SALE OF CORPORATE CONTROL

Recently the *Chicago Sun-Times* reviewed a situation which highlights the problems involved in selling "control" of a corporation.[1] Twice in the past six years the president of Domestic Finance Corporation has been able to sell his "control" at prices well above the market value—prices not available to other shareholders. In 1945, his gain, which eventually came out of the corporate treasury, was approximately $700,000. Again in 1951, the same man purchased about 87,000 shares in a period of five months (he owned none at the beginning of the period) and sold them for approximately three and one-half dollars over his average cost and sixty percent above market.[2] This price was offered to a select group of persons who represented some 400,000 shares (approximately thirty-five percent) which virtually controlled the corporation. The remaining shareholders were offered an exchange deal entitling them to about five dollars a share instead of the eight paid to the control group.

The courts have established that the controlling shareholder-director will be held liable if: (1) he fraudulently or negligently turns over his shares to purchasers who mismanage the corporation, or who loot the corporate assets;[3] (2) other shareholders are induced to sell their shares by his concealment of a premium paid to the controlling shareholder.[4]

The author of the *Chicago Sun-Times* series writes: "[T]here is a unanimous conviction on the part of those who have taken special interest in small stockholders that it is unethical for a management group to sell control of a company to outside interests on terms not made available to all stockholders."[5] This statement finds sympathetic response among some corporation lawyers and

[1] Vanderpoel, Column in Finance Section, Chicago Sun-Times (Sept. 9, 18, 20, 26, 27, 28; Oct. 1, 8, 9, 10, 1951).

[2] The corporation was originally set up with a great deal of Class A nonvoting stock and a small number of Class B voting shares which the president owned. After the president's first sale of control, the Board of Directors repurchased the B shares from the competitor to whom they had been sold and these were retired and the Class A made voting. The president's sudden buying of shares on the market before his second sale of control indicates that it is possible that he was already aware of a particular purchaser for the shares who was willing to pay a premium; however, it is also possible that on the basis of his information about the business he knew that he could find a purchaser who would pay a premium for control, but had no one in particular in mind at the time of his purchases.

[3] Insuranshares Corp. of Delaware v. Northern Fiscal Corp., 35 F. Supp. 22 (E.D. Pa., 1940), noted in 8 Univ. Chi. L. Rev. 335 (1941), 26 Cornell L.Q. 325 (1941), 54 Harv. L. Rev. 648 (1941), 16 Temp. L.Q. 232 (1942). The Harvard note contains an excellent and thorough discussion of the law concerning transfers of control.

[4] Dunnett v. Arn, 71 F. 2d 912 (C.A. 10th, 1934); Roby v. Dunnett, 88 F. 2d 68 (C.A. 10th, 1937), cert. denied 301 U.S. 706 (1937); Sautter v. Fulmer, 258 N.Y. 107, 179 N.E. 310 (1932); American Trust Co. v. Calif. Western States Life Ins. Co., 15 Cal. 2d 42, 98 P. 2d 497 (1940). It is to be noted that the complaining shareholders must have relied on the misrepresentations in order to recover. Roby v. Dunnett, supra. This type of liability has been imposed on members of the majority group who had close connections with the directors, although they themselves did not hold any official position in the corporation. Sautter v. Fulmer, supra.

[5] Chicago Sun-Times, Finance Section, p. 47, col. 1 (Oct. 10, 1951).

others interested in the problem of corporate control. For example, Berle proposes, but does not develop, the argument that " 'control' is an asset which belongs only to the corporation; and . . . payment for that power, if it goes anywhere, must go into the corporate treasury."[6] Berle's proposal necessitates no inquiry into the motives of either seller or buyer; any price in excess of the fair value can be attributed to the "control" element of the shares and must therefore be returned to the corporation. Since any remedial proposal will probably take this form, its implications should be examined.[7]

If a seller can be sued by other stockholders when he makes a sale in which they have not been included, he will probably insist that an offer be made to all the stockholders of the corporation. The buyer may not be willing to purchase more than sufficient shares for control at the same high price he offered for the control shares. This would either leave the former controlling shareholder with part of his shares and no control or force him to accept a lower price for his shares. The controlling shareholder may be entirely unwilling to sell under such circumstances and the buyer unwilling to buy under any other. A buyer will be willing to pay a "premium" to all shareholders only if the control group is not

[6] Berle and Means, The Modern Corporation and Private Property 244 (1933). Berle was writing at a time when Stanton v. Schenck, 140 Misc. 621, 251 N.Y. Supp. 221 (1931) was in the courts. It was Berle's hope that the decision in the case would be a clear-cut ruling that bonuses received for control would be considered corporate property. However, the result of the case was that holders of control can legitimately accept a bonus for their control shares. This case is good law today. Levy v. American Beverage Corp., 265 App. Div. 208, 38 N.Y.S. 2d 517 (1942); cf. Roby v. Dunnett, 88 F. 2d 68 (C.A. 10th, 1937). Mr. Berle indicated while attending the University of Chicago Law School Conference on Corporations that he still considered this theory of corporate assets to be valid. Clarke v. Greenberg, 296 N.Y. 146, 71 N.E. 2d 443 (1947) and Young v. Higbee Co., 324 U.S. 204 (1945) might be considered as a trend towards a corporate asset theory which approaches that of Berle. In the former, a stockholder who took money in settlement of a derivative suit was held accountable as trustee for all the stockholders on the theory that the cause of action belonged to the corporation. In the latter, stockholders were held liable for a bonus received in selling their shares which controlled a suit contesting the corporation's reorganization. The court held that the bonus attributable to control of the suit belonged to the corporation which was to benefit by the suit. The scope of these two decisions is much more limited than Berle's corporate asset theory. Only the sale of shares involved in a derivative suit is restricted; all other types of control can be bought and sold without restriction.

[7] It would appear unnecessary to concern ourselves with the control of large corporations. Berle writes: "[A]s corporations gradually increase in size . . . stock distribution increases to the point where 'control' is virtually in the hands of a self-perpetuating Board of Directors like that of United States Steel or American Telephone & Telegraph Company. But with this class of control, the public up to now has little quarrel, nor does it usually thrash out such problems in the courts." Berle and Means, op. cit. supra note 6, at 246. It is the medium and small corporations, where control can easily change hands and where buyers are usually interested only in obtaining control or sellers wish to sell their entire interest, which raise the legal problems with which this paper is concerned.

It should also be noted that a controlling stockholder owning only a minority of shares does not pass control to the purchaser of his shares unless there is an agreement between the board of directors, the seller and the purchaser. Without such an agreement the rest of the shareholders would not be affected by the sales since it remains within their power to prevent a change in the directorate and therefore any harmful plan the purchaser may have.

asking as high a price as it could demand. If a seller were asking as high a price as his control shares would bring on the market, he would lack further economic power to insist that a like "premium" to all other shareholders be "tied-in" to the sale of his control. The direct consequence of Berle's proposal would be to block some transactions in corporate shares where those shares represent control.

A basic tenet of free enterprise philosophy is the social advantage of a free market for investments. In the case of investments carrying control, the desirability of free transferability is particularly apparent. The interest of prospective purchasers of controlling shares typically springs from a belief that increased profits may be made from innovations in product or in production or merchandising policies; and under competition society gains when such beliefs may freely be put to the test. From this viewpoint one may question the desirability of a legal rule which would restrict such transfers of control. From the same viewpoint one may also question the ethical basis for a voluntary refusal of an attractive offer for controlling shares on the ground that the buyer is unwilling to extend his offer to all shareholders. Legal arguments such as Berle advances and expressions of praise for the controlling shareholder who leans over backward in refusing profitable sales show how widespread is the tendency to ignore the social advantage of transfer of business properties at prices determined by free markets.

Adoption of Berle's proposal, then, raises the problem whether transactions in control are so inimical to the society's interest in preventing fraud that it would be better to sacrifice free transferability of shares which represent control. Wise social policy would not seem to dictate such a sacrifice. The suggested change appears more drastic than the problem it is intended to correct. It would cripple the development of new corporations by sellers of control and the expansion and redevelopment of older corporations by purchasers.[8]

[8] Valuation of the control element will become a great problem if the law separates the value of control from value of the shares. The seller would constantly be open to lawsuits by various shareholders who have arrived at different values via different methods of calculation. Analogies to the valuation problem in such cases as Clarke v. Greenberg and Young v. Higbee Co. (see note 6 supra) are not helpful since the computation in both cases was more simple. In the former there was no question—the amount paid was the amount of settlement. In the latter, the court knew exactly what market value of the shares was—the excess was obviously a bonus for settlement of the suit. In many small corporations the market price of the shares is not indicative of their true value. Therefore, there will have to be recourse to criteria other than market value.

Nor is the refund method of Rule 16(b) applicable here. In the short-sale situation, there is no question of valuation. The shares were bought for a certain price and were sold for another—both equally ascertainable. The difference between the two is to be returned to the corporation if the transaction was completed within six months of the purchase date. The situation in the control sale is not nearly so easy. Are we to consider the price the seller originally paid for his shares? What is to determine the value at the time of sale? These questions will have to be answered before any satisfactory new plan is adopted. A possible answer would be appraisal as developed for dissenting shareholders in the situation where substantially all the assets of the corporation are being sold. This, however, is an expensive and cumbersome procedure. It would involve useless litigation almost every time there is a sale of controlling interest.

Up to the present, the basis of liability in control situations has been negligence or fraud. An attempt should be made to extend these concepts in order to bring about an equitable solution without the drastic and undesirable consequences of abolishing all profit which inheres in the control of a corporation and abandoning a basic tenet of free enterprise philosophy.[9]

INADEQUATELY CAPITALIZED SUBSIDIARIES

The ritual of incorporation provides a method of insulating assets from business risks. Yet the ritual affords no protection, to a parent corporation whose subsidiary[1] may be designated as its "alter ego" or its "instrumentality." Of the many factors considered by the courts in establishing that relationship, none is more elusive than inadequate capitalization.[2]

Cases in which the subsidiary was incorporated with substantially no assets of its own, or under its control, have been easy to decide. In *Garden City Company v. Burden*,[3] a parent corporation which owned most of the water rights in

[9] The situation outlined in the Sun-Times articles could more accurately have been analyzed in terms of an abuse of a director-officer's relationship with other shareholders. If there was anything improper in what the president did it was done at the time he bought the shares from the other shareholders without revealing that he had an opportunity to dispose of control at a premium. (See note 2 supra.) The author's preoccupation with an abuse of the sale of control seems to have been mainly misdirected.

There are three rules in this situation, all of which are presented in American Trust Co. v. Calif. Western States Life Ins. Co., 15 Cal. 2d 42, 56, 98 P. 2d 497, 504 (1940). The minority rule, given support in Berle, Publicity of Accounts and Directors' Purchases of Stock, 25 Mich. L. Rev. 827 (1927), recognizes the "director's obligation to the stockholders individually as well as collectively, and refuses to permit him to profit at the latters' expense by the use of information obtained as a result of his official position and duties." The majority rule is that a "corporation director owes no fiduciary obligation to the stockholder as such, but only to the corporation. Hence . . . non-disclosure [is] not fraudulent because there [is] no duty to disclose." The special facts doctrine, as laid down in Strong v. Repide, 213 U.S. 419 (1909) is that "where special circumstances or facts are present which make it inequitable for the director to withhold information from the stockholder, the duty to disclose arises, and concealment is fraud."

[1] The attempted insulation is most common in the parent-subsidiary relationship although it may also be seen in the "one-man" corporation. Pepper v. Litton, 308 U.S. 295 (1939). There appears to be no reason why a distinction should be made between parent corporations as stockholders and the stockholder in the "one-man" corporation in the case of corporations organized with inadequate capital. However, liability appears to be more frequently limited when the stockholder is not a corporate entity. Consult Latty, Subsidiaries and Affiliated Corporations 194 ff. (1936).

[2] Douglas and Shanks, Insulation From Liability Through Subsidiary Corporations, 39 Yale L.J. 193 (1929). The authors list eighteen relationships between parent and subsidiary saying of inadequate capital: "Courts are more impressed by an obvious inadequacy of capital on the part of the subsidiary than they are by the presence of any of the indicia of identity between the corporations. . . . In fact, sufficient capital and adequate financial arrangements or the lack of it, insofar as the various factors motivating the courts are capable of ascertainment from the cases, in some instances seems to be largely determinative." Ibid., at 214.

[3] 186 F. 2d 651 (C.A. 10th, 1951). The case follows almost directly the landmark case of Erickson v. Minnesota & Ontario Power Co., 134 Minn. 209, 158 N.W. 979 (1916).