Corporate Control and the Corporate Asset Theory

Richard L. Beatty
INTRODUCTION

Since the corporation has become the institution responsible for the bulk of American industrial production, its importance cannot be over-emphasized. In 1933, Mr. Justice Brandeis commented that:

Through size, corporations, once merely an efficient tool employed by individuals in the conduct of private business, have become an institution—an institution which has brought such concentration of economic power that so-called private corporations are sometimes able to dominate the State. The typical business corporation of the last century, owned by a small group of individuals managed by their owners, and limited in size by their personal wealth, is being supplanted by huge concerns in which the lives of tens or hundreds of thousands of employees and the property of tens or hundreds of thousands of investors are subjected, through the corporate mechanism, to the control of a few men. Ownership has been separated from control, and the separation has removed many of the checks which formerly operated to curb the misuse of wealth and power. And as ownership of the shares is becoming continually more dispersed, the power which formerly accompanied ownership is becoming increasingly concentrated in the hands of a few.

Thus, the decisions made by corporate management have a profound effect not only upon employees directly concerned, but also upon the whole of our society. For this reason we should be vitally concerned that the corporate institution is run not only at maximum efficiency in terms of profit to the corporation, but also that it pursues a course of conduct that is most beneficial to the entire society which it serves.

However, corporation law has in many areas failed to recognize this need. As Professor Berle points out, corporate law has evolved from the time when corporations were relatively small and private, and has been directed primarily toward the protection of the property interests of minority stockholders. Although the attention given to this area has been deserved, other important areas have become wastelands of conflicting rules of case law. One of the most important of such areas is that of corporate control.


See, e.g., Revised Codes of Montana, 1947, §§ 15-902, 908. (Hereafter Revised Codes of Montana will be cited R.C.M.) In order to secure uniform corrective legislation, the federal government, acting under its power over interstate commerce and over the mails, passed the Securities Act of 1933, 48 Stat. 74, 15 U.S.C. § 77(a) et seq. (1958), and the Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. § 78(a) et seq. (1958). These acts generally apply only to large "quasi-public" corporations, but the main purpose of the Acts is to protect the public as investors in corporate securities.
"Corporate control," in its broadest sense, is power over corporate conduct. This power may be exercised either through the ability to choose corporate directors and management, or through influence over the decisions made by such officers. Because the power to choose directors is generally related to the voting shares of stock issued by the corporation, control may initially appear to be a property right, inherent in the stock. It may be argued that the election of the directors is a function of the corporation that has been delegated to the stockholders and is exercised by the votes of the shares. The owner of the shares acquires this power to elect directors in proportion to the amount of stock he owns. Since control power is majority power under most corporate codes, if a stockholder holds a majority of the stock he may be said to "own" control as a part of his property right in the stock.

Another view of control is that although it is a private function, it has substantial public responsibilities, and as such, is a corporate asset. Professor Berle first advanced this concept in 1932. Under this view, the holder of control is not so much the owner of a proprietary right as an occupier of a power position. The reason for this is the very nature of our corporate codes. Each state grants the corporation the power to choose its board of directors, and requires that this be accomplished through the votes of the stockholders. Since a requirement of unanimity is impractical, a "corporate democracy" is allowed, and the majority may elect and prevail over the minority. Berle asserts that this is essentially nothing more than a device to assure continuity of management—a matter of corporate convenience—and therefore it is corporate power although it is exercised by individual stockholders. Thus, although a majority stockholder has the capacity to control the corporation through the votes of his stock, he does not own this control in the same sense as he owns his right to participate in dividends or liquidation. His control is extraneous and occurs as a result of the corporation's power to choose a board of directors by less than unanimity.

Professor Bayne concurs with Berle that control is a corporate asset but expands upon the concept from the fiduciary aspect. Since a majority stockholder exercises control over all the corporation's affairs, he is in fact controlling some assets belonging to the minority stockholders. Bayne argues that the holder of control is therefore in a fiduciary custodial relationship to the minority stockholders and is accountable to them.
This custody is an assumption in trust of a valuable item, with all the appurtenant duties and rights. Therefore, according to Bayne, control is the dominion over another's goods and the duties and rights appurtenant to such dominion. Reasoning under this broad concept, he maintains that control is actually a corporate office, rightfully belonging within the corporate entity with the management and shareholders and subject to all the fiduciary duties and responsibilities inherent in this position.

The useful applicability of these two divergent views cannot be fully appreciated unless they are applied to situations where control problems occur, and the results are compared. The location of control itself is a large factor in determining whether either theory is workable.

THE LOCUS OF CONTROL

Under normal circumstances, control is closely connected with the voting shares of stock, although situations may occur where it is totally unrelated to such shares or votes. There are five general situations that illustrate the location of control:

1. Where the holder of control holds 100 percent of all voting stock.
2. Where the holder of control holds more than fifty percent of all voting stock.
3. Where the holder of control holds less than a majority of all voting stock, but holds a large minority block, and the majority is scattered.
4. Where the holder of control holds a small minority block, but also has a relationship with the board of directors whereby they will act in accordance with his wishes.
5. Where the holder of control holds a negligible amount of stock, or even none, but is in a position to influence corporate decisions nonetheless.

Under the first two situations, in most cases, the control is carried purely by the voting power of the stock. This is compatible with the present general system of corporate law which allows the majority of voting stock to choose the corporate directors.

However, the problem in locating control arises as one progresses down the scale.

The third situation is one in which control is not carried by the majority of the stock. Rather it is found in a combination of the minority block vote and the holder's capacity to secure the necessary complement.
of votes from the scattered majority by use of the corporation's proxy machinery. For example, if the holder of control owns thirty percent of the outstanding voting shares, and there are several thousand other stockholders holding less than one percent of the shares each, he can easily acquire the requisite fifty-one percent vote necessary to elect his slate of directors by use of the proxy. Most small investors trust the judgment of corporate management, and will follow the slate recommendation as found in the proxy. The control then becomes a combination of the minority thirty percent individual control plus the overwhelming probability that the scattered stock will acquiesce in the recommendation. Although our present corporate codes do not recognize the legitimacy of such control, most businessmen and courts realize this kind of control is a fact of life. The United States Congress, in the Investment Company Act of 1940, provided that there is a rebuttable presumption that twenty five percent of voting stock carries control.\textsuperscript{18}

In the fourth situation, it is even less apparent that control is connected to the ownership of voting stock. This is frequently called "working control"\textsuperscript{19} and is one of the most problematical areas. Here the bulk of control is lodged in the control holder's ability to persuade corporate management to accept his suggested slate of directors or business decisions. The power carried in the stock is subordinate and incidental, although it may be used as one of many tools of persuasion. Such control probably occurs with greater frequency in the large corporate entities in which a substantial percentage of the outstanding stock is not held by any one person or group. Control of this sort is not expressly recognized in corporate codes or by Congress, and probably occurs less frequently than the other types mentioned.

In the fifth situation, control is dependent almost solely upon the personal influence that the holder has over corporate management, without regard to any stock he may hold. Such control is always exercised \textit{sub rosa}, as it is hardly recognized even as a fact, and when found is considered to be most reprehensible. It is difficult to estimate the frequency of occurrence of this type of control, due to its inherent secrecy. Whether it is exercised by a lone ultimate consumer or a crime syndicate, the control is no less absolute.

The above examples illustrate the gamut of situations in which control problems may arise. As the percentage of voting stock owned by any one shareholder becomes smaller, the less control depends upon such stock for its power, and the more the holder must rely upon his extraneous personal relation with the board of directors or management.

CONTROL CONCEPTS RELATED TO CONTROL LOCUS

The concept that control is a property right inherent in stock ownership is arguably applicable in the situation where an absolute majority

\textsuperscript{16}Berle, \textit{The Price of Power}, supra note 10, at 630.
of voting stock is held. If the control holder has absolute majority, his control is usually not based upon any purely personal power. In such case, control may be said to be inherent in the stock much the same as the right to participate in dividends or liquidation. By such reasoning, it is arguable that control in this situation is neither a corporate asset nor a corporate office.

However, this concept is unworkable in many situations where control problems arise, since control by definition does not require absolute majority stock ownership, and may be equally absolute and effective through outside influence over the decision-making function of corporate management. When the holder of control owns less than an absolute majority, his control is due partly to voting power and partly to outside factors such as the distribution of the majority of the stock, his personal relations with the directors or management or lethargy in the majority shareholders. Although he may have effective or practical control, the corporate codes do not provide for control existing anywhere but in the majority of shares. Thus, the concept that control is a property right is wholly inadequate in many corporate situations.

Professor Berle's thesis that control is actually a corporate asset is a more useful concept in the varied situations which may arise. It is equally applicable to control through stock ownership and to control through personal influence. If control is a corporate asset, it must be treated as property of the corporation by whomever happens to be the holder at the time. The broad fiduciary duties incumbent upon one entrusted with such an asset facilitate the solution of any problems arising with respect to control.

Despite the fact that the corporate asset theory is more advantageous than the property right doctrine, it has received a good deal of criticism from writers and courts. The principal criticism advanced by property rights theorists is that application of the corporate asset concept would interfere with stock sales and prevent the holder of controlling shares from realizing the full market value of his shares. The sale of a block of controlling shares usually carries with it a substantial premium price paid for the transfer of control. The purchaser's willingness to pay a premium springs from an expectation of returns which are derived from the control, and that this premium is part of the value of the control shares. Under the corporate asset theory, this premium is paid for a corporate asset and belongs to all the shareholders ratably.

Another criticism is that the corporate asset theory is inapplicable since all transfers of control are not reprehensible. It is argued that the
theory assumes the purchaser will pay the premium to later exploit the corporation and that his directors therefore will not exercise their management powers in the interests of all the stockholders. The critics contend that such is not always the case, and that the power may be used to improve earnings and management, thereby benefitting all the stockholders. The restriction on the sale of control by application of the corporate asset theory could therefore harm more corporations than it helps, and the application of such a broad rule would impede desirable transfers.

A third criticism is that application of the corporate asset theory would discourage majority investments by reducing the incentive to make such investments. The purchaser would be reluctant to invest in a control block of shares if he could not later himself sell it at a substantial premium as a return on his investment.

Although all these criticisms are in a sense legitimate, further inquiry will demonstrate that the application of the corporate asset theory is not so detrimental as the critics would make it appear. In answer to the first criticism, the holder of control is not deprived of any value inherent in the shares themselves. He realizes the same full “investment” value on a sale as any other stockholder would, but is not allowed to retain a profit from selling something other than his stock unless he shares this profit with all the other stockholders.23 Since the buyer may not pay the control holder a premium and thereby gain 100 percent of the dividend rights on a purchase of eighty percent of the stock, neither should he be allowed to pay the holder of control a premium to gain 100 per cent of control for eighty per cent of the stock. To do so would be to allow the seller to retain a profit for selling the other stockholders’ ratable share of a corporate asset. The buyer should therefore be required to prorate to all of the shareholders any sum greater than the seller’s proportionate interest in the corporation. If the buyer does pay the seller more than his proportionate share of the total value of the corporation, although the amount he pays may be correct, he is paying part of it to the wrong party. If the seller retains this premium, he denies the other shareholders their right to this amount. Since the premium belongs to all the shareholders, it belongs to the corporation and is therefore a corporate asset.24

The corporate asset theory does not necessarily assume that all control transfers are reprehensible, but is merely a safeguard against those

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23For example, if the control holder has less than 100 per cent of all the outstanding stock, but the purchaser buys 100 per cent of the stock, the total price paid is the legitimate value of the corporation’s assets to the buyer. These assets include physical assets, receivables, cash, goodwill and control. In the 100 per cent purchase, the buyer pays each individual stockholder his proper proportion of the total, including a prorated amount for control. If the control holder has eighty per cent of the outstanding stock, he receives eighty per cent of the total value of the corporation to the buyer, and eighty per cent of the amount paid for control. Similarly, if the buyer only purchases working control or majority control, the basic equities are unchanged. The fact that only a part, rather than the whole of the corporation has been purchased, does not alter the respective rights of each individual stockholder. As each has a proportionate share of the whole, each has a proportionate share of the part purchased.

24For a more complete explanation, see Bayne, supra note 11, at 64-65.
that in fact are. Its application does no harm to the honest entrepreneur who takes over control for the purpose of improving the corporation and his interest. The corporate asset theory allows him everything that is due to him, while at the same time it removes the temptation for a quick profit which would benefit the holder individually, but would be a detriment to other shareholders and the public at large.

The same counter-argument may be applied to the assertion that the corporate asset theory would discourage majority investments. So long as the investor makes no attempt to appropriate property which in equity should belong to all the shareholders, he has nothing to fear from the corporate asset theory. Its application would, however, encourage minority investors by insuring the safety of their investment and affording them a greater means of protection from the occasional unscrupulous majority investor.

**ABUSE OF CONTROL**

Since the holder of control, by definition, exercises the final authority in corporate decisions and conduct, the manner in which it is exercised is of great concern. Since the holder of control in many cases is also an officer in the corporation, the danger of an exorbitant salary is always present. Although the executive is entitled to a "living wage" the problem of overpayment may frequently occur. The dispensation of jobs to unqualified family or friends may be an abuse of control to the detriment of the other shareholders. The holder of control is in a position to grant favorable, non-competitive contracts to other businesses in which he may have an interest, and is able to exploit a "corporate opportunity" for his own personal benefit. Another area open to abuse by the holder of control is exploitation of a "tax loss" corporation.

But perhaps the largest number of instances of abuse of corporate control, and the one which has raised the most provoking litigation, is the outright sale of control through the transfer of shares or otherwise.

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2A corporate opportunity may take many forms, but is most generally found as a contract or offer which was made to or intended for the corporation. It is usually something which the corporation would handle in its course of business as a part of its profit making scheme, although other types of offers such as an offer of merger also qualify. Therefore, when an executive in a corporation accepts the offer in his individual capacity, or subverts the contract for his personal profit, his conduct is a breach of a fiduciary relationship.

6INT. REV. CODE OF 1954, §§ 381, 382, allows a tax advantage in the form of an operating loss carryover that inures to the benefit of the acquiring corporation. When the outstanding shares of the acquired corporation bring a price which takes into account the value of the tax advantage, this may be described as a "non balance sheet asset". Thus, the holder of control could elect to sell his corporate control to a purchasing corporation who wanted the benefit of his corporation's losses for tax purposes, and might command a premium price for the existence of these losses. This could act as a detriment to stockholders in the acquired corporation, as it is doubtful that the acquiring corporation would seek to improve earnings and hence their dividends for a time. For a further explanation, see Jennings, *Trading in Corporate Control*, 44 Calif. L. Rev. 1, 15-16 (1956).

2See, Berle, "Control" in Corporate Law, 58 Colum. L. Rev. 1212 (1958); Berle,
Because most corporate codes are inadequate to cope with this problem, it has been incumbent upon the courts to decide the issue. This has produced a variety of conflicting and confused rules.

SALE OF CONTROL

"Old Majority" Theory of Sale of Control

Most courts once accepted the position that the holder of control was free to sell his shares to any person, at any time, at any price, and that he owed no fiduciary duty to the corporation or other stockholders. This was true even when the holder was also a corporate officer, so long as he was dealing with his own stock. This broad freedom has generally been qualified by the traditional restrictions that the sale of control is improper where the holder 1) negligently relinquishes control to looters, 2) fraudulently conspires with purchasers to relinquish control in return for a premium payment, and 3) receives a premium for the sale of a corporate office.

Keely v. Black was one of the early cases which allowed the seller of control to keep his premium even though at the time of sale he was president and a director of the company. The court reasoned that the seller "was not dealing with the property of the company, but with his own, the title to some of which he derived from other stockholders." Stanton v. Schenck, which was pending when Berle first raised his theory of control as a corporate asset, is another such case. There, the seller of control overcame an allegation of conspiracy and breach of fiduciary duty, and was allowed to keep a premium on the sale of her stock. The court found that there was no abuse of power and position and that no fiduciary duty was breached by the directors since "[I]f it is granted that a director may freely sell his own stock, it must follow that he may benefit from the advantage due to his holding of an exceptionally large block of stock." In a derivative suit based on breach of fiduciary duty


*Berle, "Control" in Corporate Law, supra note 3.

*Stevens, Private Corporations (2d. ed. 1949); 3 FLETCHER, CYC. CORP. § 900 (perm. ed. 1965).

*91 N.J. Eq. 550, 111 Atl. 22 (1920).

*Id. at 523, 111 Atl. at 23.

*140 Misc. 621, 251 N.Y. Supp. 221 (Sup. Ct. 1931).

*See, Berle and Means, op. cit. supra note 8, at 243-44.

by failure to properly investigate parties to whom he sold control, the appellate court in *Levy v. American Beverage Corp.* allowed the seller to retain his premium.\(^3\) The court found that there was no inference of actual fraud, constructive fraud or negligence. A further ground was that the plaintiff's entire complaint was based upon breach of fiduciary duty, but a controlling stockholder is not a fiduciary in the sale of his holdings.

The latest case adhering to this theory is *Tryon v. Smith.*\(^5\) The action was brought on the theory that the seller had breached a fiduciary duty to the stockholders by concealing from them the knowledge that he and his associates were receiving over twice the amount for their control shares as the other stockholders were to receive for the sale of their stock. The court denied recovery and stated that there was no fiduciary relationship between the stockholders so far as the sale of individual stock was concerned and that there was no duty to apprise the minority stockholders of the premium offer. It was also held that the existence of a premium was not evidence of fraud since it is generally recognized that the stock of majority stockholders is of more value than that of the minority.\(^6\)

These cases illustrate that at least some courts, from the period of 1920 to 1951, still adhered to the strict property right doctrine of control. However, other courts in other cases have withdrawn from this position, and this former majority rule may well now be the minority.\(^4\)

**The Sale of Office Limitation**

Transfer of control has been disallowed by courts when it was apparent that the transfer amounted to nothing more than a naked sale of corporate power. One of the earliest cases to adopt this rule was *McClure v. Law.*\(^4\) The seller was a former president and director of an insurance company who delivered control to a stranger. Without purporting to sell any corporate shares, control was transferred by procuring resignations of the directors and substituting a new board, which then looted the corporation. The action was brought by the receiver of the insolvent corporation to recover payments made to the seller on the theory of breach of fiduciary obligation. The court accepted this theory, stating that a fiduciary obligation was owed to the corporation for official acts. Since the election of directors and transfer of the management and property of the corporation were official acts, whatever money the seller received from such acts was derived by virtue of his office, and he should account to the corporation for that amount.\(^2\) Under facts such as these, the concept of control as a property right is totally inapplicable, since the trans-
fer of control was in no way connected to any stock. The corporate asset theory, however, is easily applied.43

Another case which barred the sale of office was Porter v. Healy.44 However, in this case, control was transferred by the sale of an absolute majority of outstanding voting stock. A separate fund was set aside and paid to the sellers for control. The court rejected the sellers' contention that the fund was part of the price for the shares, and treated it as secret consideration paid for the purpose of gaining immediate control of the board of directors, that is, compensation for sale of the office. This holding extended the rule of the McClure case to apply to transactions transferring control where shares of stock were also exchanged. Although it was relatively simple to segregate the amount paid for the stock itself from the amount paid for control, the difficulty of this computation in other transactions has raised objections to the corporate asset theory.45

These cases illustrate that where a separate payment is made for the sale of corporate directorships, whether accompanied by a sale of stock or not, the seller is liable to account to the corporation or other shareholders. Utilizing the corporate asset theory in these situations is helpful, since it clearly shows that any payment made over and above the actual "value" of the shares must go into the corporate treasury, or at least through such treasury to the other shareholders.

Negligent Sale to Irresponsible Buyer Limitation (Looting Cases)

Another area where courts have refused to allow the seller of control to retain premium benefits of his sale is where control is transferred to persons who later looted the corporation, and the sale was made under circumstances putting the seller on notice of the probability of such injury to the corporation. The leading cases in this field involve investment companies which are particularly susceptible to looting due to liquidity of assets.

One of the earliest cases imposing liability for transfer of control to irresponsible purchasers was Bosworth v. Allen.46 The former directors of a savings and loan association sold their shares to outsider purchasers for an amount in excess of the withdrawal value of the shares. The directors resigned, and the purchasers took over and looted the company. The receiver brought action on the dual theories of sale of office and tortious transfer of control to persons whom the defendants knew to be irresponsible. The court granted relief holding that the sellers were liable to account to the corporation not only for the money or property in their hands, but also for the damages resulting from their misconduct. The doctrine of the McClure case was utilized in support of imposition of

43See also, Field v. Western Life Indemnity Co., 166 Fed. 607 (N.D. Ill. 1908), aff'd sub nom. Moulton v. Field, 179 Fed. 673 (7th Cir. 1910), cert. denied, 219 U.S. 586 (1911), for a similar situation reaching a similar result.
44244 Pa. 427, 91 Atl. 428 (1914).
45The problem of valuation is discussed at length in Hill, The Sale of Controlling Shares, 70 Harv. L. Rev. 986 (1957).
46168 N.Y. 157, 61 N.E. 163 (1901).
liability for the premium, and the tort theory of liability for damages.

In *Insuranshares Corporation v. Northern Fiscal Corp.*, controlling shares totaling twenty-seven per cent of the corporation's outstanding stock were sold and an action was brought by the company against the sellers for damages sustained from the subsequent looting. The court allowed recovery on the tort theory of negligence, and imposed a duty upon the sellers to make a genuine effort to investigate the purchaser and his motives for fraud before making the sale. Although this reasoning has been criticized, when the absolute power of control is considered, it does not seem to be an undue burden upon the seller to make such investigation. The standard is not one of strict liability, but of reasonableness only.

An investment company case some forty years after *Bosworth*, and one year after *Insuranshares* combined the doctrines of these two cases and imposed liability on the sellers for both premium and damages. This has been criticized as double recovery and improper except as a punitive sanction where the seller's action are flagrant and fraudulent. However, if the corporate asset theory is applied, such is not the case. The proceeds of the sale of the office, a corporate asset, rightfully belong in the corporate treasury. Any premium above the value of the stock sold is a corporate profit. Additionally, if the seller is negligent in transferring control to the actual detriment of the corporation, the corporation should be allowed to recover for such tortious conduct to the extent of the damage incurred. The two acts are separate and distinct. The transfer of control may be fully legitimate and not be detrimental to the corporation. However, the asset transferred is rightfully the corporation's, and any profit therefrom is corporate profit. The latter act, as established by the foregoing cases, is an illegal, tortious act for which the corporation has a right to be compensated. Moreover, the theories of recovery are distinctly different.

The foregoing cases illustrate that there is liability separate and apart from any stock sold if control is transferred to irresponsible persons without an adequate investigation by the seller. Unlike the recovery of a premium, this recovery is based upon tort liability and actual damages. It may be imposed separate from and in addition to recovery of the premium.

**The Corporate Opportunity Limitation**

It has been held that one in a fiduciary relationship to the corpora-
tion may not reap the benefits of a "corporate opportunity," by subverting such opportunity to his private use.

In *Irving Trust Co. v. Deutsch*, the corporation's opportunity to take over a bankrupt corporation holding patents and manufacturing rights necessary to the business of the defendant president's corporation was appropriated by the individual defendant and some associates. The defendant and associates later sold the controlling shares of the bankrupt corporation at a large profit. Action was brought by the receiver of the defendant's corporation against the defendant to account for the profits under the theory of violation of a fiduciary duty. The court allowed recovery, holding that directors of a solvent corporation may not take over a corporate contract for their individual profit. "If the directors are uncertain whether the corporation can make the necessary outlays, they need not embark upon the venture; if they do, they may not substitute themselves for the corporation any place along the line and divert possible benefits into their own pockets."

The court in *Guth v. Loft, Inc.*, found a similar rule. In that case, the president of a corporation selling and manufacturing candy, syrups and beverages appropriated his corporation's opportunity to acquire ninety one per cent of the outstanding stock of the then insolvent Pepsi-Cola company. He did not inform the other directors of the opportunity, used his own corporation's assets to produce Pepsi-Cola, and in turn sold the syrup to his corporation. The corporation brought suit asking that the shares of Pepsi-Cola held by the president be transferred to it. The court granted relief, holding that if an officer of a corporation acquires an advantage rightfully belonging to the corporation, the law charges this interest with a trust for the benefit of the corporation, and denies the officer all benefit or profit. The court went on to say:

> The rule . . . does not rest upon the narrow grounds of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation.

Another case illustrating this principle is *Commonwealth Title Ins. and Trust Co. v. Seltzer*. The directors were approached by another corporation wishing to purchase their corporation's assets. They did not disclose this offer, but quietly bought enough stock to acquire control, negotiated privately with the prospective purchaser, and then sold the control at a premium. After the sale of control, the directors acted as the purchaser's agents and participated in the sale of the corporation's assets to the purchasing corporation. A suit was brought to impress a trust upon the excess profits taken. The court held that although the price received by the corporation for the assets was adequate, the special

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[473 F.2d 121 (2d Cir. 1934).]
[5 M Id. at 124.]
[523 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939).]
[53 Id. at 510.]
[54 39 Pa. 410, 76 Atl. 77 (1910).]
profit received on the sale of the controlling shares was a profit received from the sale of corporate property, not a separate transaction.

These cases illustrate yet another ground upon which courts have denied the seller of control, or one in the fiduciary relationship to the corporation, the benefits of his bargain, whether or not there are actual damages present.

Transition Case—The Perlman v. Feldmann Decision

The modern case that has perhaps raised the greatest furor regarding the sale of corporate control is Perlman v. Feldmann. The defendant Feldmann owned or controlled thirty-seven per cent of the outstanding shares of Newport Steel Corporation. The remaining shares were owned by several thousand other stockholders, who had never formed a voting block for the purpose of control. Feldmann, in addition to being controlling stockholder, was also chairman of the board of directors and president of the company. Newport was a steel manufacturer selling to end users, but prior to the transfer of control was a marginal company. As a result of the Korean conflict, steel was in short supply and a grey market existed. A syndicate was formed by some steel users for the purpose of purchasing Feldmann's stock in order to insure a continuing source of steel, and Feldmann was aware of this. He sold the thirty-seven per cent control block to Wilport Co., the syndicate, for $20.00 per share, although the over-the-counter price at the time was not over $12.00 per share. Feldmann transferred control by delivering resignations of all the members of the board of directors and installing in their places nominees designated by Wilport. This took place without notice to the other shareholders. A derivative action was brought by certain of the outside shareholders against Feldmann on the theory that the transaction was not a mere sale of stock, but an unlawful sale of control. The lower court gave judgment for Feldmann. The court of appeals reversed, and remanded the case to the district court with the order that the burden of proof as to the value of the stock as an investment and the value of the control be shown by the defendant. The court ruled that the premium should be shared by the defendant with the plaintiffs to the extent of their respective stock interests, and that the plaintiffs were entitled to recover individually. Judge Swan dissented on the ground that the theory of recovery should have been sale of a corporate asset and the recovery, if any, should go into the corporate treasury.

The language of the majority is so broad that it is difficult to ascertain upon what basis the recovery was predicated. The case could be treated as analogous to the looting cases, but since no reference is made to these cases, it may be that the court intended to make the opinion broad enough to encompass a wider variety of situations. It could also be analogized to the sale of office or corporate opportunity cases on its facts. A court could reason that since there was a rising market, the fu-
ture profits the corporation could have made were sacrificed for Feldmann’s quick profit. The rationale of the Porter case, that the amount of payment above the value of the shares belonged to the corporation as a payment for the sale of an office, could also have been used. The result is justified by the need to protect the corporate institution in such situations. Since the corporate asset theory is workable here, it should have been utilized to avoid confusion as to how far the court was purporting to extend its ruling. Judge Swan’s dissent, requiring an accounting to the corporation for that portion of the price paid for the stock which represented a payment for voting to elect new directors, is at the heart of the corporate asset theory. As Professor Berle pointed out, it makes little difference whether the premium is distributed directly to the shareholders, or taken into the corporate treasury and distributed from there. The broad and sometimes confusing language of this decision has influenced a number of courts and has produced varied decisions. Recent cases have not served to clarify this point of law.

**RECENT CASES**

In *Essex Universal Corp. v. Yates* the president and chairman of the board of directors of Republic Pictures owned 28.3 per cent of its voting stock. Essex negotiated a contract with him for the sale of his interest at a price roughly two dollars above the market price, which amounted to over two million dollars in premium. The transfer of control was to be effected by the seriatim resignation of eight of the fourteen directors. The defendant president repudiated the contract and Essex sued for breach. The district court rendered a summary judgment for the defendant and the court of appeals reversed. The sole question considered by the court of appeals was whether the provision for seriatim resignations rendered the contract illegal and unenforceable. The court held not, but for various reasons. All the judges agreed that although a sale of office is illegal, it is a sale of office only if the majority consent of the stockholders is not obtained. The court felt that a majority was present.

*a* Porter *v.* Healy, supra note 44.
*b* Perlman *v.* Feldmann, 219 F.2d 173, 179 (2d Cir. 1955) (dissenting opinion). The problem of stock valuation here was more difficult due to the absence of a separate premium fund. The difficulty lies in segregating the legitimate value of the stock sold from the amount paid for control. The considerations of market value, book value, liquidation and future earnings may enter into the computation. In *Feldmann*, the shares were selling over the counter below $12.00; the book value was $17.03, and the Wilport syndicate paid $20.00 per share. The court found that the excess over $14.67 per share plus interest was paid for control. 219 F.2d at 175. Once the true value of the stock has been determined, and the premium established, there is no justification for the seller being allowed to retain any excess over this amount. See also, Leech, *Transactions in Corporate Control*, supra note 29, at 819-820; Jennings, *Trading in Corporate Control*, supra note 28, at 37; and Hill, *The Sale of Controlling Shares*, supra note 45, at 994-96, for an extended discussion of the factors involved.

*c* Berle, *The Price of Power*, supra note 10, at 639. The majority and dissent seemed to think the manner of distribution was quite important. Although it makes little difference, this could account for the majority’s hesitation to adopt the corporate asset theory by name.

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

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clearly with the consent of fifty per cent of the stock and equivalently with 28.3 per cent, so the sale here was legal. However, Judge Friendly felt that if anything less than fifty per cent of the stock gave permission, the sale would be illegal, although the transfer on its face would be legal. The court went on to state a general rule: "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. In other words, there was no impropriety per se in the fact that Yates was to receive more per share than the generally prevailing market price for Republic stock." This rule was qualified by citations to the "looting cases" of Gerdes and Insurshares, but as the court could find no threat to the interests of the corporation or its shareholders in the instant case, it concluded that the seller could keep the premium. The majority rule is that, absent any detrimental effect to the corporation or its shareholders, the payment of a premium is legitimate if made in conjunction with consent by majority stock ownership or its equivalent. Judge Friendly would rather require absolute majority stock consent as an essential to both the legality of the transfer and premium.

The application of the corporate asset theory would change only half the conclusions drawn in this opinion. The legality of the sale as such has no bearing upon whether the premium ought to be retained by the seller. If the sale is illegal ab initio, then certainly no premium ought to be retained. However, even though the transfer is legal, the premium ought to go through the corporation to the stockholders pro rata.

In Honigman v. Green Giant Co., the court of appeals for the Eighth Circuit upheld the lower court’s decision to allow the retention of premium by the seller of control. Cosgrove was the founder and holder of control of the Green Giant Corporation. The company had two classes of stock: class A voting and class B non-voting. There was no difference between the two classes except as to voting rights, but the class B stock represented 99.9 per cent of the equity, earnings and dividend rights. Cosgrove possessed twenty-six of the forty-four class A voting shares. Over 400,000 class B shares were held by 1250 widely scattered people, none of whom held more than two per cent. In 1960 the company voted to recapitalize, providing for a single new class of voting stock. Class B was exchanged share for share and class A at 1000 to one. By this, class A equity increased from .01 per cent to 9.3 per cent, and Cosgrove received about thirty three per cent of the vote through the exchange. A
minority stockholder brought a class action to cancel the recapitalization and to set aside the issuance of the premium shares to Cosgrove on the theory that the controlling stockholders were taking a two million dollar bonus\(^7\) on something they didn’t own, since corporate control is a corporate asset. The court denied relief because no class A stockholder could be expected to forego the power of control without receiving in return consideration commensurate with the value of that control. Therefore, the class A holders were entitled to their premium on the sale of control.\(^7\) Nor could the court find any conduct which would vitiate the sale, saying that so far as considerations of immoral and reprehensible conduct are concerned, the seller’s position must be judged by that which businessmen of ordinary prudence would have done under similar circumstances.\(^7\) The court of appeals, in affirming the lower court relied wholly on its reasoning and concluded that “plaintiff has wholly failed to demonstrate that the court’s failure to apply the Berle rule, that corporate control is a corporate asset, misapplied or misinterpreted the applicable Minnesota law.”\(^7\)

The court apparently reasoned that since there was no immoral or reprehensible conduct analogous to looting,\(^7\) the sale of control was legal. As shown before, the legality or illegality of the sale has no bearing upon whether control is or is not a corporate asset. But more important, since the court determined that there had been an actual relinquishment of control,\(^7\) it felt the sellers had a right to retain the amount paid for that control. However, control was in fact not relinquished by Cosgrove. He merely exchanged absolute control for effective working control, as his ownership of thirty three per cent of the class B shares after the exchange was sufficient to allow retention of all the power had had with the class A shares.

Cosgrove made this exchange in an effort to improve the capital structure of the company. For this, he “paid” himself a two million dollar premium.\(^7\)

However, since the decisions made to the holder of control affect all the assets of the corporation, including those assets represented by

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Even though here there was no actual payment, and no money changed hands, the bonus nonetheless existed. Before the transfer, Cosgrove’s stock represented only .01 percent of the corporation’s assets, while after the transfer, his class B stock represented about thirty three percent of the assets. Thus, if the corporation had liquidated immediately before, Cosgrove would have received very little, but after the transfer, he would have received approximately two million dollars more.

\(^7\)Honigman v. Green Giant Co., supra note 71, at 758.

\(^7\)Id. at 762.

\(^7\)309 F.2d 667, 670.

\(^7\)Honigman v. Green Giant Co., supra note 71, at 762.

\(^7\)Id. at 765.

\(^7\)A cogent argument may be made that even granting the existence of a corporate asset, the class B shareholders had no interest. It can be argued that if the class B stock had no dividend rights, the class A stock could have commanded a higher price for its dividend rights without having to share this amount with the class B holders. Since the class B stock here had no voting rights, the class A holders should therefore not have to share any premium paid for the purchase of the votes.

In this situation, the corporate asset argument breaks down unless it is approached from the fiduciary relationship point of view.
the outside shareholder's stock, he owes a duty to the other shareholders to make decisions just such as this. Therefore, the effect here was a payment for a fiduciary duty owed to the corporation. The conclusion that emerges from this case is that the holder of control was responsible for providing the best possible corporate structure, and had at his disposal the entire corporate apparatus with which to fulfill this responsibility. The utilization of these assets should have been no more than the performance of the fiduciary duty owed, and the premium paid should go to benefit all the shareholders in the corporation.80

In In re Caplan's Petition,81 the New York Court of Appeals disallowed a sale of control. Roy M. Cohn controlled six of the ten directors of the Lionel Corporation with less than three per cent stock ownership. In early 1963 he agreed to a deferred sale with an immediate transfer of control to Defiance Industries, at a price equal to the existing market price. His stock was in pledge at the time of transfer of control. Seven months later, one Sonnabend made a similar arrangement with the now controlling Defiance at a higher price. This agreement provided that a majority of directors of Lionel should be persons designated by Sonnabend. The control transfer was made, but Cohn's stock was still in pledge and had never been delivered to Defiance.82 A stockholder brought action to set aside the election of the Sonnabend directors as illegal.83 The court held that it was illegal to sell a corporate office without sale of sufficient stock to carry voting control. The elections were vacated, with the court quoting Essex and citing the McClure case.84 The appellate division affirmed this holding,85 and the court of appeals affirmed without opinion.86

The Caplan analysis compares well with the analysis in Essex. As in Essex, the court in Caplan was concerned with the corporate democracy idea of majority consent. However, the Caplan court refused to view practical working control as equivalent to absolute majority control,87 and took the position of Judge Friendly in Essex as to the transfer.88 The court said: "Even assuming that some sale or transfer of such stock could be imputed in the transaction, certainly this three per cent of the stock cannot be considered as carrying with it the power to elect management of the corporation."89 The facts in Essex and Caplan are similar, and the Caplan court relied heavily on the Essex decision, thus failing to distinguish between the separate problems of legitimacy of sale and re-

80 For an extended discussion of this case see Bayne, A Philosophy of Corporate Control, supra note 12, at 45-49.
83 See, In re Caplan's Petition, supra note 81.
84 In re Lionel Corp., supra note 82.
85 In re Caplan's Petition, supra note 81.
87 In re Lionel Corp., supra note 82.
88 Essex Universal Corp. v. Yates, supra note 64.
89 In re Lionel Corp., supra note 82.
tention of premium. However, the situation in Caplan violates the sense of corporate democracy more deeply, which may account for the difference in the positions taken by the two courts.

In Caplan, as in Essex, the application of the corporate asset theory clarifies the situation. The determination of whether the actual sale is legitimate should be left to principles laid down by the "sale of office," "looting cases" and other similar limitations. The adjudication of the premium should be determined by the corporate asset theory. Once an excess payment over the true value of the stock is found, it must go to the corporate treasury or to the other stockholders.

Another case closely connected with Essex is Carter v. Muscat. Zeckendorf controlled six of the eleven directors of the Republic Corporation with less than ten per cent of the voting stock. In 1963, the B. S. F. Corporation agreed to buy the Zeckendorf interests. Control was to be transferred by the seriatim resignation of the Zeckendorf directors and their replacement with six B. S. F. nominees. One day after this, B. S. F. paid market price for the Zeckendorf stock and took delivery. The former president of Republic, brought action to set aside the election as illegal since it did not take place in connection with the sale of either a majority of the stock of Republic or of such a per cent as gives working control, and relied on the rule of the Caplan case. The court held that the transfer and election was not per se illegal, and ruled for the defendants. The court also distinguished the facts from the Caplan case in that here, the purchase price was substantially the same as market price, and in Caplan the price paid was one and one half times the market value of the stock. In other words, there was no premium paid for control.

As in Essex and Caplan, this case involved a sale of control where something less than an absolute majority of stock was transferred. It had the choice of following the "equivalent majority" rule of Essex, or the "absolute majority" requirement of Caplan. It chose to follow the former. In so doing, the court again failed to make the necessary distinction between the legality of the transfer and election and the payment of premium. Since there was no premium paid for the shares of controlling stock, the corporate stockholders were not deprived of a corporate asset because of the transfer. The only remaining consideration was whether there had been overreaching or impropriety in terms of actual damage to

**Professor Bayne argues that the determination of legitimacy should be based upon the theory that the payment of premium raises a rebuttable presumption of illegality, which if unrebutted or unexplained, raises a presumption of unsuitability of the nominees because of the impropriety of the appointment. 51 CORNELL L.Q. 49, 86 (1965). The case is analyzed in detail in this article.**

**121 App. Div. 2d 543, 251 N.Y.S.2d 378 (1964).**

**Id. at 379-380.**

**Id. at 381.**

**Id. at 380.**

**The court seemed to give weight to the fact that here there was an actual transfer of the stock of Republic, where in Caplan, the control stock remained in pledge. The court also apparently thought that the Caplan rule allowed something less than an absolute majority (working control) and that the ten percent present in the instant case fulfilled this requirement. Actually, the court followed the majority position of Essex in allowing legitimacy under an "equivalent majority" rule.**
the corporation resulting from the transfer and election. Since the court found none, the corporation had not been deprived of any property or damaged by an illegal transaction. The court reached the correct result here, although its reasons for doing so are unclear.

CONCLUSION

The cases summarized above demonstrate the lack of understanding with which the courts have disposed of problems raised by corporate control. At the present time, the law is in a state of flux; each court is searching for the correct answer on its own theory. If the modern corporation is to fulfill its role in our present economic and societal structure, it is necessary that the controlling hand be exercised in the best interests of the many rather than the few. Because of this and the fact that corporate codes are generally inadequate in this area, there is need for a rule which will afford consistency in the solution of the problem. The corporate asset theory would help to provide a norm for the most acceptable and efficient exercise of control. While it is no panacea, its application would achieve the correct result in most situations, and simultaneously afford a broad enough basis to offer consistency, thus alleviating the corporate control anomaly existing in the courts.

RICHARD L. BEATTY.