, if accepted, would, as the Court of Appeal point out, deny him the real value of his holding.

In this paper, however, my concern is not with the present state of the law but with the desirability of a rule which would destroy the premium value of controlling shares. Such a rule was urged by Berle and Means in The Modern Corporation and Private Property. They suggested that “the power going with ‘control’ is an asset which belongs only to the corporation; and that payment for that power, if it goes anywhere, must go into the corporate treasury.” Why should this be true? Presumably the notion of control as a corporate asset is a way of saying that the law should make it impossible for holders of controlling shares to realize the full market value of their shares—or what would be the market value in the absence of the rule suggested. Why should the law intervene in this way?

The first reason urged for a broad restriction on sales of control springs from concern over the motives of the purchaser and the type of transactions likely to follow the transfer of control. Professor Jennings suggests that in the usual case the purchaser’s willingness to pay a premium springs from an expectation of returns which will not be shared with all shareholders, returns flowing from private exploitation of “corporate patronage or other non-balance sheet assets or from diversion of profits in reorganization or liquidation.” The concern is that the purchaser and those he places on the board will not exercise their management powers in the interests of all the shareholders and that the usual rules of fiduciary loyalty are insufficient protection against such mismanagement.

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This suggestion recalls the Newport Steel Corporation case, in which the sale was to a group interested primarily in

![Barnabas Sears, vice-president of the Illinois State Bar Association, and Stanton Hyer, JD '25, of Rockford, Illinois, at the dinner for Justice Burton.](image-url)
securing the corporation’s output of steel and unlikely to allocate this output in the corporation’s own interest. Modern complexities of business practice and tax law open up many similar opportunities for private advantage through corporate control. For example, a corporation with a substantial carry-forward of income-tax losses may be led into a merger on terms which do not realize for the corporation’s shareholders the value of the tax advantage which it is contributing. While the word “looting” is perhaps too strong for these activities, they all constitute breaches of fiduciary duties of management.

Professor Jennings recognizes that the power incident to voting control may also be utilized “to organize an energetic and capable managerial echelon, improve earnings, and thereby boost the price of the stock, to the benefit of all stockholders.” But he considers that cases of such motivation are unusual and apparently so rare as not to have weight in the analysis of the problem. This is a critical assumption. Suppose it is unwarranted; suppose that there is a significant proportion of cases where existing management is ineffective and where outsiders are attracted by the opportunity for profit through purchase of controlling shares and improvement of management, earnings, and dividends. If this is true, one must consider the consequences of a rule restricting the opportunities of such purchasers—consequences to the holders of minority shares as well as more remote economic consequences.

It is difficult, of course, to be confident of any generalization about the motives of typical buyers of control as compared with those of typical sellers. In the absence of evidence one might expect considerable variety in both groups, and it is by no means obvious that potential sellers are typically persons who resist temptation to abuse their management powers while potential buyers are hardened, though sophisticated, sinners. Professor Leech is apparently dubious about both groups, for he says: “It is still to be shown that there is inherent virtue in protecting a system whereby one block of shareholders largely unresponsive to their fellows is supplanted by another.”

It seems clear that a rule requiring the same offer per share to be made to all shareholders would block some sales of control. It is likely that there are some persons willing to bid for controlling shares who would be unwilling to purchase all the shares. Furthermore, a rule requiring equal offers will tend to reduce the amount that buyers will offer to the holder of the controlling block (since it increases what must be offered to others), and in marginal cases the reduction may make the offer unacceptable to the seller. It is impossible to estimate the proportion of possible sales that would thus be blocked by the rule under consideration. If it is a substantial proportion, and if cases of sales blocked by the rule include a substantial number where present management is inefficient, the adoption of the rule would be at the expense of groups of minority shareholders whose prospects might otherwise be improved. Indirect economic effects of thus impeding the improvement of management might also be substantial.

These considerations should not be treated as negligible. Cases where buyers are likely to inflict particular injuries upon the corporation can be handled by a rule limited to such situations, as in the Newport Steel case. Even if there are many such situations, they afford inadequate support for a broad rule which impedes desirable transfers.

Sometimes the case for a rule against premium sales is argued in different terms, entirely without reference to the motives of the buyer or his anticipated behavior. Here the starting point is a general concept of community of interest among shareholders—a concept of joint venture with strong overtones of equality. Such a concept is apparently implied when Professor Berle speaks of control as a corporate asset. From this premise of community of interest, it is thus argued that, when the controlling shareholder withdraws from the joint venture, it should only be on terms which put other shareholders in a position of equality.

This would be the rule in the case of a partnership. No partner by selling his interest can transfer control over the investment of his co-partners. But should the transferability of corporate shares be similarly restricted? It puzzles me to find Professor Berle insisting on this equalization of controlling and non-controlling shares. One of the main themes of his book is the distinction between “active property” (property actively managed by its owner) and “passive property” (held by inactive, “absentee” owners). Berle criticizes the legal “logic of property” for ignoring this distinction. He questions whether the owner of “passive property” is entitled to the full incidents of ownership. “Because an owner who also exercises control over his wealth is protected in the full receipt of the advantages derived from it, must it necessarily follow that an owner who has surrendered control of his wealth should likewise be protected to the full?” It seems incongruous that the same author insists that the law should transfer to the “passive” shareholder part of the value which the market allocates to the controlling block.

Why should the law impose this particular concept of community of interest upon all corporations? Such a rule might possibly encourage investment in small holdings; but it might also reduce the incentive to make majority investments. Suppose that the law were to leave the matter to negotiation between the parties prior to the organization of the corporation. It is by no means clear that they would always agree that the prospective majority holder should forego opportunities for premium sales. Minority investors might well realize that in some eventualities their interests might be served by a free transferability which would facilitate improvement of management. I cannot find in the general idea of community of interest a persuasive reason why incorporation should necessarily be on terms restricting alienation of controlling shares.

The community-of-interest argument is sometimes stated in more limited terms. In this form it is an argument...
for restricting sale of controlling shares only when there is a buyer seeking either all the shares or a "corporate transaction" such as a merger or asset purchase. Here the argument for "equality" is at its strongest, since equality would be the rule in case of a "corporate transaction." The proponent of such a limited restraint concedes the propriety of premium sales in other situations. But how is one to define the situation in which the restriction is to apply? Is the controlling shareholder free to sell only after he has failed, after reasonable efforts, to find a proposal in which all can participate? Will the presence of any such proposal, regardless of the terms, bring the restraint into operation? Or must it be an offer on terms which are later found to be "adequate"? There seems to me no way of defining the proposed limited rule which will accomplish its purposes and yet afford a workable basis for advising the controlling shareholder as to his freedom to sell. The only practical alternatives seem to me the general restriction which Professor Jennings supports and the rule for which I have argued—limiting relief to cases of special abuse.