Sale of Control at a Premium: Time for Some Changes

Norwood Beveridge
Sale of Control at a Premium: Time for Some Changes

Norwood P. Beveridge, Jr.*

In a recent article, Roswell B. Perkins, President of the American Law Institute (ALI), cited the law on sale of control at a premium as an outstanding example of the confusion of the law of corporations in some critical areas and as one of the reasons for starting the ALI's Corporate Governance Project in 1978.1 This is certainly an area of the law where clarification is welcome, and the fault has been as much with the academic commentary as with the case law. The ALI draft proposes the following:

Section 5.04(a)(2)[Part V - Duty of Loyalty. Use of Corporate Position, Non-Public Information Concerning the Corporation or Corporate Property] also does not preclude a director or senior executive from selling shares of the corporation at a premium, even if the shares constitute a control block, if no independent breach of the duty of loyalty based on facts other than the sale of the shares, is present. Section 5.04 therefore does not accept the rule proposed by some commentators, but not supported by judicial decisions, that a controlling shareholder must share with other shareholders any premium received from sale of a controlling block of shares or provide an opportunity for all shareholders to sell their shares on the same terms.2

Professor Robert W. Hamilton reviewed the cases on sale of corpo-

---


2. American Law Institute, Principles of Corporate Governance: Analysis and Recommendations 73, 74 (Tent. Draft No. 5, April 15, 1986) (hereinafter ALI). The ALI draft also states that “Where resignation of a director is incident to sale of a controlling block of shares, § 5.04(a)(2) would not preclude such resignation, whether or not a premium was paid for the sale of the controlling shares.” Id. at 87.

As will be explained in Part VI [Transactions in Control], § 5.11(a)(2)[Use of Dominating Position, Non-Public Information Concerning the Corporation, or Corporate Property] does not preclude a dominating shareholder from selling shares of the corporation at a premium, even if the shares constitute a control block, if no other conduct is present that would constitute a breach of the duty of loyalty.

Id. at 168. A “dominating shareholder” is defined to mean a more than 50% voting shareholder, or one who in fact controls the management of the business, with a presumption of control for a holder of 25% or more of the voting securities. Id. at 7.
rate control as recently as January 1, 1985, and concluded that the issue had been resolved against any sharing of the premium or requirement of equal opportunity for sale. However, standard texts on corporate law continue to teach Perlman v. Feldmann and to present the sharing and equal opportunity arguments as open questions, although they have been repeatedly rejected by the courts.

SALES OF CONTROL SHARES ONLY—SELLER KEEPS CONTROL PREMIUM.

In a memorandum opinion in Zetlin v. Hanson Holdings, Inc., the New York Court of Appeals rejected an argument by a 2% minority stockholder that all minority stockholders were entitled to an equal opportunity to sell their shares at the premium paid for a controlling interest in the corporation. There, the holders of a 44.4% controlling interest had sold their shares for $15 per share when the open market price was $7.38 per share. The Court stated:

Recognizing that those who invest the capital necessary to acquire a dominant position in the ownership of a corporation have the right of controlling that corporation, it has long been settled law that, absent looting of corporate assets, conversion of a corporate opportunity, fraud or other acts of bad faith, a controlling stockholder is free to sell, and a purchaser is free to buy, that controlling interest at a premium price.

Professor Adolf A. Berle, Jr. first stated the proposition that control is a corporate asset. In commenting on the then pending case of Stanton v. Schenck, Professor Berle stated, “But it apparently involved too great a leap into the dark for the New York court to say 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

4. 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955). See Ruder, Duty of Loyalty—A Law Professor’s Status Report, 40 BUS. LAW. 1383, 1396 (1985) (“[It remains in corporate casebooks to confuse generations of students”). This fulfills Judge Swan’s prophecy in dissent that the legal profession and the business world would find the decision incomprehensible. Perlman, 219 F.2d at 178 (Swan, J., dissenting).
7. Id. at 685, 397 N.E.2d at 388, 421 N.Y.S.2d at 878.
treasury.”

In *Stanton*, a group of controlling stockholders in the Loew’s Theatre chain sold their stock at a price nearly double the current market price of the shares. The court held that the minority stockholders were not entitled to have the premium for control shared:

No one will argue that the holder of a large block of the stock of a corporation would be under a duty to account for his profit to the corporation. As such holder he might be in a position to command a considerable premium above current prices in a favorable market. The advantage would be entirely his, for which he would in no way be compelled to respond to the corporation.

Professor Berle’s thesis was perhaps consistent with his greater theme that the modern corporation would possibly supercede the state as the dominant form of social organization and that in the future the great corporations would be operated in the interests of neither management nor stockholders, but in the interests of all society in general. However that may be, this early observation by Berle might have lain quietly at rest had not *Perlman v. Feldmann* burst upon the world to perplex and confound the corporate bar.

The facts were not complicated. Feldmann was the president, Chairman of the Board and the controlling stockholder, (with his associates,) of Newport Steel Corporation. Newport was a marginal steel producer, but with the demand for steel high following the commencement of the Korean War on June 26, 1950, Newport was in the position of rationing its output among all of its customers.

As explained in the case, reputable steel producers were not selling at high prices in the gray market which developed for steel, but continued to sell their product at the same price out of considerations of patriotism, so it was said. Sixteen end users of steel formed the Wilport

10. A. BERLE & G. MEANS, supra note 8, at 244. Berle did not really develop this idea at all. He merely concluded that “the law thus far has been unable to deal with the situation.” Id. at 244. He further stated: “It is more likely that the law will deal, blunderingly, with each situation as it comes up on its individual merits; and most likely of all, the transactions by the ‘control,’ lying outside the technical sphere of corporation action, will remain outside the normal cognizance of the law.” Id. at 246.
12. Id. at 233.
15. Id. at 174.
16. Id. at 177-78.
17. Id. A more cynical assessment might be that the steel producers were trying, unsuccessfully as it turned out, to avoid the imposition of excess profits taxes and wage and price controls. For a general history of the steel industry at this time, see Youngstown Sheet & Tube Co. v. Sawyer, 343 U.S. 579 (1952).
Company for the purpose of buying control of Newport.\textsuperscript{18} Following the sale, the buyers intended to purchase about fifteen to twenty thousand tons of steel per month from Newport.\textsuperscript{19} During the period prior to the sale, those six members of the purchasing group who were Newport customers had been able to buy only a total of 500 tons per month although all wanted more.\textsuperscript{20} Feldmann and his associates sold 37% of the outstanding stock to Wilport for a price of twenty dollars per share, as compared to a price on the over-the-counter market of about ten to twelve dollars per share and a book value of $17.03.\textsuperscript{21}

In a two-to-one decision, with Judge Swan dissenting, the Court of Appeals reversed a judgment for the defendants in a derivative suit brought by minority stockholders to compel a sharing of the premium, and the court remanded the case for a new trial on the issue of the value of the Feldmann stock without the appurtenant control over the corporation's output of steel.\textsuperscript{22} At the second trial, Judge Anderson found that the enterprise value of the stock was $14.67 per share and that therefore, the difference between that figure and the purchase price of $20 per share was a premium for control over Newport's output of steel.\textsuperscript{23} The total premium at $5.33 per share for 398,927 shares was $2,126,280.91. Since the Feldmann interests held 36.99% of the outstanding shares, they would keep that proportion of the premium. The balance of $1,339,769.62, together with interest at 6% per annum from August 31, 1950, and costs, would be paid to the plaintiffs and those whom they represented, the present stockholders of Newport other than Wilport or its successors.\textsuperscript{24} The case was subsequently settled for $1,150,000, of which $450,000 in fees and $38,329.73 in expenses went to plaintiffs' lawyers.\textsuperscript{25}

Another challenge to the Newport sale had, in the meantime, been

\textsuperscript{19} Id.
\textsuperscript{20} Id. at 174-75.
\textsuperscript{21} Perlman v. Feldmann, 219 F.2d 173, 174-75 (2d Cir. 1955).
\textsuperscript{22} Id. at 178.
\textsuperscript{24} Id. at 446-47.
\textsuperscript{25} 160 F. Supp 310 (D. Conn. 1958). The balance of $661,670.27 went to the holders of record of Newport stock (other than the Wilport stockholders and their successors in interest) as of the close of business on September 30, 1957. Id. at 311. As a matter of fact, almost all of the Newport stock on that date was held by a single company, Meritt-Chapman & Scott Corporation, headed by Louis Wolfson, which in 1954 had acquired 94.7% of the outstanding Newport stock in an exchange offer of one share of Meritt-Chapman (then selling at about $22) for 2.1 shares of Newport, so that the non-Feldmann (as well as the Wilport) stockholders had already sold out for about $10.50 per share. See Andrews, The Stockholder's Right to Equal Opportunity in the Sale of Shares, 78 Harv. L. Rev. 503, 511 n.18 (1965).
dismissed in Birnbaum v. Newport Steel Corp. on the grounds that plaintiff minority stockholders, not being sellers or purchasers of stock, had no standing to sue under Section 10(b) of the 1934 Securities Exchange Act and Rule 10b-5 of the Securities and Exchange Commission (S.E.C.). Considerable law review commentary greeted the decision in Perlman but there was (and still is) no agreement as to what the case stood for.

First, it should be noted that the premium which was shared was not a premium for the ability to control the corporation in general. The district court on remand said that the general power to control was only a part of the enterprise value of the control shares:

What special value there may have been to an investor in being able to manage the corporation without controlling or having any particular interest in using the product or channeling its distribution to end users in which he was interested, is implicit in the factors going to determine enterprise value.

Secondly, some commentators have argued that the corporate asset misappropriated by Feldmann was the opportunity to merge on favorable terms as alleged in the case of Birnbaum v. Newport Steel Corp., but there was no evidence that an advantageous merger was possible. The only negotiations for merger took place in May, 1950 with Follansbee Steel Corporation, and Judge Hincks found as a fact that “Follansbee never made a firm offer of merger on any basis and Follansbee’s Board of Directors decided on July 11, 1950 against a merger on a basis of 1 1/2 to 1.” That basis had been suggested by Feldmann, and it would have been worth about $10.67 per share to Newport’s stockholders.

28. 17 C.F.R. § 240.10b-5.
32. 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).
34. Id.
Most troubling of all has been the insistence that no harm had been alleged to Newport itself as a result of the Feldmann sale or the proposed purchases by Wilport.35 Judge Swan said in his dissent that there is nothing illegal in a dominant shareholder purchasing from his own corporation at the same prices it offers to other customers, and there was no proof that Newport suffered any detriment therefrom.36 This thinking is inconsistent with the obligations of controlling stockholders and directors with respect to self-dealing in general, and in particular with respect to the use of the steel shortage to generate interest-free advances from customers (the Feldmann Plan) and to curry favor with prospective long-term local steel customers, both as suggested in Judge Clark’s majority opinion.37

The ALI draft, in simply changing the facts of the Perlman case to use it as an illustration of abuse of dominating position, is to be commended. The changes make it clear that the monopolization of Newport’s product would have the long term effect of destroying Newport’s customer base and arrangements for future capital improvements and harming Newport’s future business prospects.38 In the thirty years since the decision in Perlman, the case has been cited in over 130 reported decisions (but never followed as to its particular result), and it is cited principally for the proposition that Feldmann had appropriated a corporate asset.

Professor Berle, however, thought he discerned acceptance of his argument that control was a corporate asset:

These decisions point to a slowly emerging rule (by no means universally acknowledged) that, where stockholdings carrying controls are sold, any identifiable portion of the consideration paid for the power position over and above the value of the stock ex the control-power element belongs not to the control-seller but to the corporation or (perhaps) to all the shareholders ratably.39

In fact, there was no such “slowly emerging rule,” but by the time of Professor Andrews’ famous article in 1965,40 perhaps it began to look as if there were. Now Professor Berle was more insistent:

He [Professor Andrews] accepts the proposition — as have most courts — that an individual or group selling stock carrying control of a corporation and receiving a premium over market for that stock will be

36. Id.
37. Id. at 177. See Annotation, Fairness to Corporation where “Corporate Opportunity” Is Allegedly Usurped by Officer or Director, 17 A.L.R. 4th 479, 503 (1982).
38. ALI, supra note 2, at 177-78, 183.
required to account to the other stockholders for the premium unless the other stockholders have been offered [sic] opportunity to sell their holdings, in whole or pro rata with the control sellers, at an equal price.\(^{41}\)

But “most courts” had not in fact accepted any such proposition\(^{42}\) although some judges in the Second Circuit began to act as if they had.\(^{43}\)

Has it not become apparent by now that the \textit{Perlman} case stands in isolation as an intrusive interference by a federal court in a question of


\(^{42}\) Goode v. Powers, 97 Ariz. 75, 397 P.2d 56 (1964); Benson v. Braun, 286 A.D. 1098, 145 N.Y.S.2d 711 (1955), \textit{dismissed}, 8 Misc. 2d 69, 155 N.Y.S.2d 622 (1956); Levy v. American Beverage Corp., 265 A.D. 208, 38 N.Y.S.2d 517 (1942); Schwarm v. Alpert, 31 Misc. 2d 768, 221 N.Y.S.2d 917 (1961); Tryon v. Smith, 191 Or. 172, 229 P.2d 251 (1951); \textit{cf. In Re Caplan's Petition}, 20 A.D.2d 301, 246 N.Y.S.2d 913, \textit{aff'd}, 14 N.Y.2d 679, 198 N.E.2d 908, 249 N.Y.S.2d 877 (1964) (sale of 3% of outstanding Lionell stock by Roy Cohn to Defiance Industries and by Defiance to Mr. A. M. Sonnabend, admittedly not working control of stock; related resignations of seven of ten Lionell directors illegal). In Essex Universal Corp. v. Yates, 305 F.2d 572 (2d Cir. 1962), it was held that the sale of 28.3% of the outstanding stock at a premium over market and related resignations of directors was not per se illegal under New York law. The Court said: "There is no question of the right of a controlling shareholder under New York law normally to derive a premium from the sale of a controlling block of stock." \textit{Id.} at 576. In Honigman v. Green Giant Co., 309 F.2d 667, 670 (8th Cir. 1962), \textit{cert. denied}, 372 U.S. 941 (1963), in the context of a corporate reorganization where the class A voting stock was giving up its exclusive voting rights, the court gave short shrift to Professor Berle's view that control is a corporate asset: "No authorities are cited by Professor Berle squarely supporting this broad contention"). \textit{Accord}, Manacher v. Reynolds, 39 Del. Ch. 401, 165 A.2d 741 (1960).

\(^{43}\) Ferraioli v. Cantor, 281 F. Supp. 354 (S.D. N.Y. 1967) (question whether controlling stockholder selling at a premium, who invites some minority stockholders but not others to join him, violated 10(b) of the 1934 Act.); SEC v. Talley Indus., 399 F.2d 396, 401 n.2 (2d Cir. 1968), \textit{cert. denied}, 393 U.S. 1015 (1969); see \textit{Norte & Co. v. Huffines}, 416 F.2d 1189 (2d Cir. 1969) where an opinion by Judge Lumbard indulged in a little judicial revisionism:

There [in \textit{Perlman}] the plaintiffs were individually injured and sued for injuries caused them by the defendants who sold their controlling stock at a premium without offering plaintiffs an opportunity to sell their stock on similar terms. We held, with Judge Swan dissenting, that the controlling stockholders had breached a duty to the plaintiffs who were minority stockholders and therefore were liable to the minority stockholders for the premium they would have received had they been included.

the state law of a distant jurisdiction (Indiana) in a way that is no longer appropriate, if ever it were, post *Erie Railroad Co. v. Tompkins*?44 In 1962, Judge Lumbard, sitting on a panel with Judge Clark, the author of the *Perlman* majority opinion, stated that *Perlman* was based “only nominally on Indiana law.”45 In the same case, Judge Friendly stated, in a concurring opinion, that a lack of Indiana controlling authority gave the court in *Perlman* a “freedom used to good effect.”46 The result of this attitude is that *Perlman* is not really a part of a principled body of corporate law. Now that most states have procedures for certification of questions of controlling state law by the federal courts, it is not likely that such “freedom” is appropriate.47

If the *Perlman* “doctrine” were to be further developed by the New York federal courts, a case involving another Indiana corporation would have to be presented, or a corporation of some other jurisdiction with the same “freedom,” barring of course untoward developments in the state courts or state legislature. But the next case, *Essex Universal Corp. v. Yates*,48 was from New York, an inhospitable jurisdiction not presenting the necessary freedom.49 The route of incorporating notions of fiduciary duty of directors, officers and controlling stockholders through the fed-

---


46. *Id.* at 580 (Friendly, J., concurring). See also *Alleghany Corp. v. Kirby*, 333 F.2d 327, 348 (2d Cir. 1964) (Friendly, J. dissenting), *aff’d en banc*, (by equally divided court), 340 F.2d 311 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966) (do not need state precedents “directly in point” to enforce fiduciary duties) (citing Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955)).

47. See *Analysis of State Laws Providing for Certification by Federal Courts of Determinative State Issues of Law*, 42 Rec. A.B. City N.Y. 101 (1987). This can be seen from the attempt by the U.S. Court of Appeals for the Second Circuit to export to Florida an expanded version of the New York doctrine of Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969) (insiders liable to corporation in derivative suit for losses avoided by selling corporation’s stock on inside information of bad news). In *Lehman Brothers v. Schein*, 416 U.S. 386 (1974), the U.S. Supreme Court remanded the case to the Second Circuit to reconsider certification of the question to the Florida Supreme Court. The U.S. Supreme Court said that certification would be particularly appropriate since a novel question of law was involved, there was great unsettlement of Florida law and Florida was a distant state. Also, New York federal judges were outsiders lacking a common exposure to local law which would come from sitting in the jurisdiction. *Id.* at 390-91. Following certification, contrary to the Second Circuit’s earlier decision, the Florida court firmly rejected not only the expansion of *Diamond* to include tippers, but the original notion itself of permitting a derivative suit in the absence of demonstrated harm to the corporation. *Schein v. Chasen*, 519 F.2d 453, 461 (2d Cir. 1975). *Cf Carret v. Western Nuclear, Inc.*, 436 F. Supp. 952 (S.D. N.Y. 1977) (court resists notion of exporting *Perlman* doctrine to Wyoming). It was held in *Freeman v. Decio*, 584 F.2d 186 (7th Cir. 1978), that the “innovative” *Diamond* ruling would most likely be rejected by the courts of Indiana, but a federal court in New Jersey has created a shareholders, *Diamond* derivative cause of action under New Jersey law and applied it to directors of a Utah corporation. *In re ORFA Sec. Litig.*, 654 F. Supp. 1449 (D.N.J. 1987).

48. 305 F.2d 572 (2d Cir. 1962).

49. *Id.* at 576.
eral securities laws was blocked in *Santa Fe Industries v. Green*, so it remained to be seen if the seed planted in *Perlman* and watered by law review commentary would take root in other state court soil, with or without the aid of the federal judiciary. As it turned out, the doctrines of sharing the premium for control and providing equal opportunity for sale did not, but expanded notions of fiduciary duty owed to minority stockholders by the control stockholders did begin to take hold here and there.

Every state and federal court which examined the question of sharing the premium for control, in one way or another, decided against any such broadly stated rule. Dictum in one California case suggests that some steps must be taken to avoid coercing the minority stockholders into selling for less than the majority, but it falls far short of adopting any general rule.

Professor Berle's observation in 1932 that "control" is a corporate asset was, as he said then, "a leap into the dark." It was not a well developed thesis, and the suggestion of paying the premium for control into the corporate treasury is illogical, as was pointed out by the court in *Stanton v. Schneck*. It has the anomalous result of enriching the buyer

---


The rule we have adopted here simply is that the duty of the majority stockholder-director, when contemplating the sale of the majority stock at a price not available to other stockholders and which sale may prejudice the minority stockholders, is to act affirmatively and openly with full disclosure so that every opportunity is given to obtain substantially the same advantages that such fiduciary secured and for the full protection of the minority.

*Id.* at 272, 76 Cal. Rptr. at 793-94. In that case, the buyer from the beginning had made it clear he wanted to buy the whole company. The selling majority holder, who was also chairman of the board and president and manager, actively misled and abused the minority stockholders into selling their shares for $300 per share while he sold for $1,548.05 per share. No general rule can be drawn from this case. See Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); Brown v. Allied Corrugated Box Co., 91 Cal. App. 3d 477, 487, 154 Cal. Rptr. 170, 176-77 (1979); H. Marsh, *Marsh's California Corporation Law*, § 10.33 (2d ed. 1981).

53. *A. Berle & G. Means*, supra note 8, at 244.
54. 140 Misc. 621, 251 N.Y.S. 221 (1931). The court stated, "A finding for the plaintiffs would
of control as well as the minority stockholders at the expense of the seller; it won’t do to say that such a proposal was made “with remarkable prescience.”

Professor Clark suggests that the Berle rule could be made to work by requiring the controlling stockholder never to sell at a price significantly higher than that available to minority stockholders. The law is settled to the contrary.

Case law has established the following propositions: 1) Control is not a corporate asset in the sense Professor Berle wanted it to be: the seller of control stock keeps the premium; 2) non-controlling stockholders have no equal right to sell their shares when control shares are sold; and 3) Perlman cannot properly be cited as authority against propositions 1 and 2.

The looting cases are also really not on point with respect to the question of sharing any premium for control. They stand for the proposition that the seller of control (whether majority or working control) has a duty of care to the corporation and perhaps to the non-controlling, non-selling stockholders not to sell control to a buyer if the facts indicate a need for an investigation which would reveal that the buyer intended to loot the corporation. For violation of this duty of care, the seller is liable

result in enriching one of the alleged conspirators to the extent of 45 per cent of the net amount of the restored property.” 251 N.Y.S. at 239. See also Keely v. Black, 91 N.J. Eq. 520, 523, 111 A. 22, 23 (1920) (“We cannot conceive of a more unjust and inequitable result than to force the Bell Company to take back this money, which it paid in good faith, and for the return of which it does not ask”). Stanton v. Schnick, 251 N.Y.S at 239-40.

55. Greene & Junewicz, A Reappraisal of Current Regulation of Mergers and Acquisitions, 132 U. PA. L. REV. 647, 660 (1984). The decision in the Perlman case can lead to odd results, too. The seller, Feldmann, received enterprise value of $14.67 plus 36.99% of the $5.33 premium, a total of $16.64. The minority will receive $3.36 per share, while keeping their stock. The buyer paid $20 per share. If the buyer is now forced to sell for whatever reason at the same $20 per share, he will presumably be in the same position as Feldmann. While it may be argued that he has paid for control and thus may now sell it, this does not necessarily follow, and in any event, Feldmann certainly paid for the control stock one way or another. See Andrews, supra note 25, at 513. Thus, the minority will receive another $3.36 per share while still keeping their stock. The buyers of control take a loss on their investment. If the minority sell their stock at market (about $10 to $12 per share), they have now received more per share than the sellers of control. If the minority combine their 63.01% of the outstanding stock in some fashion and wrest control from the buyers of control, they then have control and the two premiums. No sense can be made of this. If, as suggested earlier, it would not be proper for the buyers of control to divert the steel supply of the corporation to themselves when alternatives were presented which arguably would better serve the corporation, this buying and selling of control of steel supply would not happen in the first place.

The court of appeals in Perlman stated that Newport had possible ways of using the steel shortage to its advantage. “Only if defendants had been able to negate completely any possibility of gain by Newport could they have prevailed.” 219 F.2d 173, 177 (2d Cir. 1955). See Letts, Sales of Control Stock and the Rights of Minority Shareholders, 26 BUS. LAW. 631 (1971).

56. R. Clark, supra note 5, at 495.

to the corporation for damages caused by the buyer-looter.\textsuperscript{58}

The amount of damages therefore does not bear any relationship to the amount of any control premium or even the purchase price of the stock.\textsuperscript{59} To be sure, the two defendants in one case were found liable to pay to the corporation both the damages caused by the looter and the amount by which the total purchase price of the stock exceeded its market value as found by the court.\textsuperscript{60} That liability was imposed on defendants as officers and directors for breach of fiduciary duty in turning over control to looters. It was not imposed on them as selling stockholders; indeed, they had not even received that money in either capacity since much of it was paid to other selling stockholders not before the court. The question of the unfairness of a windfall for the buyers of stock did not come up in that case since the corporation was insolvent, and almost all of the premium went to defrauded third parties anyway.

The same measure of damages was applied to the selling stockholder in \textit{Gabriel Industries v. Defiance Industries},\textsuperscript{61} a companion case to \textit{In re Matter of Caplan v. Lionel Corp.}\textsuperscript{62} Defiance had sold only three percent of the outstanding stock, not representing working control, but had delivered control of the board of directors.\textsuperscript{63} Liability was found in the full amount of the consideration received by Defiance ($283,712.50) since the court found that Defiance had delivered nothing of value to the buyer. Apparently the stock itself was never delivered and the Cohn notes transferred by Defiance to Mr. Sonnabend were found to have no value since


\footnotesize{\textsuperscript{59} The buyers in \textit{Insuranshares} paid a total of $273,358.80, representing $3.60 per share for 75,933 shares. The market price was from $1 to $1.25, and the book value was $2.25. The buyers in \textit{DeBaum} paid $250,000 for the 70 shares, $50,000 down and the balance of $200,000 to be paid over five years. Whether or not this was a premium over fair market value was not at issue and not discussed.}

\footnotesize{\textsuperscript{60} Gerdes v. Reynolds, 28 N.Y.S.2d 622 (1941) (sale of 59% of outstanding stock to looters for $2 per share when asset value was 86 and fair market value not more than 75; two of four selling stockholders, officers and directors jointly and severally liable for all damages to corporation and for the $1,318,750 excess over fair market value).}

\footnotesize{\textsuperscript{61} 22 N.Y.2d 405, 239 N.E.2d 706, 293 N.Y.S.2d 65 (1968); accord, Brecher v. Gregg, 89 Misc. 2d 457, 392 N.Y.S.2d 776 (1975), aff'd, 56 A.D.2d 525, 391 N.Y.S.2d 829 (1977) (where only 4% of stock sold, not constituting working control, premium for control unlawful). Compare Carter v. Muscat, 21 A.D.2d 543, 251 N.Y.S.2d 378 (1964) (9.7% of outstanding stock sold, apparently working control; court relies on fact that stockholders ratified election of buyer's directors at subsequent meeting of stockholders). See, Annotation, \textit{Validity of Agreement in Conjunction with Sale of Corporate Shares that Majority of Directors will be Replaced by Purchaser's Designees}, 13 A.L.R. 3d 361 (1967).}

\footnotesize{\textsuperscript{62} 20 A.D.2d 301, 246 N.Y.S.2d 913 (1st Dept.), aff'd, 14 N.Y.2d 679, 198 N.E.2d 908, 249 N.Y.S.2d 877 (1964).}

\footnotesize{\textsuperscript{63} \textit{Gabriel Indus.}, 22 N.Y.2d at 407, 239 N.E.2d at 707, 293 N.Y.S.2d at 66.}
they were never paid and were subject to the defense of illegality.\textsuperscript{64} The legality of the actions of resigning directors who elect the buyer's nominees to the Board thus depends on the transfer of working control if not an absolute majority of the outstanding stock.\textsuperscript{65}

The S.E.C. has long been an advocate of the notion that control is a corporate asset; in fact, the S.E.C. filed a brief in support of the plaintiff's position in \textit{Honigman v. Green Giant Co.}\textsuperscript{66} at the district court level. The district court, however, was not impressed that there was any violation of state or federal law in the reorganization.\textsuperscript{67}

The S.E.C. Advisory Committee on Tender Offers made in its Report of Recommendations\textsuperscript{68} the following as Recommendation 14:

No person may acquire voting securities of an issuer, if, immediately following such acquisition, such person would own more than 20\% of the voting power of the outstanding voting securities of that issuer unless such purchase were made (i) from the issuer, or (ii) pursuant to a tender offer. The Commission should retain broad exemptive power with respect to this provision.\textsuperscript{69}

Consistent with the provisions of Part V of the Corporate Governance Project,\textsuperscript{70} the ALI has decided not to adopt the provisions of Recommendation 14 for publicly-held companies in its forthcoming Part VI, Transactions in Control.\textsuperscript{71} Part VI is an ambitious and controversial part of the Corporate Governance Project, and it is still under development.\textsuperscript{72} The S.E.C. has had its mind set for some time on "equal opportunity" in the purchase and sale of securities, and it has pursued its

\textsuperscript{64} \textit{id.} at 409, 239 N.E.2d at 708, 293 N.Y.S.2d at 68.
\textsuperscript{65} In the case of a close corporation with no majority stockholder, where the Board of Directors was approached by a buyer wanting majority control, it was held to be a breach of fiduciary duty for the officers and directors secretly to put together a selling group owning a majority of the shares. This group consisted of themselves, their friends and relatives. The selling group was paid $1,000 per share compared to $600 per share book value; a minority stockholder was later offered $225-$250 per share by the buyer. The court gave minority stockholders judgment for the difference between the fair value of their stock before the sale and its fair value after the sale, plus punitive damages of $120,000. \textit{Forinash v. Daugherty}, 697 S.W.2d 294 (Mo. App. 1985).
\textsuperscript{67} \textit{id.} at 766.
\textsuperscript{69} A modified version of Recommendation 14 was incorporated in the Tender Offer Reform Act of 1985 introduced by Senators D'Amato and Cranston but never enacted, S. 1907, 99th Cong., 1st Sess. (1985); \textit{see Comment, supra note 57}, at 120-31. Under the bill, a person acquiring 20\% or more of a class of registered securities could not acquire more than 2\% in any succeeding year except from the issuer or by public tender offer. This is of course quite a different proposition.
\textsuperscript{70} ALI, supra note 2.
\textsuperscript{71} \textit{American Law Institute, Reporters' Study No. 1: Transactions in Control 19-21} (Feb. 22, 1985).
notions despite nonagreement from the courts or even Congress. In the area of tender offers, this mind set has caused the S.E.C. to override the provisions of the Williams Act with respect to pro-rating purchases in an oversubscribed tender offer by including all tendering stockholders rather than just those tendering in the first ten days, as provided in Section 14(d)(6); Chairman Shad and Commissioner Treadway dissented from the adoption of revised rule 14d-8 for that reason. Also, the Commission has now adopted the “all holders” rule following decisions by both the federal and state courts that an issuer engaged in a self-tender might properly exclude a third party offeror from participating. The Commission adopted the “best-price” provision at the same time, but of course all of these provisions only come into play after a tender offer is commenced.

The problems in a tender offer situation are not at all the same as the one we have been considering. In a tender offer, those stockholders who lose out on the control premium are, for instance, those who sell out prior to the announcement of the offer. It is perfectly legal for a tender offeror to buy shares at the prevailing market before the offer is announced and he does not have to identify himself until ten days after the five percent threshold of the Williams Act is reached. The Commission’s goals are not directed towards the problem of the control premium in the sense of the sale of a control block of stock by one owning it. They are pertinent, however, to the related question whether the non-controlling stockholders can be compelled or persuaded by the buyer of an existing control block, with or without the assistance of the seller, to


75. Rule 14d-10 (Equal Treatment of Security Holders) was adopted following the decisions in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) and Unocal Corp. v. Pickens, 608 F. Supp. 1081 (D.C. Cal. 1985) (injunction against offer denied; Congress did not intend to regulate tender offers substantively); Rule 13e-4 was amended at the same time, Amendments to Tender Offer Rules: All-Holders and Best-Price, Release Nos. 33-6653, 34-23421, 51 Fed. Reg. 25,873 (July 17, 1986).

76. Staffin v. Greenberg, 672 F.2d 1196, 1204 (3d Cir. 1982).

77. Securities Exchange Act of 1934, § 13(d), 15 U.S.C. § 78m(d)(1981); 17 C.F.R. § 240.13d-1(1987). There are other creative ways of acquiring stock without complying with the “best price” and “all holders” provisions; see Kelinsky, supra note 57, at 96-97; Segre, supra note 68, at 720-21. These are legal stratagems; there are others, such as “parking” stock with friendly sources that have been much in the press in recent times. The S.E.C. also has under consideration the proposal by the N.Y.S.E. to change its rules to allow listing of non-voting and disproportionate voting common stock. This proposal obviously would also affect the market for corporate control of Big Board companies, see Seligman, Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy, 54 GEO. WASH. L. REV. 687 (1986).
part with their shares at a lesser price per share than that paid for the control shares.

There is no authority for the proposition that the buyer of a control block of stock is obliged to buy the remaining non-control stock.\textsuperscript{78} However, supposing he fully intends to do so from the start, may he pay less per share for the non-control stock?\textsuperscript{79} Current opinion is divided. As to a freeze-out merger following the purchase of control block privately or by tender offer, Professors Brudney and Chirelstein propose an unequivocally negative answer.\textsuperscript{80} Others disagree.\textsuperscript{81} Professor Hamilton opines that the case law "seems to contemplate that result," i.e. that the non-control stock may be bought for less.\textsuperscript{82}

\textit{Sale of All Stock—May a Lower Price Be Paid For Non-Control Stock?}

The question of the two-price structure (high tender offer followed by low freeze-out merger) in corporate tender offers has been much discussed. There has been disagreement over the merits (it eliminates the "free rider" problem) and demerits (it creates a "prisoner's dilemma" for stockholders who do not want to tender but are afraid of being caught up in the back end if they don't).\textsuperscript{83} It has been a purpose and result, among other things, of the second generation state anti-takeover statutes to eliminate two-tier tender offers by requiring the same price to be paid at both

\textsuperscript{78} Doleman v. Meiji Mut. Life Ins. Co., 727 F.2d 1480, 1484 (9th Cir. 1984) ("Such an 'all or nothing' principle has been embraced by no case or commentary of which we are aware"). But see F. O'NEAL & R. THOMPSON, supra note 5, § 4.04 at 25 (courts are moving to require that selling control shareholder "must take effective measures to insure that minority shareholders will receive an equivalent per share benefit").

\textsuperscript{79} This question has a different, and older, pedigree than the questions of premium sharing and equal opportunity which we have been discussing. A good summary is contained in W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS, 683-88 (5th ed. 1980). The editors group the cases under the headings of (1) corporate action, e.g., Commonwealth Title Ins. & Trust Co. v. Seltzer, 227 Pa. 410, 76 A. 77 (1910), (2) sale of corporate office, e.g., Porter v. Healy, 244 Pa. 427, 91 A. 428 (1914), and (3) misrepresentation and nondisclosure, e.g., Upton v. Southern Produce Co., 147 Va. 937, 133 S.E. 576 (1926). See Hill, supra note 29, at 1028-35; Jennings, supra note 29, at 19-29; Leech, supra note 29, at 750-58; Andrews, supra note 25, at 556-61.

\textsuperscript{80} Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 HARV. L. REV. 297, 334-35 (1974); Brudney & Chirelstein, A Restatement of Corporate Freezeouts, 87 YALE L.J. 1354, 1361 (1978) (would apply same rule if control obtained by tender offer).


\textsuperscript{82} Hamilton, supra note 3, at 280.

ends. The United States Supreme Court has recently upheld the Indiana second-generation statute, and at least for companies subject to these statutes, the question may be moot.

Two-tiered tender offers are only superficially similar to the problem of a freezeout of the minority following the private purchase of an existing controlling block. In the tender offer situation, the blended price is theoretically available to all stockholders, and there is not the same strain on the fiduciary duty of the controlling stockholder.

In general, in the absence of nondisclosure or deception, the strongest argument for an equal price for all stockholders is the corporate action theory. It is one thing to say that a controlling stockholder may sell his shares and keep the price. In that situation the minority are arguably no worse off than they were before. The controlling stockholder has only sold something which belonged to him, a controlling block with the power to control the management of the corporation, albeit a power to be exercised as a fiduciary for the corporation and all of the stockholders. However, when the buyer is only interested in unencumbered title to all of the corporation's stock and thereby title to all of its assets and properties, business and good will as a going concern, if the controlling stockholder can deliver that, he is selling something which definitely does not belong to him.

Where no statute or regulation dictates the result, and in the absence of controlling "fair-price provisions" in the acquired corporation's charter, in one way or another the courts have generally tried to give the minority stockholders a price per share equal to that of the existing control stockholders where all of the stock is to be bought. It has been recognized for some time that the majority stockholders are fiduciaries for the minority stockholders with respect to the exercise of the right to control the corporation, but the extent of this duty is not well defined. In a leading case, where the majority stockholders through a corporate reorganization and enforcement of mortgages upon the corporate property

---

84. These are also referred to as post-MITE statutes; see Edgar v. MITE Corp., 457 U.S. 624 (1982), in which a divided Court struck down the Illinois first-generation statute. For an analysis of first-generation statutes, see Note, Supremacy and Commerce Clause Limitations on State Regulation of Tender Offers, 42 A.B.A. L. REV. 492 (1978).


86. W. CARY & M. EISENBERG, supra note 79, at 684-85. See also Commonwealth Title Ins. & Trust Co. v. Seltzer, 227 Pa. 410. 76 A. 77 (1910).
obtained all of the corporation's assets for themselves through a new wholly-owned subsidiary, the Court ruled that these stockholders were holding the stock in the new company pro rata for the old minority stockholders in a direct, not derivative, action.\(^8\)

In the case of a corporation whose sole asset was a valuable piece of real estate, the president was approached by a buyer for the real estate.\(^8\) The president instead negotiated the sale of a controlling block of stock of the corporation, which the president proceeded to acquire by buying up shares.\(^9\) Following the sale of the shares, the new controlling stockholder sold himself the real estate for a purchase price found not to be inadequate.\(^9\) In a direct action by the minority stockholders, the president and those acting in concert with him were found liable to pay the plaintiffs that portion of the secret profit which they would have received if the purchase price for the real estate had been increased by the profits on the stock.\(^9\) This is the "corporate action" theory: that the effect is the same as if the corporation, by corporate action, had sold all of its assets and liquidated, in which case each stockholder, controlling or non-controlling would receive the same consideration per share.\(^9\)

In one case, the court did squarely hold that the seventy percent majority stockholder properly sold his controlling interest to a buyer for $460 per share while minority stockholders were induced by the buyer to sell their shares for $220 per share.\(^9\) The court stated: "The fact that Smith et al. received more for their stock than the minority is no evidence of fraud, since it is generally recognized that the stock of majority stockholders is of more value than that of the minority."\(^9\) The purchase price for the minority stock, which had been suggested by the selling majority stockholder, president and director, was in excess of book value

\(^8\) Southern Pac. Co. v. Bogert, 250 U.S. 483 (1919) (the holders of a majority of the stock of a corporation who dominate its affairs are held to act as trustee for the minority).

\(^9\) Commonwealth Title Ins. & Trust Co. v. Seltzer, 227 Pa. 410, 414, 76 A. 77, 78 (1910).

\(^9\) Id.

\(^9\) Id.

\(^9\) Id. at 415-16, 76 A. at 78-79. In the recent case of Alpert v. 28 Williams St. Corp., 63 N.Y.2d 557, 473 N.E.2d 19, 483 N.Y.S.2d 667 (1984), where the sole asset of the corporation acquired in a two-step, freeze-out merger was an office building, the buyers paid the same price per share for the two-thirds controlling shares and the one-third minority shares. The total price equalled the agreed value of the building. It is doubtful that a lesser price for the minority would have passed muster. See also, American Trust Co. v. California W. States Life Ins. Co., 15 Cal. 2d 42, 98 P.2d 497 (1940); Comment, Corporations: Fiduciary Duty of Directors to Shareholders, 29 CALIF. L. REV. 67 (1940).


($200) and current market ($160-170) per share. However, the crucial fact was as found by the court that the control stockholder had nothing to do, directly or indirectly, with the sale of the minority's stock, which was negotiated directly between them and the buyer. This fact pattern is unlikely to be repeated.

In most cases, there is some interaction between the selling control stockholder and the minority, and this proves fatal to an unequal price. Thus, where the majority connived at informing the minority that a buyer for all the stock was willing to pay $165 per share, a total of $115,500, while in fact the buyer was willing to pay a total of $202,330 and had deposited the difference of $86,830 secretly in an account for the control stockholders, officers and directors, the court held that the secret account must be shared ratably with all stockholders.

Likewise, in Dunnett v. Arn, where the buyers wanted all of the stock of the corporation, this was held to be in substance a corporate transaction, so that where the minority were led to believe that all stockholders were selling for $14.12 per share whereas in fact the majority shares were sold for $15.95 per share, the court held that the minority stockholders must be given an equal share with the majority. However, the court also held that this remedy was not available to minority stockholders unless they sold relying upon the belief that all were being paid the same price. If they knew the true facts and still sold, then that was a voluntary stock sale and not a corporate transaction.

This result is consistent with the notion that a controlling stockholder, knowing of the opportunity to sell the shares at a profit to an acquirer, will not be permitted to buy the shares from a minority stockholder without disclosure, either under the common law or under Section 10(b) of the Securities Exchange Act.

Similar considerations underlie the holdings under statutes allowing

---

95. Tryon, 191 Or. at 174, 229 P.2d at 252.
96. Id. at 175, 229 P.2d at 254.
97. Porter v. Healy, 244 Pa. 427, 434, 91 A. 428, 430 (1914). The court did say, however, that the fund had to be shared because it was paid for immediate control of the corporation through resignations of officers and directors and election of successors. It said that the minority would not have had a cause of action if instead the majority had been able to obtain a higher per share price than the minority were subsequently able to obtain. Id. at 435, 91 A. at 431.
98. 71 F.2d 912 (10th Cir. 1934).
99. Id. at 920.
100. Id.
corporate dissolution at the behest of minority stockholders for oppressive conduct by the majority; these statutes typically give a right to the majority stockholder to avoid dissolution at its option by buying the minority stock at its "fair market value." In such a situation, where the buyer is already in control of the corporation, it has been held that the value of the minority shares should not be discounted for the fact that they are non-controlling since they are hardly worth less to the purchaser due to that fact.\textsuperscript{103}

The decision of the Delaware Supreme Court in \textit{Rabkin v Philip A. Hunt Chemical Corp.},\textsuperscript{104} illustrates the difficulties the courts have in dealing with this issue of a lower price for the minority. There Olin Corporation had purchased 63.4\% of the outstanding common stock of Hunt from an existing majority stockholder, Turner and Newall Industries, Inc., at $25 per share.\textsuperscript{105} The agreement between Olin and Turner, at Turner's insistence, provided that if Olin acquired the minority stock of Hunt within one year after the Turner sale, the minority would be paid at least the same value as the $25 paid Turner.\textsuperscript{106} The testimony of Olin's chief executive officer was that this commitment "meant nothing,"\textsuperscript{107} an inaccurate assessment as it turned out. Fifteen months later, Hunt was merged into Olin in a cash-out merger in which the Hunt minority were paid not $25 but $20.\textsuperscript{108} A special Committee of the Hunt outside directors were informed by their financial advisor, Merrill Lynch, that $20 was fair to the minority from a financial standpoint, but that the range of values for the common stock was probably $19 to $25 per share.\textsuperscript{109} The state supreme court reversed a decision by the Court of Chancery dismissing a minority stockholders class action challenging the merger and held that the complaint stated a good cause of action and that the plaintiffs would not be relegated to their appraisal remedy in the circumstances.\textsuperscript{110} The court did not hold that Olin had a fiduciary duty to merge within a year and pay the $25 per share price,\textsuperscript{111} only that the

---

\textsuperscript{103} Johnson, 227 Kan. 495, 608 P.2d 908 (1980) (Kansas law, nondisclosure of buyer for all stock at profit); Loss, \textit{supra} note 74, at 818-29.
\textsuperscript{105} Rabkin, 498 A.2d at 1101.
\textsuperscript{106} Id.
\textsuperscript{107} Id. at 1106.
\textsuperscript{108} Id. at 1102.
\textsuperscript{109} Id. at 1103.
\textsuperscript{110} Id. at 1106.
\textsuperscript{111} Id. at 1106-07. See Davis, \textit{Judicial Review of Fiduciary Decisionmaking — Some Theoreti-
complaint sufficiently alleged acts of unfair dealing.\textsuperscript{112} In answer to Olin’s argument that it had no legal obligation to effect the cash-out merger during the one year period, the court replied simply that “inequitable conduct will not be protected merely because it is legal.”\textsuperscript{113}

What case law there is accepts the proposition that the price paid by an acquirer in initially obtaining a control block of shares is not controlling in a subsequent freeze-out merger appraisal proceeding, since more than the market price for stock is often paid for control.\textsuperscript{114} Furthermore, the Delaware Supreme Court has held that in a short-form merger cashing out five percent minority stockholders, dissenting stockholders claiming their appraisal remedy were entitled only to going concern value of $254.40 per share (at least more than the $125 recommended to management by Morgan Stanley or the $150 offered in the merger), dismissing arguments that appraisals of the corporation’s assets showed a liquidating value of $670 per share.\textsuperscript{115} The court thus rejected the plaintiff’s arguments that they were entitled to value based on what the company could bring in a sale of all the stock to an outsider.\textsuperscript{116}

None of this changes the situation. If the selling control stockholder has in his pocket an offer to buy the whole of the corporation’s stock or assets for a given price, the courts should not allow him to freeze out the minority stockholders at any lesser price, \textit{Bell v. Kirby Lumber Co.}\textsuperscript{117} notwithstanding.\textsuperscript{118} What he cannot do directly, he should not be al-

\begin{flushleft}
\textsuperscript{112} \textit{Rabkin}, 498 A.2d at 1105.

\textsuperscript{113} \textit{Id.} at 1107 (citing \textit{Schnell v. Chris-Craft Indus.}, 285 A.2d 437 (Del. 1971)) (management may not advance date of stockholders meeting to obstruct dissenting stockholders engaged in proxy contest).

\textsuperscript{114} \textit{See, eg.}, \textit{Gibbons v. Schenley Indus.}, 339 A.2d 460, 468 (Del. Ch. 1975); \textit{In re Olivetti Underwood Corp.}, 246 A.2d 800 (Del. Ch. 1968). In \textit{Gibbons}, a control block had been bought at $53.33, with an obligation to offer the minority the same price. Following a tender offer to the minority at $53.33, in a subsequent cash-out merger appraisal proceeding, the court held that the $53.33 figure was not the floor and fixed value at $33.86 per share. \textit{Cf.} David J. Green \& Co. v. \textit{Schenley Indus.}, 281 A.2d 30 (Del. Ch. 1971).


\textsuperscript{116} \textit{Bell}, 413 A.2d at 142.

\textsuperscript{117} \textit{Cf.} Weinberger, 457 A.2d at 713 (“But elements of future value...known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered.”); \textit{In re Creole Petroleum Corp.}, 3 DEL. J. CORP. L. 606 (1978) (100% weighting to asset value in appraisal proceeding where intermediate nationalization of assets contemplated); \textit{cf.} Universal City Studios v. Francis I. duPont \& Co., 334 A.2d 216 (Del. 1975).
\end{flushleft}
ollowed to do indirectly by selling out and having the buyer freeze out the minority for less.

The problem is well exemplified by the *Rabkin* case. The buyer is not obliged to buy all shares, and if he says he wants only the control shares, then we must allow the control stockholder to sell to him. But the control stockholder must be sure of the buyer's representations; if the facts are such that he should be aware that the buyer's real intention is to squeeze out the minority, then the corporate action theory should come into play. A one year period has been suggested as a rule of thumb as to what constitutes an integrated acquisition.119 The experience of the *Rabkin* case demonstrates that this is too short, and the question should be treated as one of fact. Five years would be more realistic for a presumption of integration.

**Conclusion**

We have passed the point where it can be reasonably questioned that in general, in the absence of looting or bare sale of office or corporate opportunity, a controlling stockholder can sell his shares for whatever they will bring without any obligation to share with the minority or obtain an equal offer for them.

However, where an existing controlling stockholder has reason to know that the buyer at the outset wants to buy substantially all of the corporation's outstanding stock or assets, he is in a different position. He need not sell his own shares at any price not entirely satisfactory to him. However, he cannot properly sell his controlling interest and turn over control of the Board of Directors and the corporation to a buyer who he knows will cash out the minority for a lesser price.

---