

1972

Restraints on Incumbent Directors in Intracorporate Battles for Control (Introduction)

Aaron Yoran

Follow this and additional works at: <http://scholarship.richmond.edu/lawreview>



Part of the [Business Organizations Law Commons](#)

Recommended Citation

Aaron Yoran, *Restraints on Incumbent Directors in Intracorporate Battles for Control (Introduction)*, 7 U. Rich. L. Rev. 287 (1972).

Available at: <http://scholarship.richmond.edu/lawreview/vol7/iss2/5>

This Article is brought to you for free and open access by UR Scholarship Repository. It has been accepted for inclusion in University of Richmond Law Review by an authorized administrator of UR Scholarship Repository. For more information, please contact scholarshiprepository@richmond.edu.

RESTRAINTS ON INCUMBENT DIRECTORS IN INTRACORPORATE BATTLES FOR CONTROL

Dr. Aaron Yoran*

[Editor's Note: This issue contains the Introduction and first portion of Dr. Yoran's Article. The remainder will appear in the Spring issue.]

INTRODUCTION

ANY organization that entrusts the management of its affairs to a controlling group must devise checks to restrain the controllers during their incumbency. Those in control must specifically be placed under restraints that will prevent their using the organization's powers and assets to perpetuate their incumbency. In the corporate system, the need for effective restraints has become more compelling with the progression from private ownership through majority ownership and minority control to management control.¹

In light of this development, the courts have invented the derivative suit to enable shareholders to redress corporate claims against directors when the directors' control over the power to sue prevents the corporation from suing its directors. A derivative suit to redress abuse of directorial powers for perpetuation of control may be brought only if such abuse is redressable by the corporation itself. Derivative suits, moreover, are subject to burdensome restrictions.² This article examines, therefore, whether abuse of directorial powers is a breach of the directors' duties and whether derivative suits are available to redress abuses of directors power for retention of control.

At one time it was thought that, with ownership separated from control, the shareholders' dearest right was suffrage—the right to determine

*Lecturer in Law, Hebrew University; LL.B., Hebrew University, 1966; LL.M., Columbia University, 1968; S.J.D., Harvard University, 1971.

¹See A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 94 (1934). Bromberg, *Tender Offers: Safeguards and Restraints—An Interest Analysis*, 21 *CASE W. RES. L. REV.* 613, 678-79 (1970), points out that takeover bids may be a solution to the problem of the separation of ownership and control. Through a bid, an offeror may assemble from scattered holdings a minority control block or even a majority block. Note, however, that the offeror itself is most often a publicly held company suffering from a divorce of ownership and control. The concentration of management control in fewer, larger companies amplifies rather than cures the problem of directors having virtually uncontrolled power to manage other people's money.

²This is true especially in England where a derivative suit for negligent mismanagement has not been allowed thus far. Boyle, *The Shareholders' Derivative Action in Anglo-American Law*, 35 (S.J.D. paper, Harvard Law School, 1968).

by vote who should manage the corporate business for the common benefit (the power to hire and fire). It is now accepted, however, that "shareholders democracy" has become a myth³ because of the advantages that directors derive from their control of the corporate machinery and powers during intracorporate battles for control.

Recently, it has been suggested that the market for corporate control, rather than corporate democracy, safeguards the value of shares in publicly held corporations. Briefly, this market operates in the following manner. Shareholders respond to poor management by selling, and the market price is driven down to the point indicated by the quality of the incumbents' management. Outsiders who think that their own, more efficient, management could generate higher prices will purchase control. These outsiders will respond to the opportunity to make capital gains by purchasing control, managing the corporation efficiently, and either enhancing or realizing the value of their investment. This process, by which individuals think only in terms of personal gain, both enhances the value of shares in the corporation and provides a stronger incentive to managerial efficiency than the derivative suit or the power to hire and fire.⁴ A proper functioning of the market for corporate control, however, requires that outsiders have techniques at their disposal for purchasing control in spite of incumbents' opposition. The two techniques available to the insurgents are the proxy contest and the takeover bid. The proxy contest, however, being an intracorporate control battle, is subject to the same limitations that render shareholder democracy a fiction.⁵

This article analyzes the duties of incumbent directors in intracorporate battles for corporate control in two jurisdictions: the United States and England. First, one should compare the restraints that are imposed in these jurisdictions to prevent the directors of closely held

³ E. MASON, *THE CORPORATION IN MODERN SOCIETY* 5-6 (Atheneum ed. 1966); Gower, Book Review, 68 *HARV. L. REV.* 922 (1954); Manning, Book Review, 67 *YALE L.J.* 1477, 1487-88 (1958).

⁴ Manne, *Some Theoretical Aspects of Share Voting*, 64 *COLUM. L. REV.* 1427 (1964); Manne, *Mergers and the Market for Corporate Control*, 73 *J. POL. ECON.* 110 (1965). The existence of a separate market for corporate control was denied by Berle, *Modern Functions of the Corporate System*, 62 *COLUM. L. REV.* 433 (1962). Brudney, *A Note on Chilling Tender Solicitations*, 21 *RUTGERS L. REV.* 609, 631, n. 48 (1967), thinks that "the 'market' is extremely thin and seems to operate only interstitially."

⁵ A comparative study on restraints on defensive tactics against takeover bids is the subject of another article by the author. Most of the defensive tactics employed against takeover bids may also be employed against proxy fights.

companies from using corporate powers to perpetuate their control. Then, in order to ascertain what remains of the concept of shareholders democracy in closely and publicly held corporations, one should compare the rules that these systems have set up for insurgents' access to shareholders and for shareholders to exercise their power to appoint and remove directors.

DIRECTORS' MANEUVERING POWER IN CLOSED CORPORATIONS

Presentation of the Problem

In closed corporations, the management is usually appointed according to the distribution of voting power or some understanding between the coventurers.⁶ Proxy machinery plays either no role or only a marginal one. Those instances when incumbent directors use corporate powers for maintaining control occur either when through acquisitions a shift in voting power dispossesses the incumbents of voting control, or when the shareholders who once instated the directors want them removed. To perpetuate control, the directors may then use various measures, for example, the issuance of additional shares to themselves, or the vitiation of acquisitions that have taken place by refusing to register them.

In determining whether the incumbent directors have misused their powers, the first issue examined in a legal forum is the purpose for which the power was utilized. If a challenger contends that the incumbents exercised their power to maintain or gain control, the incumbents may reply that they used the power to achieve a proper corporate purpose. Disposition of this issue hinges on which party carries the burden of proof or whether a court will infer from the mere fact that control was shifted that power was exercised to achieve that result. Despite the presence of the control motive, the directors may, however, manage to show that their acts also achieved a proper corporate purpose, thus raising the question of the validity of the exercise of a corporate power for multiple purposes, one proper, the other improper. Theoretically, one of several principles may be applied to such a situation. To outlaw manipulations of control, a legal system may invalidate the act. It may, alternatively, espouse a test of primacy of purpose: if the primary purpose was a proper one, the act will stand. This test is difficult to

⁶ See F. O'NEAL, *CLOSE CORPORATIONS: LAW AND PRACTICE*, Chs. III, IV, V (Supp. 1968); O'Neal, *Control Distribution Devices*, U. ILL. L.J. 48 (1969).

apply, and in reality may injure the corporation by invalidating profitable transactions. At the opposite end of the spectrum is the principle that the presence of any proper corporate purpose is sufficient to uphold the act even if the exercise of power was primarily actuated by a control motive. This rule fails to restrain those directors who will attempt to clothe every control tactic in the proper dress. Even if it is established that the power was exercised to effect control, the directors still may argue that, under the circumstances, the very effecting of control was a proper corporate purpose. They will maintain that the shareholder whose voting power they diluted would have otherwise ruined the company.

In litigating the issue of whether the foiling of a policy considered injurious to the company is in and of itself a corporate purpose, the burden of proof becomes crucial. The challenger will find it extremely difficult to prove that the directors effected control in order to perpetuate their incumbency rather than their policy. A rule recognizing the defense of defeating a ruinous policy without shifting the burden of proof to the directors is almost tantamount to holding that maintaining control is always a valid corporate purpose.

If, after raising all of the above issues,⁷ the directors fail, the question of an adequate remedy may handicap judicial intervention. If the directors issued shares to themselves, or to friendly parties aware of the purpose of the issuance, the court might easily cancel the issuance. However, if the third parties are not cognizant of the motive actuating the issuance, its vitiation will be difficult. The final hurdle in the path of the challenger is his standing to bring a derivative or direct suit in light of the English *Foss v. Harbottle*⁸ rule of no interference, or its American counterpart.

This question and those issues previously raised will be examined in the light of the legal system of England and the United States. Even if the general approach of the two systems is identical, still a variation in the disposition of one of the above-mentioned issues may make all the difference.

⁷ Inadequacy of consideration or self-dealing may be additional grounds for attacking a transaction resorted to by the directors in order to secure control.

⁸ 2 Hare 461 (1843).

English Law

In England, the initial case of *Fraser v. Whalley*,⁹ involving a statutory railway company, established the precedent. Although the shares of the company were publicly held, one shareholder (a contractor of the railway being paid in shares) held 75% of the voting power, a setup similar to the structure of a closely held company. On the verge of a general meeting, the directors of the railway company learned that they were likely to be removed by the controlling shareholder. In order to foil their removal and to control the ensuing general meeting, they resolved to place shares into friendly hands. The court enjoined the issuance of the shares and rejected the directors' contention that they had a business purpose in issuing the stock. The court failed to elaborate on whom the burden of proving the actuating purpose lies. It emphasized that it was irrelevant whether the policy advocated by the directors or that advocated by the insurgent (holder of 75% of the voting power) was more in the interest of the company, stating "that is a matter wholly for the shareholders."¹⁰ The case thereby established that directors may not use corporate powers to perpetuate control, even if they sincerely believe that foiling the insurgent is in the interests of the company. The force of the *Fraser* decision is weakened, however, by the fact that the directors purported to act on the authority of a slate shareholders' resolution entrusting the issuing power to them for a different purpose. Thus it may be argued that the decision is based on *ultra vires* rather than on misuse of existing powers.

A later case, *Punt v. Symons & Company, Ltd.*,¹¹ upheld the *Fraser* ruling as regards a private joint stock company. The circumstances in that case were somewhat odd. A controlling shareholder, empowered by the bylaws, appointed two general directors. When the latter realized that they were going to be removed, they hastened to issue shares to their friends for the purpose of amending the bylaws so as to cancel the appointing and removing power of the controlling shareholder and thereby perpetuate their own control. Since the controlling shareholder could not, according to the bylaws, demand a poll, a distinct minority, including the new shareholders, would thus have been able to alter the bylaws and permanently entrench the incumbent directors. The court

⁹ 2 H. & M. 10, 71 Eng. Rep. 361 (1864).

¹⁰ 71 Eng. Rep 361, 369 (1864).

¹¹ [1903] 2 Ch. 506.

held that the directors misused their corporate power and enjoined the convening of a special meeting to alter the bylaws. The court found that the shares were issued "for the express purpose of acquiring an unfair majority for the purpose of altering the rights of parties under the articles"¹² and that they "were not issued bona fide for the general advantage of the company."¹³ The court stressed that the issuing power could be used in the ordinary case only for the purpose of raising capital. The court allowed that, on certain occasions, other purposes for the use of the power would be proper. However, the example it gave¹⁴ (issuance to create a sufficient number of shareholders to exercise a statutory power), and the endorsement of the *Fraser* ruling, establish that the foiling of a corporate policy considered injurious will not qualify as a proper business purpose.

In the next case, *Piercy v. Mills & Company, Ltd.*,¹⁵ the court found that "shares were allotted simply and solely for the purpose of retaining control in the hands of the existing directors."¹⁶ When the insurgent continued to acquire shares and again mustered a majority, the directors repeated their move and diluted his voting power to a minority. Since the court found that all the directors realized that the sole purpose of the allotment was to keep control and maintain a majority over the plaintiff, and that the company was not in need of further capital, it had no difficulty in vitiating the allotment. The court emphasized that it had no concern whatsoever with the merits of the dispute between the directors and the insurgent.

In none of these cases was the issue of burden of proof discussed because the courts in each case established as a fact the control motivation of the issuance. Neither was the question of multiple-purpose issuance decided. The directors in *Piercy* argued that "if one of the many motives for the allotment was to control the voting power, that is not enough to invalidate the whole allotment,"¹⁷ but the court found such motive to be the sole one and did not reach the issue. English and Commonwealth law on other aspects of multi-purpose use of power, however, tend to validate an act if the primary purpose is proper.¹⁸

¹² *Id.* at 517. The English use the term articles for what the Americans call bylaws.

¹³ *Id.* at 515.

¹⁴ *Id.* at 516.

¹⁵ [1920] 1 Ch. 77.

¹⁶ *Id.* at 79.

¹⁷ *Id.* at 82.

¹⁸ *Hirsche v. Sims*, [1894] A.C. 654; *Hindle v. John Cotton Ltd.*, 56 Scots L.T.R.

Although only *Fraser* dealt squarely with the problem, English courts reject the contention that foiling an injurious business policy is a corporate purpose for issuing shares.¹⁹ The cases establish that raising capital is usually the only recognized corporate purpose for issuing shares. Nevertheless, the courts have accepted other proper purposes, even for closely held corporations,²⁰ but they have not defined the outer limits.²¹

In the above-discussed cases, the courts did not face a difficulty in fashioning an appropriate remedy.²² In *Fraser*, the insurgent was quick

625 (1919 Scot.); *Mills v. Mills*, (1938) 60 C.L.R. 150 (Aust. H.C.). See L. GOWER, *MODERN COMPANY LAW* 524, n. 55 (3d ed. 1969) [hereinafter cited as GOWER].

¹⁹ Sealy, *Note on Hogg v. Cramphorn*, *CAMB. L.J.* 33, 34 (1967), criticizes the *Hogg* Court ([1967] Ch. 254) for citing the *Punt* and *Piercy* decisions as authorities for the proposition that defeating a policy genuinely believed to be injurious is not a proper corporate purpose. The criticism is not warranted. Sealy overlooks the statement in *Fraser* and its endorsement in *Punt* and in *Piercy*.

²⁰ Acquisitions and option plans are generally accepted as proper purposes for allotments of publicly held corporations. Issuing a determinative share to a neutral person to prevent a deadlock will presumably be upheld as proper for a closely held company.

²¹ Commonwealth jurisdictions follow the English example. There was much litigation on the subject in Canada, summarized in J. FRASER & M. STEWART, *COMPANY LAW OF CANADA* 205 (4th ed. 1962). *Boinsteel v. Collis Leather Co.*, 45 Ont. L.R. 195 (1919), stands for the proposition that defeating a business policy of controlling shareholders is not a proper corporate purpose, even when the directors in good faith believe the rejection of such policy is in the best interest of the corporation. *But see* the dictum in the minority decision of Harvey, C.J.A., in *Spooner v. Spooner Oils Ltd.*, [1936] 2 D.L.R. 634, 636, advocating in the context of a closely held corporation the rule Delaware has prescribed lately for public corporations: "There is nothing in the authorities cited that would stand in the way of upholding an issue of shares for the sole purpose of giving someone control of the company if the directors honestly believed on reasonable grounds that it was for the interest of the company that that should be done." It ought to be borne in mind, however, that these words were directed at a situation of continuing internal dissension and disharmony incident to the fight for control of the company. American courts also relax the condemnatory rule in freeze-out situations. See O'NEAL & DERWIN, *EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES* 91-98 (1961); Note, 35 N.C.L. REV. 271, 278 (1957).

²² The recent case of *Pergamon Press Ltd. v. Maxwell*, [1970] 1 W.L.R. 1167, dealt with a somewhat different aspect of the question of appropriate remedy. An English corporation taken over by an American corporation contended that Maxwell, its general director and chairman, had utilized a corporate power to perpetuate his presidency of a New York subsidiary of the English corporation. Maxwell voted the parent's 70% stock in the subsidiary to repeal a by-law entitling a majority stockholder to have a special general meeting convened. The cancellation of the by-law entrenched Maxwell in control of the subsidiary until the next general meeting, despite the fact that when the parent was taken over, Maxwell was removed from office by the parent. The parent failed to secure removal in New York courts. As a last resort, the parent brought an action in England asking the court to order Maxwell to exercise his power as the subsidiary's president and convene a general meeting of the subsidiary. Only such order,

enough to enjoin the issuance. In *Punt*, the only remedy sought was an injunction to convene a confirmatory general meeting. In *Piercy*, the directors issued shares, *inter alia*, to a third person. The court did not, however, have to deal with that issuance, because the third person was not made a party to the proceeding.²³

The issue of standing to sue was directly addressed in *Fraser*. The *Fraser* court recorded its endorsement of the rule of *Foss v. Harbottle*, but distinguished *Foss* by stating that "if the directors can clandestinely and at the last moment use a stale resolution for the express purpose of preventing the free action of the shareholders, this Court will take care that, when the company can not interfere, the Court will do so."²⁴ *Fraser* may therefore be read as establishing either a direct action by the controlling shareholder to defend his franchise, or a derivative corporate action. Later expressions in the decision about a wrong, and mischief to the corporation, tend to show that the court had in mind a derivative suit.²⁵ A plausible explanation is that a derivative action was sustained on the ground that a misuse of power by incumbents who emerged in control is an unratifiable wrong to the company.²⁶ As the editor of the decision very properly pointed out, *Fraser* involved not "a question of the internal management of the company, but an attempt on the part of the directors to prevent such management from being legitimately carried on."²⁷

In all the above cases, the directors acted when the insurgents had a legal majority. In *Fraser* and in *Punt*, the insurgents had previously installed the directors and then became upset with their management. In *Piercy*, the insurgents acquired control between the installation of

argued the parent, would restore the situation as it prevailed before Maxwell misused his power to vote the parent's stock in the subsidiary. The court refused to grant the requested remedy on two grounds: (a) that it was not an appropriate tribunal to decide about the exercise of powers of an American corporation; and (b) that the New York corporation was an indispensable party to the proceedings. A New York court would not order the president of a New York corporation to convene a general meeting because, in his capacity as general director of an English parent, he misused a corporate power. In short, the English parent could not obtain an effective remedy for the misuse of power, either in England or in the United States.

²³ [1920] 1 Ch. 77, 79.

²⁴ 71 Eng. Rep. 361, 369 (1864).

²⁵ *Id.* at 370.

²⁶ Note that even if the wrong were ratifiable there would be no point in remitting the matter to a general meeting where the new shares could not be voted. Plaintiffs would no doubt prevail in that instance.

²⁷ *Id.* at 361.

the management and the forthcoming general meeting. One could question whether the same restrictions²⁸ would be placed on directors when the insurgent has not yet mustered legal control. In a recent case, *In re Jermyn Street Turkish Bath, Ltd.*²⁹ the lower court held that the issuance of additional shares by a 50% incumbent shareholder was clearly a misuse of power. The court had no difficulty in discrediting the evidence of the incumbent director and in finding that her actuating motive was to secure control. Furthermore, the court found that the shares were not issued to raise needed capital, even though the corporation was in dire need of cash, and the director had advanced a loan to the corporation at the same time she issued the stock to herself. The court refused to accept the contention that the issuance of stock, which raised little capital, and the loan, which rescued the corporation, were an integral transaction. Nevertheless, the court found that the issuance of stock, which took place 14 years before the proceeding was instituted, was one in a chain of events which amounted to an oppressive course of conduct by the incumbent director to qualify the insurgent 50% shareholder for a Section 210 relief.³⁰ The Court of Appeal, overruling all

²⁸ One should remember that, unlike American jurisdictions, English courts have never recognized an obligatory rule of preemptive rights. See Gower, *Some Contrasts Between British and American Corporation Law*, 69 HARV. L. REV. 1369, 1380 (1956). Hence in England, the only restriction against misuse of the issuing power stems from fiduciary principles.

²⁹ [1970] 1 W.L.R. 1194.

³⁰ Companies Act, 1948, § 210:

Any member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part of the members (including himself) . . . may make an application to the court by petition for an order under this section. (2) If on any such petition the court is of opinion (a) that the company's affairs are being conducted as aforesaid; and (b) that to wind up the company would unfairly prejudice that part of the members, but otherwise the facts would justify the making of a winding up order on the ground that it was just and equitable that the company should be wound up; the court may, with a view to bringing an end to the matters complained of, make such an order as it thinks fit, whether for regulating the conduct of the company's affairs in the future, or for the purchase of the shares of any members of the company by other members of the company or by the company and, in the case of a purchase by the company, for the reduction accordingly of the company's capital, or otherwise.

Only in rare circumstances will the misuse of power not be a single act but a course of oppressive conduct to entitle every shareholder to bring a Sec. 210 action. Thus in *In re Jermyn Street Baths* a Sec. 210 action finally failed. The oppressive conduct, plaintiffs argued, consisted of issuance of shares to secure control, payment of excessive salaries without an authorizing shareholders' resolution, cancellation of a corporate debt to the insurgent shareholder, and not sending to that shareholder notices of general

these holdings, ruled that the allotment was a legitimate act, done in good faith in the interests of the company, and not oppressive in any sense.³¹

While the cases dealing with the power to issue reveal a tendency to curtail directors' powers,³² *In re Smith & Fawcett, Ltd.*,³³ dealing with the power to refuse registration of transfer of stock, points in the opposite direction. In that case the bylaws provided that "the directors may at any time in their absolute and uncontrolled discretion refuse to register any transfer of shares." When one of the 50% shareholders and directors died, the remaining shareholder and director refused to register the transfer of the totality of the 50% shares to the plaintiff. The remaining director agreed to register only the block plaintiff held as legatee (somewhat more than 25%), and to buy the rest (which plaintiff held as legal representative of the deceased) at a price fixed by himself. The court held that the director was warranted in his refusal to register the transfer, reasoning that the articles conferred upon the directors an unqualified discretionary power subject only to the fiduciary principle that the power he applied in the corporate interest as the directors see it. The court went on to say that "such matters as . . . whether by their passing a particular transfer the transferee would obtain too great a weight in the councils of the company or might even perhaps obtain control" are matters "bearing on the general interests of the company as a whole"³⁴ and not ulterior purposes. Consequently, affecting control is a proper corporate purpose for the exercise of the transfer power

meetings. The lower court accepted this argument ([1970] 1 W.L.R. 1194). However, the Court of Appeal rejected it ([1971] 1 W.L.R. 1042), mainly because the incumbent shareholder did not use the additional voting power in effectuating the other acts.

Sec. 210 enables the court to fashion a remedy for regulating the company's affairs in the future, or to purchase shares from one shareholder by another shareholder or by the company. This leaves the courts sufficient flexibility to correct a distortion of the voting power that the directors cause. Moreover, the courts can award something akin to damages in fixing the price for an ordered transfer of shares. *Scottish Co-operative Wholesale Soc'y Ltd. v. Meyer*, (1959) A.C. 324, 369 H.L. (Sc.); *In re Jermyn Street Baths*, [1970] 1 W.L.R. 1194, at 1208.

³¹ [1971] 1 W.L.R. 1042, C.A.

³² As GOWER, *supra* note 18, 524, n.54 points out, a similar curtailing rule was applied to other powers, e.g., forfeiture of shares (*Stanhope's Case*, (1866) L.R. 1 Ch. App. 161), calls (*Galloway v. Halle Concerts Society*, [1915] 2 Ch. 233), and passing transfers (*Bennett's Case*, (1854) 5 De G.M. & G. 284). *But see In re Smith & Fawcett Ltd.*, [1942] Ch. 304, C.A., discussed *infra*. See also Boyle, *supra* note 2, at 40-45.

³³ [1942] Ch. 304, C.A.

³⁴ *Id.* at 308.

(provided that the articles confer an unqualified power) but it is not an improper purpose for the utilization of the issuance power. This discrepancy seems inexplicable and unwarranted. The court also rejected plaintiff's argument that the incumbent director refused to register the transfer for another collateral purpose, namely a desire to acquire part of the shares for himself at an under-value. The court held that the burden of proving the impropriety of purpose rested with the plaintiff, and that he had failed to discharge it. It would appear from a close examination of the case that a shifting of the burden of proof was warranted.

The American Approach

The question of the validity of the issuance of shares in closely held corporations in order to preserve, acquire, or shift control has been extensively litigated in the United States.³⁵ The power of American corporations to repurchase their own stock, unlike English corporations,³⁶ opens another control-affecting tactic for incumbents, and its misuse has also been heavily litigated.³⁷ To the extent that a jurisdiction recognizes preemptive rights, the directors may not in any way abuse the power to issue for political purposes. However, the fact that the issuance does not violate the rules of preemption³⁸ does not legalize it. The issuance

³⁵ See authorities collected in Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259, 265, n. 17 (1966) [hereinafter cited as *Brudney*]. Brudney's penetrating article contains an excellent analysis of the American law on this topic.

³⁶ English law prohibits a corporation from repurchasing its own stock, regarding it as a reduction of capital. *Trevor v. Whitworth*, (1887) 12 App. Cas. 409, H.L. American jurisdictions allow repurchase but impose restrictions to prevent dilution of creditors' cushion. Note, *Buying Out Insurgent Shareholders with Corporate Funds*, 70 YALE L.J. 308, 320-21 (1960). The soundness of the American rule has been subject to much criticism. Dodd, *Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law*, 89 U. PA. L. REV. 697-98, 706 (1941). The leading English authority, on the other hand, does not minimize the advantages of the American rule. "While clearly capable of abuse unless regulated, it has enabled the U.S.A. to adopt a very much more straightforward alternative to the unit trust—namely the open-end investment trust company or mutual fund. It also facilitates employee share-ownership schemes and enables shareholders in private companies to be bought out more easily." Gower, *Memorandum on Corporate Law and Practice in the U.S.A.*, Appendix XXXIX to JENKINS REPORT MINUTES at 1052. This observation was amplified by the American witnesses, yet the Jenkins Committee was not moved. JENKINS REPORT, CMND. 1749, Paras. 167, 168 (1962) [hereinafter cited as JENKINS REPORT].

³⁷ See authorities in *Brudney*, *supra* note 35, at 268, n.26.

³⁸ The reason for this is that either the jurisdiction or corporate constitution does not provide such rights or because they were waived.

will be subject to further scrutiny to verify its purpose. If the purpose was to manipulate control, the court will invalidate the issue even though the directors believed the manipulation of control to be in the best interests of the company.³⁹ American decisions in this respect are more categorical than the English decisions. The few decisions upholding control-motivated issuances are obsolete⁴⁰ or were reached to achieve the very results that the proscription rule aims to effectuate in the usual circumstances.⁴¹ The proscription rule is directed at allotments principally designed to effect control. The courts do not have difficulty, however, in administering that rule.⁴² Due to the structure of a closely held corporation, the directors can not easily invent an independent corporate purpose as they successfully do in cases involving publicly held corporations. Moreover, the courts are ready to infer the electoral purpose of the issuance from the actual resulting shift in control.⁴³ Therefore, the fact that the courts place the burden of proof on the challenger⁴⁴ does not leave much leeway to the incumbents.

Professor Brudney emphasizes the courts' readiness to invalidate allotments of close corporations in contrast to the upholding of control-motivated allotments of public corporations. He attributes the difference in attitude to the fact that in a public corporation the control maneuvers only prevent an insurgent from gaining control, while in private corporations, they "freeze out" a faction theretofore participating in control and enjoying the control emoluments. Brudney continues, suggesting that a rule of preemptive rights, while infeasible for public corporations, may very well apply to private corporations and thus proscribe selective issuances regardless of purpose or motive.⁴⁵

³⁹ See, e.g., *Elliot v. Baker*, 194 Mass. 518, 80 N.E. 450 (1907); *Luther v. C.J. Luther Co.*, 118 Wis. 112, 94 N.W. 69 (1903). For further cases, see *Brudney*, *supra* note 35, at 267, n.23. Only need of the proceeds of the issuance for the execution of the business of the corporation is usually recognized as an appropriate business purpose. *Elliot v. Baker*, 194 Mass. 518, 80 N.E. 450 (1907).

⁴⁰ *State v. Smith*, 48 Vt. 266 (1876).

⁴¹ In *Standard Int'l Corp. v. McDonald Printing Co.*, 159 N.E.2d 822 (Ohio C.P. 1959), the court allowed the minority to issue shares to itself in order to require a purchaser to pay the minority the same premium he paid to the controlling shareholder.

⁴² See the cases cited in note 39 *supra*. See also *Dunlay v. Avenue M Garage & Repair Co.* 253 N.Y. 274, 170 N.E. 917 (1930); *Chapman v. Troy Laundry Co.*, 87 Utah 15, 47 P.2d 1054 (1935).

⁴³ *Sheppard v. Wilcox*, 26 Cal. Rptr. 412, 419-20 (D. Ct. App. 1962).

⁴⁴ *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).

⁴⁵ *Brudney*, *supra* note 35, at 266.

The cases involving reacquisitions espouse condemnatory rules similar to those regarding issuances,⁴⁶ although a recent Washington case, influenced by the Delaware cases dealing with public corporations, upheld a control-motivated reacquisition.⁴⁷

Restrictions on Incumbents' Shares Transactions

The question whether incumbents of close corporations may use their own resources to preserve or gain control has been rarely⁴⁸ litigated; however, such practice has been held legitimate in the cases that have decided the issue.⁴⁹ Moreover, when invalidating the directors' misuse of the corporate machinery to improve their voting powers, the courts note that the directors should have used their own resources.⁵⁰

In dealing with other shareholders, the directors are subject to fiduciary and statutory rules, certainly in the United States and arguably in the United Kingdom. These rules impose on the directors the duty to disclose to their trading parties information that may affect the latter's decisions whether to sell and, if so, at what price. The fact that the purpose of the directors' purchase is to preserve or gain control, and the possibility that a control battle is imminent may affect shareholders'

⁴⁶ See, e.g., *Gilchrist v. Highfield*, 140 Wis. 476, 478, 123 N.W. 102, 103 (1909) (dissenting opinion); *Petre v. Bruce*, 157 Tenn. 131, 136-37, 7 S.W.2d 43, 45 (1928); *Andersen v. Albert & J. M. Andersen Mfg. Co.*, 325 Mass. 343, 346, 90 N.E.2d 541, 544 (1950). The *Andersen* decision elaborated that a derivative suit can be brought to challenge the reacquisition since it seeks to vindicate a corporate right against controlling persons. If Massachusetts, known for its strictness in allowing derivative suits, so holds, a fortiori are derivative suits allowed in jurisdictions more "liberal" in this respect?

⁴⁷ *Hendricks v. Mill Eng'r & Supp. Co.*, 68 Wash. 2d 490, 413 P.2d 811 (1966), involved not a repurchase but a redemption of callable preferred stock. The charter allowed redemption "out of earnings or funds not necessary to the conduct of the business . . . in such manner as may be determined by the board of trustees." Hence the case might be construed narrowly as relating only to the utilization of a special broad power conferred in the corporate constitution. Cf. the English case of *In re Smith & Fawcett, Ltd.*, *supra* note 30. The disposition of the case does not lend itself to such a reading, however. The court ruled that the incumbents, convinced that management by the insurgents would clearly threaten the future of the business and would bring about the loss of the valuable services of the president to a competitive outfit, were warranted in "exercising their honest, informed business judgment" to take steps to meet the situation. *Id.* at 814.

⁴⁸ For American cases, see *Brudney*, *supra* note 35, at 289, n.98. There are no English decisions squarely in point.

⁴⁹ See, e.g., *Mairs v. Madden*, 307 Mass. 378, 30 N.E.2d 242 (1940).

⁵⁰ The Israeli case of *Schadjinsky v. Syndicate of Trucks, Ltd.*, 19 P.M. 16 (D. Ct. T.A. 1959), *approved* 13 P.D. 1592 (1959), is an example of such a case.

decisions whether to sell and are, therefore, material facts that must be disclosed. The significance of the disclosure rules in curtailing the freedom of incumbents of closely held companies to engage in transactions affecting control is, however, marginal at best. The shareholders in the usual case will be aware of the control arrangements and of the effect of the transaction on the allocation of voting power. Hence, curtailment can be achieved not through disclosure rules but only through a condemnatory rule.

Professor Brudney has submitted that the courts should indeed prescribe a condemnatory rule,⁵¹ reasoning that fiduciary principles are infringed upon when incumbents deprive participants in the control group of their share in the control emoluments. The seller, he continues, stands on the same footing as a seller of a controlling block of shares in a publicly held corporation. Inasmuch as the latter presents a danger to existing shareholders by placing control in the hands of an irresponsible purchaser,⁵² the former exposes them to similar hazards by depriving them of their political power. Hence, Brudney concludes, purchaser and seller should be subject to a prohibitory fiduciary rule. Brudney's analogy is not warranted. The seller who can tip the scale of voting power may not be a controlling shareholder, and may not even have participated in the controlling group. These decisions that deal with sellers of control of publicly held companies have not subjected holders of a determinative small block to the accountability rule. Moreover, when the seller is held liable, he is only obliged to disgorge a portion of the control premium. The sale is not impinged even though the seller did not afford other shareholders the same opportunity to sell.⁵³ That is, the seller is not obliged to prorate his sale among existing shareholders. In the absence of a ready market for the shares, it is unlikely that the challenger could prove that the departing shareholder received a premium for his shares.

As for the purchaser, one may question whether the fiduciary um-

⁵¹ *Brudney, supra* note 35, at 290-91. Although Brudney does not elaborate, it seems fair to conclude that he advocates conferring upon existing shareholders a statutory right of first refusal in any case of transfer of shares.

⁵² For cases holding incumbents accountable for selling their controlling block to looters, see *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (Sup. Ct. 1941); *Insuranshares Corp. v. Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa. 1940), 42 F. Supp. 126 (E.D. Pa. 1941). Cf. *Levy v. American Beverage Corp.*, 265 App. Div. 208, 38 N.Y.S.2d 517 (Sup. Ct. 1942), *rev'g* 29 N.Y.S.2d 550 (Sup. Ct. 1941).

⁵³ *Pellman v. Feldman*, 219 F.2d 173 (2d Cir. 1955).

brella should extend to share transactions beyond the requiring of adequate disclosure. Professor Brudney's suggestion has the effect of freezing the allocation of power at the moment the corporation is created and prohibiting any control-affecting transfer of shares. But the incorporators have at their disposal a host of control devices to assure perpetuation of whatever allocation of power they desire. Short of actual employment of one of these devices, the law should not prescribe the status quo to closely held corporations. Brudney asserts that the possibility of a contractual restriction does not rule out a fiduciary restriction, and that the fiduciary principles govern many situations where a contractual provision could protect the parties. One may doubt, however, whether the cost of a condemnatory fiduciary rule is justified.⁵⁴

⁵⁴ *Brudney, supra* note 35, at 291, concludes as follows:

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.

So put, one's difference with Brudney narrows to the extent to which one is ready to credit incorporators (and their legal advisers) with knowledge of the corporate rules. One maintains that by not providing for a control device, the shareholders waived whatever protection they could have received. Brudney would probably answer that only a condemnatory rule, out of which the incorporators may contract, will focus the incorporators' attention on the possible consequences of free transferability of shares.

Brudney, supra note 35, at 291-94, rejects on balance the introduction of a prohibitory rule to share transactions by incumbents of publicly held corporations. But federal law may impose restrictions on controlling shareholders of publicly held corporations.

UNIVERSITY OF RICHMOND

LAW REVIEW

VOLUME 7

WINTER 1972

NUMBER 2

EDITORIAL BOARD

ROBERT F. PANNELL
Editor-in-Chief

JOHN L. KNIGHT
Executive Editor

WILLIAM L. PERKINS, III
Executive Editor

JAMES W. TREDWAY
Articles Editor

RICHARD C. KAST
Articles Editor

JOHN FRANKLIN
Decisions Editor

JAMES Q. KORNEGAY, JR.
Decisions Editor

FRED A. TALBOT
Decisions Editor

M. RICHARD EPPS
Note and Comments Editor

JOHN H. MILNE
Note and Comments Editor

JOHN L. GREGORY, III
Legislation Editor

JAMES H. JOHNSON
Corresponding Editor

STAFF

WILLIAM D. BAYLISS
EDWARD A. BECK, III
EDWIN A. BISCHOFF
GEORGE L. CONSOLVO
K. WAYNE GLASS
PAUL F. GLUCHOWSKI
FREDERICK J. HINTON
DENNIS O'CONNOR LAING

H. SEWARD LAWLOR
OLIN R. MELCHIONNA, JR.
STERLING H. MOORE
FRED W. PALMORE, III
N. CARSON STOGNER, JR.
KENNON C. WALDEN, II
ALPHA WARD WALDEN
G. WILLIAM WATKINS

BUSINESS STAFF

GREER P. JACKSON, JR.
Managing Editor

FRED H. COMBS
Business Manager

HARRY L. SNEAD, JR.
Faculty Adviser

The materials published in the Review express the views of the writers. Publication does not imply agreement with any statement made.