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# PRIVATE SALE OF CONTROL TRANSACTIONS: WHERE WE STAND TODAY\*

by  
*Robert W. Hamilton\*\**

*The law with regard to privately negotiated "sale of control" transactions is well-settled. The premium paid for the sale of control of a corporation by majority shareholders is generally not a corporate asset which must be shared with other shareholders. Nor is there any generally accepted principle of "equal opportunity" that permits other shareholders to participate in the favorable transaction along with the controlling shareholders. Several exceptions to these principles have been developed by the common law to prevent abusive transactions; these exceptions involve ex post examination of factual questions and have been criticised by economists of the "Chicago school." The author of this article evaluates "sale of control" transactions in light of recent legal economic theory, and concludes that the legal system has created a set of rules that appear to strike a reasonable balance between considerations of economic efficiency on the one hand, and simple justice and fairness, on the other.*

## INTRODUCTION

THE "SALE OF control" transaction discussed in this paper is well illustrated by the facts of *Zetlin v. Hanson Holdings, Inc.*<sup>1</sup> The defendants owned 44.4% of the voting shares of Gable Industries, Inc. (Gable), a publicly held corporation whose shares were traded on the New York Stock Exchange. This ownership interest was clearly sufficient to give the defendants effective control over Gable's affairs. At a time when the market price of Gable's shares was \$8.38, the defendants sold their shares for \$15 per share to Flintkote Co., also a publicly held corporation whose shares were traded on the New York Stock Exchange. The court did not ex-

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1. *Zetlin v. Hanson Holdings, Inc.*, 48 N.Y.2d 684, 397 N.E.2d 387 (1979).

plain why Flintkote was willing to pay nearly twice the market price for Gable stock, but the reason is obvious: Flintkote was buying immediate control of Gable, and the difference between \$15 and \$8.38 was the premium for obtaining that control.

The transaction was attacked by a minority shareholder of Gable who argued that all shareholders should be entitled to an opportunity to share equally in any premium paid for control of a corporation. Rejecting this argument in a one-page, unsigned memorandum, the New York Court of Appeals cited the "long . . . settled law" that absent "looting of corporate assets, conversion of a corporate opportunity, fraud, or other acts of bad faith,"<sup>2</sup> a controlling shareholder is free to sell his shares at whatever price the shares can command. The premium over market the court explained, reflects the amount "an investor is willing to pay for the privilege of directly influencing the corporation's affairs."<sup>3</sup> Furthermore, the court continued, the rule of mandatory sharing of the control premium contended for by the plaintiff would "profoundly affect the manner in which controlling stock interests are now transferred [since it would] require, essentially, that [all] controlling interest[s] [could] be transferred only by public tender offer."<sup>4</sup> Such a "radical change" in existing law, the court concluded, should be made by the legislature and not by the courts.

In one sense, *Zetlin* does indeed represent "long settled law" set forth, either in holding or in dictum, in scores of cases.<sup>5</sup> There was a period during the 1960's when it appeared possible that the rule rejected in *Zetlin*, requiring sharing of the premium, might be generally adopted in sale of control cases, but that period has long passed. The "long settled law" has recently been reaffirmed in an impressive number of cases.<sup>6</sup> It is unlikely that any American court today would reject the general proposition that controlling shareholders may obtain a premium for their shares which they need not share with other shareholders. Yet, the fact that a simple, and apparently hopeless, case such as *Zetlin* would be appealed through

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2. *Id.* at 685, 397 N.E.2d at 388.

3. *Id.*, 397 N.E.2d at 389.

4. *Id.*

5. For an early statement to this effect, see *Stanton v. Schenck*, 140 Misc. 621, 251 N.Y.S. 221 (1931).

6. Recent cases supporting this statement, in addition to *Zetlin*, include *Doleman v. Meiji Mut. Life Ins. Co.*, 727 F.2d 1480 (9th Cir. 1984); *Delano v. Kitch*, 663 F.2d 990 (10th Cir. 1981); *Treadway Companies v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980); and *Haberman v. Murchison*, 468 F.2d 1305 (2d Cir. 1972).

two levels of New York courts reflects continued unease and uncertainty about this "long settled law."

Part of this uneasiness is doubtless a result of the fact that most academic commentary on the sale of control issue—including that of many of the most respected academic writers in the corporations law field between 1930 and 1970—has been critical of it.<sup>7</sup> They argue with great intensity that "control" is a corporate asset, and the premium should be recoverable by the corporation, or that the premium should be shared proportionally by all the shareholders through the principle of "equal opportunity" to participate in the desirable sale transaction. I do not mean to suggest, of course, that the sheer weight of this commentary demonstrates that its basic thesis is correct. However, it was not until the recent writings of the "Chicago School" of legal economics that the "long settled law" received any substantial degree of academic support.<sup>8</sup>

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7. See A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 216-17 (rev. ed. 1968); Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965); Berle, *The Price of Power: Sale of Corporate Control*, 50 CORNELL L.Q. 628 (1965); Berle, "Control" in *Corporate Law*, 58 COLUM. L. REV. 1212 (1958); Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259 (1966); Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956); Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725 (1956). See generally O'Neal, *Sale of a Controlling Corporate Interest: Bases of Possible Seller Liability*, 38 U. PITT. L. REV. 9 (1976).

In a somewhat different category is a series of articles by Professor Bayne, who seeks to establish that the payment of control premiums is morally illegitimate and a "bribe." See Bayne, *The Noninvestment Value of Control Stock*, 45 IND. L.J. 317 (1970); Bayne, *The Sale-of-Control Premium: The Intrinsic Illegitimacy*, 47 TEX. L. REV. 215 (1969); Bayne, *The Sale-of-Control Premium: The Definition*, 53 MINN. L. REV. 485 (1969); Bayne, *The Sale-of-Control Premium: The Disposition*, 57 CALIF. L. REV. 615 (1969); Bayne, *A Legitimate Transfer of Control: The Weyenberg Shoe-Florsheim Case Study*, 18 STAN. L. REV. 438 (1966); Bayne, *Corporate Control as a Strict Trustee*, 53 GEO. L.J. 543 (1965); Bayne, *The Sale-of-Control Quandry*, 51 CORNELL L.Q. 49 (1965); Bayne, *The Definition of Corporate Control*, 9 ST. LOUIS U.L.J. 445 (1965); Bayne, *The Sale of Corporate Control*, 33 FORDHAM L. REV. 583 (1965); Bayne, *A Philosophy of Corporate Control*, 112 U. PA. L. REV. 22 (1963).

8. The most detailed explanation of the economic analysis of the control premium issue appears in Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982) [hereinafter cited as Easterbrook & Fischel, *Corporate Control*]. See also R. POSNER, *ECONOMIC ANALYSIS OF LAW* § 14.6 at 303-05 (2d ed. 1977). Other writings of the "Chicago School" that are relevant to the control premium issue include Fischel, *Efficient Capital Market Theory, the Market for Corporate Control and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978) and Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) [hereinafter cited as Easterbrook & Fischel, *The Proper Role*].

Two early defenses of the traditional rule, written in response to Professor Andrews' "equal opportunity" article, are Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, 32 U. CHI. L. REV. 420 (1965) and Comment, *Sales of Corporate Control and the Theory of Overkill*, 31 U. CHI. L. REV. 725 (1964).

Two other factors contributing to the general uneasiness about the "long settled law" also deserve mention. The first is the intuitive feeling by many persons—lawyer and layman alike—that taking a premium for control *is* inherently suspect in some situations. *Zetlin* is not one of those situations; in that case, both the corporation whose shares were being acquired and the acquirer of them were subject to the public disclosure requirements of the Securities Exchange Act of 1934.<sup>9</sup> Further, the number of shares being sold (44.4%) certainly constituted working control of a publicly held corporation, and there was no evidence that the transaction actually harmed the corporation or its remaining shareholders in any way.

The situation is not so clear, however, where the corporation is closely held, so that the minority shareholders do not have a "market option" and may face serious difficulty in obtaining information about the corporation's affairs; where the number of shares being sold is so small that they would not normally carry with them control of a publicly held corporation; where the non-control shareholders are simultaneously offered significantly lower prices for their shares; or where the purchaser thereafter significantly harms the corporation.<sup>10</sup> Second, several well-recognized exceptions or qualifications to the "long settled law" about control premiums exist. These exceptions are not readily bounded or limited and threaten to swallow up all, or the greater part of, the general principle. These exceptions, discussed in a later section of this Article, are usually described under the phrases "looting," "corporate opportunity," "sale of corporate office," and more recently, "fiduciary duties." All in all, this "long settled law" with its well-recognized exceptions seems ripe for reconsideration in light of recent cases and the new writings of the "Chicago School."<sup>11</sup>

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9. 15 U.S.C. § 78a (1984).

10. Other variations also exist. For example, some corporations, such as mutual insurance or mutual savings and loan associations, have extremely diffuse voting populations. In a mutual insurance company, for example, every policyholder is entitled to vote. Sale of control of such an organization may take the form of a sale of an affiliated corporation, where both are under the common control of a small group. See *infra* notes 63-64 and accompanying text.

11. An additional motivating factor was my participation in the *Canada-United States Comparative Corporation Law Conference* (Cleveland, Ohio, Oct., 1984), held under the auspices of the Canada-United States Law Institute. A major benefit of this Conference, in addition to my exposure to the Canadian experience, was the presence of economists who were willing, indeed anxious, to explain the economists' view of the phenomenon under discussion.

## I. THE ECONOMIST'S VIEW OF SALE OF CONTROL PREMIUMS

The basic argument made by economists in favor of the "long settled law" set forth in *Zetlin* involves two propositions: (1) transactions involving the sale or transfer of control are generally beneficial to the entity in particular, and to the economy in general, since such transfers tend to cause corporate resources to be put to higher and better uses;<sup>12</sup> and (2) many desirable transfers of control would not take place if some kind of sharing-of-the-premium rule were established. Such a rule would either increase the cost of transferring control or reduce the premium paid to the selling controlling shareholders, thereby making some sellers unwilling to complete the transaction. These two propositions will be addressed in reverse order.

The correctness of the second conclusion—that a sharing rule would reduce the number of sale of control transactions—seems to be self-evident. To meet the sharing requirement, the purchaser of control might offer the same premium price to all the shareholders, thereby increasing the purchase obligation from whatever percentage of the shares were owned by the selling controlling shareholders to as much as 100% of the shares. Alternatively, the purchaser might decline to increase the size of his purchase. The selling shareholders would then be compelled to share the benefits of the higher price with some or all of the other shareholders, thereby reducing the portion of the control premium the controlling shareholders may keep for themselves.<sup>13</sup> In either event, sale of control transactions would be less frequent.

On the other hand, I do not find the first proposition—that privately negotiated transfers of control are generally beneficial—to be either self-evident or supported by persuasive empirical evidence. It may be asserted, of course, that such a proposition is so self-evident

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12. Easterbrook & Fischel state the following in *Corporate Control*, *supra* note 8, at 705: The sale of a control bloc of stock . . . allows the buyer to install his own management team, producing the same gains available from a tender offer for a majority of shares but at lower cost to the buyer. Because such a buyer believes he can manage the assets of a firm more profitably, he is willing to pay a premium over the market price to acquire control. The premium will be some percentage of the anticipated increase in value once the transfer of control is effectuated. If there were no anticipated increase in value, it would be irrational for the buyer to pay the premium. There is a strong presumption, therefore, that free transferability of corporate control, like any other type of voluntary exchange, moves assets to higher valued uses.

13. Conceivably, the selling shareholders might be required to retain a minority interest in the enterprise, permitting other shareholders to sell a fraction of their holdings to the purchaser at the premium price. This, too, would reduce the frequency of sale of control transactions, since selling shareholders would presumably not elect to remain as minority shareholders in many situations.

or intuitively obvious that it does not require empirical verification, but I would hope such an assertion will not persuade either economists (who pride themselves on discovering counter-intuitive propositions) or lawyers (who are familiar, primarily, with real-life illustrations where such transfers were in fact *not* beneficial and *did* cause substantial harm to the shareholders "left behind"). Certainly, such a proposition is one that can be studied empirically, at least in the case of publicly held corporations such as Gable Industries. However, as with many other propositions confidently asserted in the field of economics, there do not appear to be direct and persuasive studies or empirical data to support the economists' proposition.

In a broad sense, the first proposition appears to be based on the rather controversial economic conclusion that takeovers of publicly held corporations by case tender offers are generally desirable.<sup>14</sup> Privately negotiated sales of controlling shares are at least superficially analogous. In the case of tender offers, economists suggest that the societal gain can be measured by comparing the tender offer price with the prior market value of the shares of the target, reduced by any decline in value of the shares of the aggressor.<sup>15</sup>

Empirical evidence apparently establishes that there is usually a net increase in value of the two corporations measured in this way.<sup>16</sup> The explanation usually given for this net increase in market value is that takeovers eliminate less efficient management and tend to cause economic resources to be put to a higher (more efficient) use. This explanation is almost an article of faith among economists since, otherwise, takeovers at premium prices are irrational and not explainable by rational profit-maximizing.<sup>17</sup> Its correctness, how-

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14. In a letter to the author, Professor Easterbrook suggested that a study relating to tender offers, Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345 (1980), showed shares not acquired pursuant to the offer also appreciated in value following the transaction. He also suggested block accumulation studies, which examined price movements in publicly held shares following the assembling of a large and potentially controlling block of shares, also show that the "left-out" shares increase in value following the block assemblage and decline in value upon disassemblage. The studies are cited in Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 38-39 (1983), in the context of the effect of repurchase of such blocks by the corporation, usually at a premium over market.

15. See Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 274 (1983).

16. Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983).

17. The legal literature taking this position largely pivots around Easterbrook & Fischel, *The Proper Role*, *supra* note 8. See also Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Bebchuk, *The Case for Facilitating Competing Tender*

ever, does not appear to accord with anecdotal evidence from the real world, at least since 1982,<sup>18</sup> or with comments and descriptions from "players" in the takeover game during the same period.<sup>19</sup> As a result, recent commentary has increasingly refused to accept these economically derived conclusions as a matter of simple faith.<sup>20</sup>

There is, furthermore, a considerable difference between the assembling of a control block by way of a tender offer to widely scattered shareholders and the private, negotiated purchase of a control block from a small group of shareholders. A tender offer is subject to disclosure requirements which assure that some information is available about the offerors. A sale of a controlling block, however,

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*Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982); Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 A.B.F. RESEARCH J. 341; Easterbrook & Fischel, *Corporate Control*, *supra* note 8; Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982); Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982). This extensive legal literature contains citations to the voluminous economics literature that discusses the same phenomena.

18. It appears likely that most takeover targets are not concentrated in corporations having current management problems. Rather, the aggressors usually seek well-managed targets and try to encourage their managements to remain in place after the takeover. This is obviously not true in all cases; it may not be true, for example, in certain oil industry mergers where the aggressors' plan is to dismantle all or part of the target corporation. A second phenomenon that appears to be inconsistent with the "inefficient management" thesis is the development of the "pac man" defense, when the target seeks to take over the aggressor as a defensive measure. There is also often a surprisingly short period of time for a corporation to go from the status of aggressor to that of target. See generally Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984). Of course, these phenomena may have economic explanations consistent with the general "pruning deadwood" hypothesis.

19. Peter Drucker has recently pointed out that most shares of publicly held corporations are now held by institutional investors, many of which have fiduciary duties to other persons to maximize the short-term profitability of their investments. Wall St. J., Oct. 30, 1984, at 14, col. 3. This emphasis on short-term market profitability, Drucker suggests, is damaging to the long-term well-being of American industry, since longer-term considerations (which may motivate individual investors) do not enter into institutional investors' calculations.

20. See Coffee, *supra* note 18; Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647 (1984); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); Lowenstein, *supra* note 15.

The response of economists (to Professor Lowenstein's article in particular) was vitriolic. See, e.g., *Separate Statement of Frank H. Easterbrook and Gregg A. Jarrell*, FED. SEC. L. REP. (CCH) No. 1028, 70, 117-18 (July 15, 1983). The data in this Statement forms the basis for Easterbrook & Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277 (1984).



may be negotiated with no disclosure and virtual secrecy as to the identity of the purchaser.

The price in a tender offer is set on the basis of market considerations, including the market price of the shares, the probable public shareholder response to a higher price, and the likelihood of competing bids. This price is publicly known and widely discussed, and the opportunity exists for competing bidders to offer a higher price. In a private sale of control, on the other hand, the price is privately negotiated with no public input until after the transaction is closed.<sup>21</sup> Finally, the premium over current market price in a tender offer is a type of control premium, but all shareholders, at least theoretically, have an opportunity to vie for a portion of that premium by tendering their shares; in the private sale of control, the controlling shareholders seize the entire premium.

The leading article on the economists' analysis of sale of control transactions is by Easterbrook and Fischel.<sup>22</sup> They demonstrate their analysis with the following illustration:

A sharing requirement also may make an otherwise profitable transaction unattractive to the prospective seller of control. To illustrate, suppose that the owner of a control block of shares finds that his perquisites or the other amenities of his position are worth \$10. A prospective acquirer of control concludes that, by eliminating these perquisites and other amenities, he could produce a gain of \$15. The shareholders in the company benefit if the acquirer pays a premium of \$11 to the owner of the controlling block, ousts the current managers, and makes the contemplated improvements. The net gains of \$4 inure to each investor according to his holdings, and although the acquirer obtains the largest portion because he holds the largest block, no one is left out. If the owner of the control block must share the \$11 premium with all of the existing shareholders, however, the deal collapses. The owner will not part with his block for less than a \$10 premium. A sharing requirement would make the deal unprofitable to him, and the other investors would lose the prospective gain from the installation of better managers.<sup>23</sup>

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21. If the sale of control involves an immediate substitution of directors nominated by the purchaser, for directors elected previously by the shareholders, federal law may require some disclosure to shareholders before the transfer of control is effected. See *infra* text accompanying notes 74-78.

22. Easterbrook & Fischel, *Corporate Control*, *supra* note 8.

23. *Id.* at 709-10. They continue their discussion in a footnote:

The common law recognizes that unequal distribution of gains facilitates the transfer of assets to higher-valued uses. Someone who discovers a lode of ore need not share the knowledge (and the profits) with the farmer under whose land the ore lies but may, instead, send an agent to buy the farm for the going price of farmland. A sharing requirement would lead to less searching for ore and lower wealth for society.

There are several problems with this kind of analysis, however. The hypothetical the authors create assumes the correctness of their thesis. The assumption that the purchasers of control will reduce the "perquisites or the other amenities" enjoyed as a result of the seller's position by \$10, thereby producing a corporate gain of \$15, illustrates that situations may exist in which unequal division is necessary for the realization of societally desirable transactions. It does not, however, bear directly on Easterbrook and Fischel's basic thesis. One can equally plausibly assume that the buyer feels that he can enjoy the same "perquisites or the other amenities" as the seller enjoyed, and even increase them to, for instance, \$14.<sup>24</sup> On this assumption, the minority shareholders are clearly worse off as a result of the sale, and both the purchaser and seller of the control shares are benefiting at the minority shareholders' expense.

The critical question is: Which assumption is more realistic? I suspect, from personal experience, that losses occur from the change of managements, particularly in smaller unlisted companies, in a large number of cases; quite possibly more often than net gains.

In this respect, Professor Ronen's analysis of sale of control transactions is strongly supportive. On the basis of largely theoretical economic analysis, he concludes that under the assumptions of either complete absence of information or asymmetric information, private sales of control stand at least a 50% chance of being harmful to the shareholders "left behind" and quite possibly the probability is higher.<sup>25</sup> Absence of information or asymmetric information is, of course, much more common in the real world than complete information, particularly in the case of unlisted companies.

There is another problem with the Easterbrook-Fischel hypothetical. Assume that the control stock sold in the hypothetical consists of 55% of the outstanding shares; if the buyers are content to allow the \$15 increase in value to remain in the corporation, they will obtain 55% of the \$15 increase in value by reason of their 55% stock ownership, or \$8.25. In other words, if they abandon the "perquisites and other amenities," they will pay \$11 in order to ob-

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*Id.* at 710 n.30. See *Leitch Gold Mines v. Texas Gulf Sulfur*, 1 Ont. 2d 469 (1969).

24. Alternatively, it may be argued that if \$14 could be safely siphoned off, the seller would previously have done it. However, there is no reason to assume that the seller is particularly efficient at obtaining the maximum "percs;" indeed it may well be inefficiency in this regard by the seller that makes the transaction appear favorable to the buyer.

25. Ronen, *The Sale of Controlling Interest by a Dominant Shareholder to a Third Party: A Financial Economic Analysis of the Governing Law in the United States and Canada*, 61 (Oct. 18, 1984) (unpublished manuscript).

tain an increase in investment value of only \$8.25. They would obviously be better off if they retain the sellers' "percs" worth \$10 and seek to squeeze out another couple of dollars here and there from additional "percs," rather than eliminating the "percs." Using Easterbrook and Fischel's analysis, one would expect sale of control transactions to occur only when the selling shareholders are extremely inefficient managers, or where most of the corporate stock is being sold. The lower the percentage of the stock being sold, the higher must be the potential gains from the transfer of control, if the minority shareholders "left behind" are to benefit from the change of control. There is no reason to think these possible inferences reflect the reality of sale of control transactions.

The basic question is: If the new purchasers are rational profit maximizers, why should they share the \$15 increase in value with the minority? It is not true that minority shareholders always share ratably in all increases in value with the majority shareholders. It would appear to be rational (and certainly practical) to place the minority shareholders on "starvation returns" from the corporation while increasing salaries or other "percs" to the new controlling shareholders in order to obtain all the additional \$15 in gains.<sup>26</sup> Why should the minority be given any of it? Starvation returns may also persuade the minority to sell their shares at low prices to the majority so that at some time thereafter the purchasers may own all of the outstanding shares and obtain all of the benefits of their skills. In short, I do not view hypothetical examples, such as those put forth by Easterbrook and Fischel, to prove anything more than that there *may be* idealized situations where everyone is better off as a result of the transfer of control; they do not prove that there are such situations, or their frequency.

Professors Easterbrook and Fischel supplement their argument that control transactions benefit those "left behind" with two further arguments. The first is, using the facts of the *Zetlin* case as illustrative, that the market for the Gable shares following the purchase by Flintkote will reveal that the shareholders were better off as the result of the sale if the price of the Gable shares rose "relative to the market as a whole."<sup>27</sup> Precisely how this is to be measured is not spelled out. Further, no data is cited to show that such a price rise usually occurs in sale of control cases.<sup>28</sup>

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26. See *infra* notes 94-98 and accompanying text.

27. Easterbrook & Fischel, *Corporate Control*, *supra* note 8, at 707.

28. This is not to say that an estimate of this performance cannot be obtained. But, unless there are one or more publicly held corporations with which to make comparisons, any

Finally, the authors recognize that data indicates investors tend to be risk averse (and therefore might prefer a sharing-of-the-premium principle to the greater risk of higher or lower returns that inevitably accompany a sale of control to unknown third parties). Nevertheless, they suggest that the risk of loss from such transactions may be protected against by portfolio diversification,<sup>29</sup> a point which certainly has some limited validity. If all actors in a sale of control case—the corporation itself, the seller of the control shares, and the purchaser of the control shares—are publicly held corporations, then any investor may share at least partially in all aspects of the sale of control game simply by holding shares in any one of the three participants, or in other corporations that assume the roles of these participants in different transactions.<sup>30</sup>

But diversification also assumes that all the shareholders in the corporation whose control shares are being acquired have liquid (or at least “liquidable”) investments so that they can diversify without substantial cost if they wish to do so. Unfortunately these assumptions often are not true in the real world. Indeed, they do not appear to be fully true in any of the leading sale of control cases, since in these cases, the seller of control is usually an individual or group of individuals and not a corporation, so that it is usually not possible to invest directly in the seller. Also, diversification is sometimes not practical except at unacceptable costs. Further, Professors Easterbrook and Fischel note, if one or more of the corporations are closely held, diversification may be impractical except at substantial and unacceptable loss. The authors suggest that the “shareholder can minimize this nondiversifiable risk . . . by not investing in firms that are controlled by an individual or a privately held firm.”<sup>31</sup> Again this sometimes may not be practical.

All in all, there is something a little unrealistic in these supplementary arguments. At best, they are valid in only certain situations and are of the “defects in my argument are not very serious”

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such estimate must necessarily be imprecise and have substantial qualifications. Easterbrook and Fischel do refer to price data about Newport Steel Corporation. Those data show the price of Newport went up somewhat following the sale of control; whether it went up “relative to the market as a whole” is not directly addressed, though the authors refer to an unpublished study which suggests that such a rise did occur. *Id.* at 718.

29. *Id.* at 712.

30. Professor Cox has convincingly demonstrated that even if all shares are publicly held, it will usually be impossible to achieve a properly balanced portfolio of securities to assure protection against disproportionate benefits obtained by a controlling person. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 751-55 (1984).

31. Easterbrook & Fischel, *Corporate Control*, *supra* note 8, at 714.

type. Fundamentally, it is not very persuasive to argue that certain broad classes of transactions are not harmful because persons who are likely to be injured by them may in some limited subclasses of those transactions insure or protect against that injury through diversification of investment or by not making certain investments in the first place.

On the other hand, the arguments which Easterbrook and Fischel are attacking rely heavily on appeals to purely intuitive notions of equity and fundamental fairness. Arguments that the purchaser of a majority of the stock is in fact buying control of 100% of the assets of the corporation appear in the academic literature. Since the premium, in fact, relates to the control of all of the assets, why should a limited group of shareholders be able to acquire the entire premium when they sell only a portion of all of the shares?<sup>32</sup> Such an argument is intuitive and rhetorical, not analytic.

Another type of argument, however, may be subject to analysis: The risks of the shareholders who are "left behind" following the sale of control shares to a third person are clearly different from the risks faced before the sale of the controlling block. For example, the purchaser may be less experienced than the seller or may be more greedy in the search for perquisites that accompany the control of a corporation. The selling shareholders entirely control the decision to whom they should sell and reap the benefits of the sale but suffer none of the adverse consequences of their choice. An "equal opportunity" requirement simply requires the majority shareholders to assume the same risk to which they are subjecting the minority shareholders.

Economists tend to reject the underlying premise that the possibility of losing transactions is large and may outnumber the successful transactions. In their view, "in the long run," the possibility of losing transactions should disappear because persons who pay too much for control will eventually have to withdraw from the market while the winning participants (those who accurately gauge the inefficiency of incumbent management and who provide more effective use of corporate resources) will continue to be active. Such reasoning, however, is also unrealistic in the real world because it assumes that the number of players is limited.

In fact, there are probably an unlimited number of persons willing to pay a premium for control over a larger group of assets with the hope that somehow they may hit upon a successful management

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32. Greene & Junewicz, *supra* note 20, at 660.

strategy. As a result, there may be probable losers entering the game all the time who have not learned from prior failures of others. Thus, there may be no discernible trend towards selection of the successful; the number of potential losing players may always outnumber the potential winning players; and, on balance, minority shareholders may lose more often than they win.

Even if one accepts the hypothesis that losses are at least as likely as gains following the sale of control, the desirability of the "long settled law" seems open to criticism: Why should the shareholders "left behind" share this 50-50 risk exclusively (and involuntarily, since they have no say in the identity of the buyer) while the majority shareholder does not? To argue, as Easterbrook and Fischel appear to do, that the minority shareholders took this risk when they "voluntarily" invested in a minority position in a controlled corporation, seems weak. It assumes that investors have far-seeing vision as to consequences or outcomes of current transactions that is often in fact not the case.<sup>33</sup>

Ultimately, the theoretical arguments for and against the "long settled law" settle to those of inference or assertion versus counter-inference or counter-assertion. The noneconomic analysis of well-known academicians such as Berle, Andrews, Jennings, and others, comes down to the intuitive argument that sales of control by controlling shareholders have a significant capacity for mischief and should be subjected to a prophylactic rule: that the premium should belong either to the corporation or, on a proportional basis, to all the shareholders.<sup>34</sup> These views appear to have been shaped

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33. I know of no study that tries to establish how unprotected minority shareholders in closely held corporations attained that status. I suspect that most arise from two major sources: the unexpected or unplanned-for death of a participant in the venture (resulting either in the transfer of controlling shares to younger generations or the interjection of a spouse or children into an ongoing closely held venture which the other participants organized and continue to operate) or an unexpected falling out between persons formerly cooperatively active in the management of the business.

Sophisticated persons, who "voluntarily" assume minority status, normally insist on a buy-out or similar arrangement so that they will be able to liquidate their investment if matters do not work out as expected. They do not, in my experience, typically pay a lower price because of the lack of marketability as suggested in Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 845 (1984).

Unsophisticated persons may, of course, enter "voluntarily" into a minority position in the corporation with no buy-out protection if they receive no legal or business advice as to the need to protect themselves from possible mistreatment. From the standpoint of the economist, all this is apparently irrelevant; in the world of rational profit maximizers, no tears are shed for the unsophisticated or for the person who inherits from someone who failed to make a rational provision for the future control of the enterprise.

34. See *supra* note 7.

by a handful of famous cases decided during the 1950's and 1960's and seem to have little relevance to the facts of a typical case such as *Zetlin*. The criticism that these views emphasize justice, to the total exclusion of considerations of efficiency, may therefore have considerable merit. On the other hand, the economists supporting the "long settled law" assert that these famous cases are either wrong or atypical and argue (almost as a matter of faith) that sale of control transactions are generally beneficial economically to all concerned and that considerations of efficiency strongly support the view that a general sharing principle is undesirable.

In one way, the supporters of the efficiency analysis seem to have somewhat the better of the argument. Lawyers in corporate practice are aware that sale of control transactions occur relatively frequently in a wide variety of circumstances and with a variety of different premiums. Even when these transactions do not turn out well from the standpoint of the shareholders "left behind," the results are often not catastrophic, and it is possible that the minority stock may be later bought out on an acceptable basis. In this connection, it may be relevant that the number of litigated instances of really "bad" cases, where the remaining shareholders have been significantly injured, has been relatively small.

## II. WHY HAS THE ACADEMIC COMMENTARY BEEN SO INEFFECTIVE IN CAUSING A CHANGE IN THE "LONG SETTLED LAW" RELATING TO CONTROL PREMIUMS?

The lively and continuing theoretical debate about sale of control cases has not led courts to reconsider the correctness, as an original matter, of the "long settled law." Indeed, the bulk of the cases arising in the recent past that strongly endorse the "long settled law" usually refer to, and expressly reject, the academic commentary urging that a sharing principle be adopted.<sup>35</sup> This judicial

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35. *Doleman v. Meiji Mut. Life Ins. Co.*, 727 F.2d 1480, 1483 (9th Cir. 1984) (no court has accepted these views "as a basis for general recovery of the control premium"); *Treadway Companies, Inc. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980) (no duty on part of noncontrolling shareholder to maximize return of other shareholders); *Clagett v. Hutchison*, 583 F.2d 1259, 1264 (4th Cir. 1978) (the position set forth in the academic commentary, "while nice theoretically, is simply not the law"); *Haberman v. Murchison*, 468 F.2d 1305 (2d Cir. 1972) (sale of stock above market value does not indicate sale at premium; no sale of office where price for stock was fixed before discussion of resignations); *McDaniel v. Painter*, 418 F.2d 545, 548 (10th Cir. 1969) ("We have read the law review articles cited by counsel and conclude that they neither state the law of the forum nor the rules generally applied in other jurisdictions."); *Ritchie v. McGrath*, 1 Kan. App. 2d 481, 571 P.2d 17 (1977) (sale of control-

response, I believe, is not based so much on the acceptance of arguments about economic "efficiency" as it is on concern by courts about interfering in an arms-length commercial transaction when there is no apparent harm to anyone. The notion that lawful property may be sold by a willing seller, for whatever price it will bring, to a willing purchaser is so fundamental that courts appear unwilling to graft an exception onto that principle in the absence of clear and visible harm to the corporation or the other shareholders.<sup>36</sup> As a corollary, when the selling shareholder owns a majority of the shares, the sale of those shares ineluctably carries with it the power to elect a majority of the board of directors; the argument that control itself is being sold is much less persuasive in this situation. In the absence of specific harm, then, courts have simply been unwilling to impose, on their own and without express legislative support, obligations in excess of those voluntarily assumed by the parties upon the sale of controlling shares. Or, put another way, courts have been unwilling to generalize judicially created principles, evolved in cases involving clear and substantial harm to minority shareholders from the transfer of control, to cases not involving any apparent harm.

### III. THE ESTABLISHED EXCEPTIONS TO THE "LONG SETTLED LAW" THAT CONTROL PREMIUMS NEED NOT BE SHARED

When one turns to the famous cases in which liability has been imposed on selling shareholders in sale of control transactions, one encounters broad and potentially troubling doctrine that logically might apply in many, if not all, cases. As indicated in the previous section, however, these logical extensions have not in fact occurred. In this section, I consider theories of liability applicable to all cor-

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ling shares at premium does not violate Kansas' "very strict fiduciary duty" to shareholders; *Zetlin v. Hanson Holdings, Inc.*, 48 N.Y.2d 684, 397 N.E.2d 387 (1979).

36. Language often quoted to this effect appears in *Roby v. Dunnett*, 88 F.2d 68 (10th Cir. 1937), where the court referred to:

the weight of authority . . . to the effect that every stockholder, including a majority holder, is at liberty to dispose of his shares at any time and for any price to which he may agree without being liable to other stockholders under circumstances such as we have here as long as he does not dominate, interfere with, or mislead other stockholders in exercising the same rights.

*Id.* at 69.

Similar comments appear in earlier decisions, such as *Keely v. Black*, 91 N.J. Eq. 520, 523, 111 A. 22, 23 (1920), where the court commented that a corporate president "had a perfect right, as an individual," to buy or sell stock in the corporation.



porations. In the following section, I consider unique arguments applicable to corporations that are privately held.

### A. *Looting*

In several cases, liability has been imposed on controlling shareholders who sell their shares to "looters," persons who thereafter criminally convert the assets of the corporation to their own purposes.<sup>37</sup> The persons injured by looters are, of course, creditors, preferred shareholders, and the remaining common shareholders—all those interests that are "left behind." The looting exception is based entirely on a judicially created duty imposed on selling shareholders to investigate the bona fides of potential purchasers when circumstances indicate that the purchasers may plan to loot the corporation.

In the leading case of *Insuranshares Corp. v. Northern Fiscal Corp.*,<sup>38</sup> the court stated, without citation of authority, that those who control a corporation "owe some duty to the corporation in respect of the transfer of control to outsiders," and the law "has long ago reached the point where it is recognized that such persons may not be wholly oblivious of the interests of everyone but themselves, even in the act of parting with control . . ." <sup>39</sup> The imposition of liability on the sellers involves a two-step factual analysis: (1) are the circumstances surrounding the proposed transfer such as to awaken suspicion and put a prudent person on guard that looting is probable; and (2) if so, would a reasonably adequate investigation have disclosed to a reasonable person that looting was likely to result. Since judicial evaluation of these factual issues necessarily involves an *ex post* analysis of facts developed at a trial, courts have tried to avoid relying on hindsight and to estimate the circumstances as they must have appeared to the selling shareholders at the time.

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37. *Insuranshares Corp. v. Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa. 1940); *DeBaun v. First Western Bank and Trust Co.*, 46 Cal. App. 3d 686, 120 Cal. Rptr. 354 (1975); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622, 651 (Sup. Ct. 1941); *Dale v. Thomas H. Temple Co.*, 186 Tenn. 69, 208 S.W.2d 344 (1948).

In other cases, looting transactions occurred but the court declined to impose liability on the ground that, on the facts of the particular case, the defendants had not been put on notice of the possible looting. *Swinney v. Keebler Co.*, 480 F.2d 573 (4th Cir. 1973); *Harman v. Willbern*, 374 F. Supp. 1149 (D. Kan. 1974); *Levy v. American Beverage Corp.*, 265 A.D. 208, 38 N.Y.S.2d 517 (1942). In a large number of other cases not involving looting transactions, dicta recognizing the existence of this exception appears. See, e.g., *Zetlin v. Hanson Holdings, Inc.*, 48 N.Y.2d 684, 397 N.E.2d 387 (1979).

38. 35 F. Supp. 22 (E.D. Pa. 1940).

39. *Id.* at 25.

Courts have held that the following circumstances should have warned the seller of impending looting: the receipt of a credit report showing numerous unsatisfied judgments against, and bankruptcy filings by, entities of which the potential purchaser had control;<sup>40</sup> an offer to purchase shares at an unreasonably high price considering the assets in question, coupled with indications that the purchaser was interested in obtaining control of liquid assets immediately upon the sale, and knowledge that the corporation had been the victim of looting several years earlier;<sup>41</sup> and, under similar circumstances with respect to the price, the obvious interest of the purchaser in getting his hands on the liquid assets of the corporation immediately after the sale.<sup>42</sup> Emphasis on an unexpectedly favorable price, plus the clear interest of the purchaser in obtaining immediate control of the liquid assets of the corporation as promptly as possible, by themselves plausibly justify a "go slow" attitude on the part of the seller. There is the obvious possibility that the purchaser will use the assets of the corporation purchased to complete the payment of the purchase price (or to repay overnight loans used for that purpose).

In contrast, one court concluded that no duty of inquiry was created where the purchaser appeared to be entirely reputable, supplied GAAP certified financial statements, and the actions of the purchaser were consistent with those of a reputable purchaser of a corporation.<sup>43</sup> In this case, the actions of the purchaser seemed to be highly suspicious only with the benefit of hindsight. In another case, the court held that a duty of inquiry was not created where the selling price was reasonable, and the selling shareholders received oral assurances from third persons that the purchaser was reputable.<sup>44</sup> In this case, even a superficial examination of the purchaser's financial statements would have created suspicion, given the size of the proposed transaction.

In one troublesome case,<sup>45</sup> the purchasers paid controlling shareholders \$43.75 for each share of Laurel Harness Racing Association, Inc. (an owner of a harness racing track in Maryland) at a time when market quotations for the stock were between \$7.50 and \$10.00 per share. The court held, over one dissent, that this gross

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40. *DeBaun*, 46 Cal. App. 3d at 691-92, 120 Cal. Rptr. at 356-57.

41. *Insuranshares*, 35 F. Supp. at 25-26.

42. *Gerdes*, 28 N.Y.S.2d at 651, 654.

43. *Swinney*, 480 F.2d at 573.

44. *Harman*, 374 F. Supp. at 1149.

45. *Clagett v. Hutchinson*, 583 F.2d 1259 (4th Cir. 1978).

disparity in price was not of itself a sufficiently suspicious circumstance giving rise to a duty to investigate.<sup>46</sup>

This case is different from the previous ones, however, since there is no indication that the purchasers actually looted the corporation; the argument about a duty to investigate was apparently put forward as a separate basis for imposing liability independently of any looting that occurred. In other words, the purpose of the suit was not to hold the selling shareholders liable for losses caused by the misconduct of the purchasers of the shares, but to require the selling shareholders to share their very substantial premium with the plaintiffs. The court pointed out that the large premium was obviously paid "for the element of control of the corporation,"<sup>47</sup> and that Laurel was a commercial business that was subject to further growth and development. Much of the real value of the corporation was apparently the entry it provided into the lucrative horse racing business in Maryland, which was rigidly controlled by the state through the limiting of racing dates and the erection of other artificial barriers against unlimited entry into that business. Whatever one says about the majority shareholders selling their stock to capitalize on this asset, this does not appear to be a looting case, and the court appears to have been correct in not imposing liability on the sellers for a failure to investigate the buyers.

No case seems to have considered how much of an investigation the sellers must undertake, once a duty to investigate suspicious circumstances has arisen. With the development of national credit reporting bureaus and agencies, however, an investigation is unlikely to be very expensive or involved.

The analysis of the economists concerning the looting exception reveals the difference in approach between lawyers and economists. At an informal level, there is a tendency by economists who do not

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46. *But see* Dale v. Thomas H. Temple Co., 186 Tenn. 69, 86, 208 S.W.2d 344, 352 (1948). The court stated: "We find the selling price to the Caldwells . . . was so far in excess of the market in May 1937, as to constitute a badge of fraud." The sale price in this case was \$2.81 per share when the value (based on an independent sale) was \$1.00. There was considerable evidence, however, that the sellers were aware (or shortly became aware) that the purchasers were of questionable background and intended to loot the corporation.

The plaintiffs in *Claggett* also argued (unsuccessfully) that provisions for a deferred closing and payment of the purchase price, and a covenant not to change the financial status of the corporation pending that closing, gave rise to a duty to investigate. *Claggett*, 583 F.2d at 1261-63. They also complained that some minority shareholders were selectively given the opportunity to sell at the \$43.75 price, arguing that these sales created an inference that the purchasers' contemplated actions were not in the best interest of the corporation and thus gave rise to a duty to investigate. *Id.*

47. *Id.* at 1262.

have legal training to reject the possibility that outright criminal or fraudulent conduct is involved; that such conduct is likely to be very widespread; or that the system should adopt an *ex ante* rule designed expressly to deter such conduct. The rational economic conduct that is the subject of economic analysis apparently does not seriously take into account the possibility that a person may actually take advantage of an opportunity to steal and then disappear, thereby presumably forfeiting the opportunity to engage in rational profit-maximizing conduct in the future. On the other hand, Professor Ronen plausibly points out that a rule of no responsibility for looting transactions under any circumstances might encourage sales to looters, since they would be able to pay higher premiums than a purchaser engaged in purely lawful economic conduct.<sup>48</sup>

Easterbrook and Fischel recognize the possibility that criminal conduct may occur and also recognize that the economic system may not make such conduct "self-detering."<sup>49</sup> They conclude, however, that it is undesirable to attempt to prevent looting from within the economic system by an *ex ante* rule. Rather, they suggest that "[l]ooters, when caught, could be heavily fined or imprisoned, taking into account the frequency with which looting escapes detection. Penalties for looting could be made high enough to be effective."<sup>50</sup>

This conclusion is based on several assumptions that have apparently never been empirically investigated: (1) that looting transactions are relatively infrequent; (2) that it is "difficult if not impossible" to detect looters in advance since "a looter takes the money and runs, and looting is by nature a one-time transaction";<sup>51</sup>

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48. Ronen, *supra* note 25, at 83-85. Professor Ronen also suggests that such a rule would have adverse effects on the formation and capitalization of new businesses. He concludes by suggesting that a general duty of reasonable investigation should be required in all cases, though this conclusion may be based in part on his unusual definition of "looting." *Id.* at 86-92. See *infra* text accompanying note 55.

49. Easterbrook & Fischel, *Corporate Control*, *supra* note 8, at 707:

Of course, some control transactions do not produce gains. In a few instances changes in control may be attributable to self-aggrandizement of buyers rather than to gains in the use of acquired firms' assets. We do not think this managerialist explanation of control shifts is important in designing legal rules . . . . The market penalizes buyers who pay too much money for a deal, and those losses serve as signals to further buyers. The corporate law can ignore overpayments, for they are self-detering.

Some corporate control transactions that do not produce gains, however, are not always self-detering. Looting may explain certain transfers of control.

50. *Id.* at 719.

51. *Id.* at 718-19. The authors argue that "[o]nce looters have absconded with the assets of one firm, they acquire a reputation that prevents them from repeating this act. But when they first obtain control, they may appear quite innocuous." *Id.*

and (3) a requirement that an investigation be made would lead to some refusals to sell, and "almost all" of these refusals would be "false positives."<sup>52</sup> In other words, they would deter desirable and non-criminal transactions involving the sale of control. On the basis of these assumptions, Easterbrook and Fischel conclude that the "costs of dealing with looting through a system of prior scrutiny would . . . scotch many valuable control shifts as a byproduct."<sup>53</sup>

It is possible that Easterbrook and Fischel are correct when they infer that the costs of an *ex ante* requirement exceed its benefits, but I doubt it. In the first place, in my personal experience, it is not true that looters abscond and only first-time looters ply their trade. Rather, persons on the fringe of the law often quietly merge into the general economy and surface from time to time, hoping that their background is not discovered, and if it is, quietly disappear again. As a result, routine and inexpensive credit checks on persons offering to buy asset-rich companies often turn up substantially negative factors.

I recall a credit check I ran on a potential purchaser of the controlling interest in an investment adviser to a small investment company: the potential purchaser turned out to be a "skip" who had left a trail of unpaid hotel and other bills in over a dozen cities! It took little imagination to figure out how he was planning to obtain funds for the purchase price of the shares or what would happen to the liquid assets in the investment company if the transaction had been completed. Indeed, the price he was offering for the shares of the investment adviser seemed so high that I can only assume that he believed the sellers might be so blinded by greed that they would accept his offer without making even a routine credit check, since he had made no effort to disguise his identity. One only needs to have one experience of this type to become a strong advocate of the investigative requirement of present law.

Second, while it is possible that the *ex ante* investigation would turn up some "false positives," I do not see why this should be so. What is supposed to be investigated is not whether the purchaser has dismantled companies in the past, but whether he has a reputation for honesty and the apparent wherewithal to finance a transaction of the magnitude under consideration without recourse to the corporation's assets in a way that defrauds creditors and minority

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52. *Id.*

53. *Id.*

shareholders.<sup>54</sup> If a person does not meet this standard, one wonders whether he is really a “false positive.”

Finally, the *ex post* deterrence proposed by Easterbrook and Fischel in the form of criminal sanctions is not very attractive. Even if it is assumed that punishment for this type of conduct will be quick and sure—hardly characteristics of current criminal sanctions against white-collar crime—the result is that the innocent shareholders and others “left behind” will usually suffer the entire economic loss, while the majority shareholders who sold to the thieves may keep the entire purchase price, premium and all. The thieves, of course, go to jail. This result seems so obviously unjust from the standpoint of the minority shareholders that it seems unreasonable to embrace it on the basis of entirely theoretical considerations of economic “efficiency.”

Professor Ronen adopts a definition of “looting” as the “combined outcome of skill and consumption of nonpecuniary benefits” by corporate managers.<sup>55</sup> This definition makes “looting” a mere extension of the “perquisites” that, in economic theory, managers of business take when they are not the sole residual owners of the enterprise.<sup>56</sup> This definition differs significantly from the definition adopted in the cases: looting as criminal conduct rather than marginally lawful conduct. The remedy provided for selling to a looter (in the criminal sense) in the cases described here is draconian. It makes the noninvestigating seller responsible for the entire loss suffered by the corporation through looting. The seller, in effect, becomes an insurer of the honesty of his purchaser, and the liability imposed may exceed by many times the amount of the original premium obtained. Professor Ronen does not address the remedy issue squarely, but it seems unlikely that he would endorse the same type of remedy for failing to discover a potential for “looting” in the broader sense in which he uses the term.

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54. It is important to distinguish the use of corporate assets in “leveraged buy-outs” from their use in looting transactions. When the purchaser acquires all the shares of the corporation, as is the normal pattern in leveraged buy-outs, the purchaser may use the assets as he wishes, consistent with his obligations to creditors. As a result, he may use corporate assets to discharge his loans used to purchase the outstanding shares, though it is more common for the corporation to incur those loans as part of a corporate repurchase of outstanding shares. It is quite different to use corporate assets to discharge the purchasers’ individual loans when there are minority shareholders; that is looting.

55. Ronen, *supra* note 25, at 46.

56. See Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

### B. *Sale of Office*

A more general argument that has found success in some cases is that the control premium is, in fact, compensation for securing the immediate resignations of the directors and managing officers; therefore, what are in fact sold are offices and not shares. The classic device to effect an immediate transfer of office upon the sale of controlling shares is a sequence of individual resignations of directors followed by the selection of successors nominated by the purchaser to fill the vacancies so created. This process of seriatim resignations and replacements is expressly authorized by modern business corporation statutes which generally authorize a board of directors to fill vacancies on the board.<sup>57</sup> This method of transferring immediate control, it should be noted, is not dependent on the sale of any particular number of shares, and if the shares being transferred are less than an absolute majority of the voting shares, the shareholders will have at least a theoretical opportunity to reject the new directors at the next regular election of directors. This does not appear to have occurred, however, in any reported sale of control case involving the sale of less than an absolute majority of the outstanding shares.

The sale of office cases start from solid historic foundations. It has been clear, at least since the nineteenth century, that a cash payment to an officer or director, in exchange for his resignation and the appointment of the purchaser as his successor, is improper; it is a bribe that may give rise to criminal prosecution.<sup>58</sup> It is only a matter of degree from these cases to those cases involving a designated side payment for the office in connection with the purchase of controlling shares.

In *Porter v. Healy*,<sup>59</sup> the majority shareholders sold their shares at \$165 per share. The same price was offered to the minority shareholders, but, at the same time, a secret escrow fund of over \$86,000 was created to be paid to the majority shareholders when actual control of the offices of the corporation was turned over to the purchasers. The transfer of control was effected through the device of seriatim resignation of directors and appointment of successors nominated by the purchasers. The court upheld the lower court's conclusion that the \$86,000 payment involved the sale of the

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57. REV. MODEL BUSINESS CORP. ACT § 8.10 (1984).

58. The earliest American case involving this proposition is *McClure v. Law*, 161 N.Y. 78, 55 N.E. 388 (1899).

59. 244 Pa. 427, 91 A. 428 (1914).

defendants' position, "with the influence flowing therefrom," and concluded that the defendants were liable for the amount received from the secret escrow fund.<sup>60</sup>

From cases such as this, it is only a small step further to cases where the side payment is not segregated but is hidden within an excessive purchase price for a small block of shares where an immediate sale of control is contemplated.<sup>61</sup> At this point, the exception threatens to overwhelm large portions of the general rule: Whenever the contract of sale provides for the immediate transfer of corporate offices, one can argue that the premium over market price was the consideration for the immediate sale of office.<sup>62</sup>

In fact, this exception has not overwhelmed the general rule. Aside from cases in which a portion (or all) of the purchase price was allocated expressly to the transfer of offices, this argument has apparently found application in only two related classes of cases.

1. *Corporations whose control is effectively vested in other entities.*

Certain types of corporations have extremely diffuse and inactive voting members. The two most widely known types are: open-end mutual or money market funds (where the investment is usually viewed by the "shareholder" as a diversified investment or the equivalent of a bank deposit), and mutual savings and loan associations (where each depositor is a voting member). In many instances, de facto control of the corporation is vested in the owners or managers of investment advisers, insurance brokerage firms, real estate brokerage or escrow firms, or similar entities that have close ties with the corporation.

In most instances, the corporation and the affiliated entity are each under the common control of a small group of persons. In

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60. *Id.* at 436, 91 A. at 431. This case also involved an element of misrepresentation, since the purchasers represented to the minority shareholders only that the defendants had also sold at \$165 per share. They did not disclose the existence of the separate "control fund."

61. In *Snyder v. Epstein*, 290 F. Supp. 652 (E.D. Wis. 1968), for example, the court upheld the sufficiency of a complaint charging a sale of office where controlling shares were sold at a price of \$7.00 when the market price was \$2.63. The contract of sale was conditional upon the resignations and transfer of control. See also *Bosworth v. Allen*, 168 N.Y. 157, 61 N.E. 163 (1901).

62. This argument has less force, of course, when the selling shareholder owns an absolute majority of the voting shares, since the contract provisions then are simply advancing the time of the inevitable. In addition, it may lose force upon a factual showing that the price was agreed upon before the provisions relating to immediate transfer of office were considered. This latter argument was found persuasive in *Haberman v. Murchison*, 468 F.2d 1305 (2d Cir. 1972).



other instances, the affiliate may have a contractual or statutory right to participate in the control of the corporation. In either event, a "sale of office" argument has sometimes been accepted when the affiliated entity's shares are sold to third persons at a substantial premium, and the contract requires or contemplates the seriatim replacement of the board of directors of the diffuse corporation.<sup>63</sup> These are true "sale of office" cases, since no substantial equity interest in the diffuse voting power of the corporation is being simultaneously transferred as justification for the transfer of the offices.<sup>64</sup>

2. *Transfers of control in connection with the sale of an insignificant fraction of the total voting shares of the corporation.*

A second type of case in which a sale of office argument has sometimes been accepted is the sale of control by a group that owns a very small fraction of the outstanding voting shares (often less than 10%).<sup>65</sup> Two New York cases decided within the same year illustrate the application of this principle.

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63. Perhaps the most graphic case is *Rowen v. Le Mars Mut. Ins. Co. of Iowa*, 282 N.W.2d 639 (Iowa 1979), which concerned transfer of control of a mutual insurance company as part of the sale of an affiliated insurance agency under common control. For a similar holding with respect to a transfer of control of a mutual savings and loan association, see *Beverly Hills Fed. Sav. & Loan Ass'n v. Federal Home Loan Bank Bd.*, 371 F. Supp. 306 (C.D. Cal. 1973) (transfer of stock at premium of a corporation handling loan escrows, acting as trustee, and providing life insurance for borrowers from the savings and loan association, accompanied by transfer of control of that association).

The application of this principle to a sale of the stock of investment advisers to open end investment companies has generated more controversy. The leading case imposing liability is *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971). *But see* *SEC v. Insurance Sec., Inc.*, 254 F.2d 642 (9th Cir.), *cert. denied*, 358 U.S. 823 (1958) (criticized in Comment, *Protecting the Interests of Mutual-fund Investors in Sales of Management-Corporation Control (or, Policing the Traffic in Other People's Money)*, 68 YALE L.J. 120 (1959)); *Krieger v. Anderson*, 182 A.2d 907 (Del. 1962) (criticized in 63 COLUM. L. REV. 153 (1963)). Both of these cases accept the argument that transfer of the ownership of the investment adviser automatically caused a cancellation of the service contracts under section 15(a)(4) of the Investment Company Act of 1940 (codified as amended at 15 U.S.C. § 80a-15(a)(4) (1983)).

64. It is possible, of course, that the sellers of control may have modest interests in the corporation, such as small investments in the mutual fund, small deposits in the savings and loan association, or insurance policies with the mutual insurance corporation. These minor direct voting interests have never been relied upon as justifying the seriatim resignation of directors.

65. *See, e.g., Brecher v. Gregg*, 89 Misc. 2d 457, 392 N.Y.S.2d 776 (1975); *In re Caplan's Petition*, 20 A.D.2d 301, 246 N.Y.S.2d 913 (1964); *see also* *Nelson v. Gammon*, 478 F. Supp. 630 (W.D. Ky. 1979) (suit dismissed; receipt by selling shareholders of legal fees and employment contracts did not constitute illegal premiums for transfer of control); *Benson v. Braun*, 8 Misc. 2d 67, 155 N.Y.S.2d 622 (1956) (complaint charging sale of control by shareholders (recently victorious in proxy fight) dismissed since there was no showing that the premium paid was for resignations).

In *In re Caplan's Petition*,<sup>66</sup> Roy Cohn owned 3% of the stock of Lionel Corporation but had successfully nominated seven of the ten directors. Cohn sold his shares on a deferred sale basis, transferring the voting power and receiving cash immediately, but gave back promissory notes equal to the amount paid to him; these notes were to be cancelled under specified circumstances. The contract included a provision for the seriatim replacement of Roy Cohn's directors. Since Cohn possessed only 3% of the voting power, the court viewed the transaction as an attempted sale of office and invalidated the substitution of directors.

In contrast, in *Carter v. Muscat*,<sup>67</sup> the same court, with two of four judges sitting in both cases, was faced with a sale of interests associated with William Zeckendorf, Sr. of 9.7% of the voting shares of Republic Corporation. The Zeckendorf interests nevertheless controlled six of the eleven directorships. The contract to sell the shares provided for the immediate substitution of directors. The price for the shares "was substantially the market price although slightly higher,"<sup>68</sup> and the seriatim resignation of directors occurring pursuant to the contract was thereafter accurately described to the public shareholders. At subsequent shareholders' meetings, the substituted directors were reelected. Relying in part on these post-sale developments, the court declined to invalidate the sale of the 9.7% block as a sale of office. No case has apparently accepted the sale of office argument when the shares being transferred are in excess of 10% of the voting shares and the price is not expressly allocated in part to the sale of control provisions of the contract.

The validity of contract provisions requiring seriatim resignations of directors in connection with sales of small percentages of voting shares also may arise in the context of breach of contract suits between the buyer and seller, rather than suits brought by shareholders not party to the contract. In the leading case,<sup>69</sup> suit was brought on a contract to sell about 28% of the stock of the corporation. The sellers were committed to deliver the resignations of a majority of the board of directors and to cause the election of successors nominated by the purchaser at the closing of the transaction. The defendants argued that the contract was against public policy because of the provisions relating to the transfer of director-

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66. 20 A.D.2d 301, 246 N.Y.S.2d 913 (1964).

67. 21 A.D.2d 543, 251 N.Y.S.2d 378 (1964).

68. *Id.* at 544, 251 N.Y.S.2d at 380.

69. *Essex Universal Corp. v. Yates*, 305 F.2d 572 (2d Cir. 1962).

ships. The case was complicated by reason of the *Erie* doctrine: The panel of the Second Circuit was forced to divine New York law in the absence of any really controlling precedent.

Chief Judge Lumbard argued as follows: (1) if the block being transferred were a majority of the shares, the clause would not be against public policy since a majority of the shares inherently carries with it the power to name at least a majority of the board of directors; (2) it is unlawful to transfer control as such (accompanied by no stock or insufficient stock to carry voting control); (3) a 28% interest "is usually tantamount to majority control" in a publicly held corporation; and (4) the case should therefore be remanded to determine whether, assuming neutrality on the part of the selling shareholders, a holder of 28% of the outstanding shares might fail to obtain the election of its candidates at a regular election.<sup>70</sup>

Judge Clark concurred in the result, suggesting that the inquiry proposed by Judge Lumbard required "hypothetical findings" and should not be determinative of the outcome. Judge Clark also stated that the agreement did not involve a "naked transfer of corporate office," and there was "no ground for declaring the present agreement void on its face."<sup>71</sup> Judge Friendly, starting from a somewhat different perspective than Judge Clark, suggested tentatively that "if I were sitting on the New York Court of Appeals, I would hold a provision like Paragraph 6 violative of public policy save when it was entirely plain that a new election would be a mere formality, such as where the seller owned more than 50% of the stock."<sup>72</sup>

The issue in these cases of the validity of the contract for the sale of minority shares that contains provisions relating to transfer of control is quite different from the issue presented by a nonselling shareholder complaining of the transfer of control. There seems to be no reason to permit a contractual party to avoid his commitment because the agreement may injure other parties unless those parties complain of the injury.<sup>73</sup>

In 1968 Congress added section 14(c) to the Securities Exchange

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70. *Id.* at 579 (emphasis added).

71. *Id.* at 580.

72. *Id.* at 581 (concurring).

73. In *Goode v. Powers*, 97 Ariz. 75, 397 P.2d 56 (1964), the purchasers of a 25% interest in the voting shares of an insurance company were sued for the balance of the agreed purchase price. The defendants argued that the stock was only inherently worth \$200 per share, but was sold for \$500 per share because of the transfer of control provisions. Not surprisingly, this argument was rejected by the court, though some evidence as to valuation was considered by the trial court.

Act of 1934.<sup>74</sup> That section authorized the Securities and Exchange Commission to require disclosure in connection with sale of control transactions involving the substitution of directors other than by a vote of shareholders. Rule 14(f)(1),<sup>75</sup> adopted by the SEC pursuant to this grant of authority, requires disclosure of substantially the same information about the new directors as would be required in a proxy statement in connection with an election by shareholders of those persons as directors.<sup>76</sup> This information must be distributed to all voting shareholders not less than ten days before the date the new directors are to take office. This requirement, it should be noted, is only applicable to transfers of directorships of registered corporations<sup>77</sup> in connection with section 13(d) or section 14(d) transactions (purchases that bring the ownership interest of the purchaser over 5% of the outstanding voting shares or tender offers that have the same effect). While it is possible that a transfer of control may entail less than 5% of the corporation's shares (indeed, witness Roy Cohn's transfer of control of Lionel Corporation)<sup>78</sup> and thus not be covered by section 14(f), that is not very likely.

### C. *Corporate Opportunity*

Some sale of control cases have been successfully attacked because they appear to be a disguised usurpation of a corporate opportunity. In the leading case,<sup>79</sup> the corporation had virtually its whole capital invested in a single piece of real estate. An outside group approached the corporation's president with a proposal that the corporation sell them the real estate at an attractive price. The president refused, but then negotiated a transaction by which he agreed to sell the outside group enough shares to give them control of the corporation. The president quietly purchased additional shares from other shareholders to make up the block he had agreed to sell. After the sale, the outside group, now in control of the corporation, arranged to purchase the real estate from the corporation

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74. 15 U.S.C. § 78n(f) (1984).

75. 17 C.F.R. § 240.14f(1) (1985).

76. It may be, of course, that legislation such as § 14(f), expressly recognizing the possibility of transfers of control other than by vote of the shareholders, may to some extent be viewed as legitimizing that practice.

77. In other words, it applies to every corporation with a class of shares registered on a national securities exchange and every corporation with more than \$3,000,000 of assets and five hundred or more shareholders of record of a class of shares. 15 U.S.C. § 78(i); 47 Fed. Reg. 17,046 (1982) (to be codified at 17 C.F.R. pts. 240, 249).

78. See *supra* text accompanying note 66.

79. *Commonwealth Title Ins. & Trust Co. v. Seltzer*, 227 Pa. 410, 76 A. 77 (1910).

at a price "which was not found to be inadequate," and the corporation was thereafter apparently dissolved. The principal argument considered by the court was whether the sale of the stock and the subsequent sale of the real estate were separate transactions or were part of a single transaction. The court treated them as a single transaction and required the defendants to account to the remaining shareholders for their profits.

Relatively few sale of control cases fit so neatly into a corporate opportunity cubby-hole.<sup>80</sup> Perhaps the most famous of all sale of control cases, *Perlman v. Feldmann*,<sup>81</sup> probably does fall into this category, however. During the Korean war, steel capacity was in great demand, and a "gray market" had developed because of federally imposed price restraints. Newport Steel Corporation was a relatively inefficient steel producer, but, because of the steel shortage, was enjoying unusual prosperity. A distant end-user of steel, Wilport Steel Company, approached Feldmann, the president and a direct or indirect owner of 33% of the outstanding shares of Newport, with a merger proposal. Feldmann rejected this proposal but ultimately worked out a plan by which Feldmann's stock (and stock owned by his family and associates) was purchased at a price of twenty dollars per share, a substantial premium over the market price of about twelve dollars per share. The stock sold by Feldmann constituted about 37% of the outstanding voting stock. Control was transferred to Wilport apparently by the seriatim resignations of Feldmann's directors and the substitution of Wilport's nominees.

This case seems to involve a misappropriation of a corporate asset—the opportunity to merge on favorable terms—which would have benefited all the shareholders if the corporate transaction had been permitted to proceed; the case has been so explained.<sup>82</sup> On the other hand, other commentary argues strongly that the case can only be explained on the basis of a broader principle of sharing of control premiums generally.<sup>83</sup> A dispute over the scope and meaning of this decision was almost inevitable, given the opacity of Judge

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80. Other early cases that arguably fit into this category include *Dunnett v. Arn*, 71 F.2d 912 (10th Cir. 1934); *American Trust Co. v. California Western States Life Ins. Co.*, 15 Cal. 2d 42, 98 P.2d 497 (1940). These early cases all involve an element of deception or nondisclosure as well as a pure sale of control.

81. *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955).

82. Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505, 515 (1965).

83. Berle, *The Price of Power: Sale of Corporate Control*, 50 CORNELL L.Q. 628, 634 (1965).

Clark's majority opinion; a commentary on God, country, motherhood, and fiduciary duties in general, with no indication of precisely what fiduciary duty Feldmann violated.<sup>84</sup>

#### D. *Fiduciary Duty*

A few courts have approached sale of control cases by analogy to cases which hold that officers and directors may have fiduciary duties to shareholders in connection with transactions in which they purchase or sell shares of the corporation.<sup>85</sup> To recognize a fiduciary duty in all sale of control cases would, of course, virtually reverse the "long established law" that permits controlling shareholders to sell their shares at whatever price they can negotiate without any obligation to share the premium with other shareholders. It is clear that most courts are unwilling to adopt such a broad principle; the actual cases that discuss or apply fiduciary duty concepts, in connection with transactions in control, involve complicating facts.

Perhaps the case that comes closest to accepting a broad fiduciary principle in a sale of control case is *Brown v. Halbert*.<sup>86</sup> The majority shareholder of a saving and loan association received an inquiry into whether the association was for sale. He stated the association was not for sale but that he and his wife would consider selling their stock. A sale was arranged at over \$1500 per share, two and one-half times book value. The purchasers simultaneously offered the minority shareholders \$300 per share; and the majority shareholder, before the closing of his sale, assisted the new purchasers by encouraging the minority shareholders to accept the \$300 price.<sup>87</sup>

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84. Judge Clark ordered the case remanded to ascertain the amount of the control premium received by Feldmann, and directed that this premium should be shared only with shareholders of Newport other than Wilport. On remand, Judge Anderson determined that the "enterprise value" of a share of Newport stock "shorn of control" was \$14.67, so that Feldmann had received a premium of \$5.33 per share, or a total premium of \$2,126,280. Following the directions of the appellate court, Judge Anderson entered judgment for the plaintiffs representing 63% of the stock (\$1,339,769) plus interest. *Perlman v. Feldmann*, 154 F. Supp. 436 (D. Conn. 1957).

85. *See, e.g., Strong v. Repide*, 213 U.S. 419 (1909) (holding that an officer or director may be required to disclose "special facts" to a shareholder in connection with the purchase or sale of shares).

86. *Brown v. Halbert*, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (1969).

87. He did this by advising shareholders that the new majority shareholders planned to pay high salaries to themselves so that no dividends would be paid for a considerable number of years, and the shareholders should accept the \$300 price because if they did not, they might not get anything. The price offered to the minority shareholders was later increased to \$611 per share and several shareholders sold at that higher price.

On these facts, the court held that the selling shareholder had a fiduciary duty to the minority. Since he acquired "an advantage" over the other shareholders, he had the burden of proof that receipt of the advantage was justified. The court stated:

Every sale of a block of control stock should not per se be subject to attack, but where the amount received by the majority-director seller is so disproportionate to the price available to the minority stockholders, then such fiduciary-seller must show that no advantage was taken if the sale is questioned. This is especially true in the instant case where Halbert in his triple fiduciary capacity was completely indifferent to his obligations to the minority stockholders. He did not advise the directors or stockholders that he had been approached by persons who desired to acquire the Association. After obtaining an agreement for the price he desired for his own stock and while still an officer-director, he failed to make any effort to obtain for the minority substantially the same price that he received and, in fact, worked actively for the buyers in assisting them to acquire all the stocks at a low figure by voicing his recommendation to the minority holders that they sell at below book value. Halbert's other actions in permitting the buyers access to the books, records and reports of the Association, and his agreement to refrain from the payment of dividends only serve to fortify the conclusion that he worked to obtain an advantage for himself and effectively placed the buyers of his stock in a position to dictate terms to the detriment of the minority holders. Further, in advising the minority stockholders to sell their stock for \$300 or they might get nothing, he was using his office, experience and reputation gained in the conduct of their affairs to prevent the minority an opportunity to obtain a higher price for their stock.<sup>88</sup>

The second case,<sup>89</sup> a well known decision from California, is not a true sale of control case, since the majority shareholders of the savings and loan association did not sell their shares to third persons. Rather, they contributed them to a holding company without offering a similar opportunity to certain minority shareholders. An active public market was then created for the holding company shares, while the market for the underlying savings and loan association shares withered away. The court imposed a fiduciary duty, relying on *Perlman v. Feldmann*,<sup>90</sup> the looting cases,<sup>91</sup> and *Brown v. Halbert*.<sup>92</sup> As described by the court,

[m]ajority shareholders may not use their power to control cor-

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88. *Brown*, 271 Cal. App. 2d at 268-69, 76 Cal. Rptr. at 791-92.

89. *Jones v. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

90. See *supra* text accompanying note 81.

91. See *supra* note 37 and accompanying text.

92. See *supra* text accompanying note 86.

porate activities to benefit themselves alone or in a manner detrimental to the minority. Any use to which they put the corporation or their power to control the corporation must benefit all shareholders proportionately and must not conflict with the proper conduct of the corporation's business.<sup>93</sup>

This language, of course, should be read as directed at the problem faced by the court, and not as of general applicability.

Kansas presents the "acid test" for the fiduciary duty concept in sale of control cases, since it has generally adopted the broadest view of fiduciary duties between directors and minority shareholders.<sup>94</sup> One would expect that if the fiduciary approach to sale of control cases was to take root, it would be in Kansas with its well-developed case law. However, in a word, it hasn't. In *Ritchie v. McGrath*,<sup>95</sup> the Kansas Court of Appeals squarely adopted the "long settled law" that controlling shareholders may sell shares at a premium consistent with their broad fiduciary duty, relying in part on an earlier Tenth Circuit decision nominally applying Kansas law.<sup>96</sup> When the Tenth Circuit again reviewed Kansas law,<sup>97</sup> it held that *Ritchie*, rather than the fiduciary duty cases, applied to all cases involving sale of control in the absence of foreseeable looting or misrepresentation by the selling shareholder.<sup>98</sup>

#### E. *Sale of Control in Closely Held Corporations: Misrepresentation or Nondisclosure*

The discussion to date has largely dealt with sales of control in publicly held corporations. Similar problems, however, often arise in corporations which are closely held so that no public market exists for their shares. Many of the early sale of control cases are of this type and were traditionally analyzed as simple cases of fraud, misrepresentation, or nondisclosure. A common fact pattern involved officers or directors assembling blocks of shares by purchas-

93. *Jones*, 1 Cal. 3d at 108, 460 P.2d at 471, 81 Cal Rptr. at 599.

94. This rule developed in connection with transactions between directors and minority shareholders. *Blazer v. Black*, 196 F.2d 139 (10th Cir. 1952); *Sampson v. Hunt*, 222 Kan. 268, 564 P.2d 489 (1977); *Hotchkiss v. Fischer*, 136 Kan. 530, 16 P.2d 531 (1932).

These cases generally hold that if a director or managing officer seeks to purchase the shares of another shareholder and has knowledge affecting the value or price of the shares, he is under a fiduciary duty to disclose such facts to the shareholders before dealing with them. The fiduciary duty, however, is expressed in strong and uncompromising terms.

95. *Ritchie v. McGrath*, 1 Kan. App. 2d 481, 571 P.2d 17 (1977).

96. *McDaniel v. Painter*, 418 F.2d 545 (10th Cir. 1969).

97. *Delano v. Kitch*, 663 F.2d 990 (10th Cir. 1981).

98. The court also held, however, that the principal lawyer for the corporation, who negotiated a "finder's fee" to find a purchaser, violated his duty to the minority shareholders when he obtained the fee from the purchasers of the shares. *Id.* at 998-99.



ing shares from current shareholders in order to resell them to the purchaser of control at a higher price.<sup>99</sup> These cases often involved affirmative misrepresentation; where no factual misstatements occurred, some courts permitted the transaction to stand ("there must be some actual misrepresentation in order to constitute fraud")<sup>100</sup> while others imposed liability for nondisclosure either on the common law "special facts" doctrine<sup>101</sup> or Rule 10b-5.<sup>102</sup>

In the closely held corporation, a sale of control by the majority shareholders, without offering all shareholders the same terms, usually presents itself as a two-price problem. The typical case involves a single majority shareholder (or a group of shareholders that together comprise a majority and who act in concert). Because the majority shareholder has an absolute majority of the outstanding shares and is unlikely to voluntarily sell his controlling margin unless he sells his entire interest, there is virtually no possibility that one or more minority shareholders may ever attain control of the enterprise. Further, if the minority shareholders are in a position of antagonism with the majority shareholder, they may be "frozen out"—entirely excluded from the fruits of share ownership, receiving neither offices nor dividends except at the sufferance of the majority shareholder.

A purchaser of the stock owned by the majority shareholder of a closely held corporation almost certainly will not improve the prospects of minority shareholders if they remain in the venture. The probability that they will be frozen out from the fruits of share ownership is, if anything, higher than it was before. A purchaser of controlling shares usually wishes to obtain all of the outstanding shares to avoid nuisance claims and to give him complete discretion with respect to the use and deployment of the corporate assets. On

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99. Many early cases of this type are assembled in Annot., 38 A.L.R. 3d 738 (1969). For an analysis of the sale of control issue, largely in terms of misrepresentation and nondisclosure, see Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725 (1956). Other cases find an agency relationship between minority shareholders and controlling shareholders to whom they gave options or rights to resell their shares. Where the controlling shareholders secretly resold at a higher price than paid to the minority, liability was imposed. See, e.g., *Reed v. Pitkin*, 231 Mich. 621, 204 N.W. 750 (1925); *Dutton v. Barnes*, 162 Minn. 430, 203 N.W. 414 (1925); *Tuller v. Swift*, 113 Minn. 263, 129 N.W. 572 (1911).

100. *Walsh v. Goulden*, 130 Mich. 531, 539, 90 N.W. 406, 410 (1902).

101. See, e.g., *Strong v. Repide*, 213 U.S. 419 (1909).

102. 17 C.F.R. § 240.10b-5 (1984). It should be noted, in passing, that if the minority shareholders are *not* solicited to sell their shares (as is true in all of the sale of control cases discussed earlier), no violation of Rule 10b-5 has occurred because the plaintiff is not a purchaser or seller of shares under the Birnbaum doctrine. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

the other hand, if the minority shareholders demand a price that the new purchaser feels is too high, the purchaser is often willing to leave the minority shares outstanding, planning to pick them up at a favorable price at some later date. In order to assure that the minority shareholders recognize that there is little point in rejecting offers in order to wait for better ones, the new majority shareholder usually will routinely exercise his power of control to freeze out the minority shareholders and deny them any substantial return on their investment. All of this tends to lead to a two-price offer to majority and minority shareholders.

When a two-price structure is established by the purchaser of the controlling shares of a closely held corporation, the modern practice is to make full disclosure to the minority shareholders that the majority shareholder has been offered a higher price for his shares.<sup>103</sup> This disclosure often creates a strong negative visceral reaction on the part of minority shareholders. They do not accept kindly the proposition that the majority shareholder should take a portion of the sale's proceeds that is disproportionate to his interest in the corporation, though the case law seems to contemplate that result.<sup>104</sup> On the other hand, a decision not to sell their shares seems to offer an even bleaker prospect.

Many lawyers, I believe, feel that there is something a little "sharp" about offering significantly different prices for otherwise identical shares under these circumstances, and that the possibility of litigation cannot be discounted if the purchaser and seller of the control shares exploit their powers over the minority shareholder to the fullest. As a result, many of these transactions are structured as single price transactions from the outset, even though the pure economic power of the parties would seem to dictate a very high price for the controlling shares and a "nuisance value" nominal price for the minority shares. It should be added that, in these situations, the selling majority shareholder often obtains an employment or consulting contract with the purchasers ("to assure a smooth transition"). A two-price structure may in fact, therefore, continue to exist to some degree even in a nominally one-price transaction if all the economic benefits of the transaction are totaled up.

Economists are apparently not troubled by a two-price structure when they are presented with a hypothetical problem involving the

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103. This is a result of the possible liability for nondisclosure under Rule 10b-5.

104. See *supra* text accompanying note 100. Where full disclosure occurs, neither Rule 10b-5 nor the "special facts" doctrine has any application.

sale of control of a closely held corporation. This reaction may be based on the theory that a two-price structure seems reasonable, since a majority block of shares is quite a different "good" than a minority block. The injustice to minority shareholders is not recognized or, if recognized, is viewed as the unfortunate consequence of a misjudgment made by the minority shareholders at some earlier time. This injustice may also be viewed as part of the acceptable cost of attaining economic efficiency.

Alternatively, economic analysis may view the closely held corporation as involving an indeterminate problem, since economic analysis deals with markets and not with transactions which basically involve barter or individual negotiation between two or three persons. In this connection, an observation by Easterbrook and Fischel<sup>105</sup> deserves repeating: They suggest that minority shareholders can avoid unfortunate results in this situation, if they wish, by electing not to invest in closely held enterprises. Such advice obviously provides little solace for the unfortunate person who inherits minority shares or invests in a corporation on the mistaken belief that amicable relations will continue.

#### F. *New Developments and New Trends*

The "long settled law" relating to sale of control of publicly held corporations is being influenced, in some immeasurable way, by the development of cash tender offers and other takeover devices and by legislative responses to these devices. When outside interests make an unwanted offer to purchase for cash a majority of the outstanding shares of a publicly held corporation at a substantial premium over current market price, the offer has some superficial resemblance to the sale of control transactions discussed in this Article.<sup>106</sup>

This relationship between two apparently widely disparate phe-

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105. See *supra* note 31 and accompanying text.

106. The analogy is superficially even closer in the "front-end loaded" tender offers, where the aggressor announces a high price for 50% of the outstanding shares together with a plan to obtain the balance of the shares at a considerably lower price if the first offer is successful. The two-price structure warps the decision whether or not to tender, however, and is therefore also not analogous to traditional sale of control cases. It warps the decision because it introduces a type of "prisoner's dilemma": whether or not to tender.

A rational shareholder, faced with a front-end loaded offer, should logically look at the blended price in order to determine whether to tender (since, if the blended price is attractive, all shareholders will tender, and each will sell half his shares at the front-end price and half at the back-end price). If the blended price is unattractive, however, the shareholder faces the classic dilemma: if he rejects the unattractive blended price, he may end up having all his shares purchased at the "back-end" price, if other shareholders tender and receive a disproportionate part of the front-end price. Since his strategy depends on the strategy of other

nomena has an unexpected impact on the sale of control cases: the apparent applicability of state anti-takeover statutes and proposed federal regulations<sup>107</sup> to these quite different transactions. The statutes discussed here are post-*Mite*<sup>108</sup> responses by state legislatures to the concerns of incumbent management to unwanted takeover attempts. Any application of them to the sale of control problem discussed here is entirely fortuitous. The statutes of several states,<sup>109</sup> and their possible application to sale of control cases, are discussed below.

### 1. *Ohio.*

In 1983, Ohio enacted a statute applicable to "control share acquisitions" of an "issuing public corporation" that appears to cover many private sale of control cases.<sup>110</sup> An "issuing public corporation" is a corporation with fifty or more shareholders with substantial economic contacts with Ohio. A "control share acquisition" is the acquisition of shares that puts the aggregate ownership of the holder through one or more of several critical ownership levels: one-fifth, one-third, and one-half. A control share acquisition is permitted under the Ohio statute only if a meeting of the shareholders approves the control share acquisition "by an affirmative vote of a majority of the voting power of such corporation in the election of directors represented at such meeting in person or by proxy, *and a majority of the portion of such voting power excluding the voting power of interested shares.*"<sup>111</sup> "Interested shares" are defined to be shares owned by the purchaser or any officer or director/employee

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shareholders, he may tender despite the unattractiveness of the blended price because of the structure of the offer.

107. The SEC Advisory Committee on Tender Offers, in its report of July 8, 1983, proposed that no person may acquire voting securities of an issuer registered under the Securities Exchange Act of 1934 if, immediately following such acquisition, the person owned more than 20% of the voting power of the securities of the issuer except (i) from the issuer, or (ii) pursuant to a tender offer. *Reprinted in* FED. SEC. L. REP. (CCH) ¶ 83,511 (Mar. 28, 1984).

The apparent target of this recommendation was "creeping" open market purchases of control, but it literally also covers a negotiated private purchase of controlling shares from one shareholder or group of shareholders. John S.R. Shad, Chairman of the Securities and Exchange Commission, subsequently testified that "[t]he Commission has serious reservations about this recommendation. Further study of the economic implications for the entire change of control area is required." *Id.* It appears unlikely that such a major change in principle will be adopted in the near future.

108. *Edgar v. Mite Corp.*, 457 U.S. 624 (1981).

109. No attempt is made here to determine whether these statutes are constitutional under the principles of the *Mite* case.

110. OHIO REV. CODE ANN. §§ 1701.01(Y), (Z), 1701.83.1 (Page Supp. 1983).

111. *Id.* at § 1701.83.1(E)(1) (emphasis added).

of the corporation.<sup>112</sup> In other words, any person who attempts to buy shares that puts him through the 20%, 33% or 50% levels, may buy them only with the affirmative vote of a majority of the shares not owned by the acquiring person or persons affiliated with the corporation. If this statute is constitutional, it appears to grant the minority shareholders the unlimited power to veto the acquisition of control shares, and in some unpredictable, erratic manner may serve to compel the sharing of premiums in control share transactions.<sup>113</sup>

## 2. *Pennsylvania.*

The Pennsylvania statute differs from the Ohio statute in several important respects: It only applies to corporations registered under the Securities Exchange Act of 1934,<sup>114</sup> and it does not condition a purchase upon the affirmative vote of other shareholders. Rather, it requires every person or group who acquires "voting power over voting shares of the corporation that would entitle the holders thereof to cast at least 30% of the votes that all shareholders would be entitled to cast in an election of directors," to agree to purchase the shares owned by other shareholders upon a request made "within a reasonable time."<sup>115</sup> The cash price for those shares must be "equal to the fair value of each voting share as of the day prior to the date on which the control transaction occurs, taking into account all relevant factors, including an increment representing a proportion of any value payable for acquisition of control of the corporation."<sup>116</sup>

This provision appears to require any purchaser of control, in a negotiated transaction, from the controlling shareholder (so long as the block exceeds 30% of the voting shares) to offer to purchase the shares of all other shareholders at a fair price. This provision may possibly be avoided by buying 29.9% of the shares at a high price accompanied by a transfer of control accomplished by a seriatim

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112. *Id.* at § 17.01(CC).

113. The full implications of this section are difficult to foresee because of the bizarre way in which "interested shares" are defined. Shares being acquired are apparently not "interested shares" if they are purchased from persons unaffiliated with the management of the corporation. It may be that some purchasers of control shares who already own minority interests may avoid the statute by agreeing to buy minority shares from outsiders as well as from officers or directors of the corporation in order to vote the minority shares to authorize the transaction.

114. PA. STAT. ANN. tit. 15, § 1910(G) (Purdon Supp. 1985).

115. *Id.* §§ 1910(B)(1), 1910(D).

116. *Id.* § 1910(E).

resignation of directors. It may also be possible to buy 30.1% at a lower price, await a "reasonable time" for the expiration of appraisal rights under section 1910 and then buy the balance of the shares owned by the majority shareholder at a much higher price. This second transaction does not violate the statute because the appraisal-type right is triggered under the Pennsylvania statute only by breaking the 30% level. Such a strategy would apparently not avoid the shareholder approval requirements in Ohio, since that state's statute has three separate "triggering" levels.

### 3. *Indiana and Hawaii.*

Indiana and Hawaii also have statutes designed to reach the problem of unwanted takeover attempts in which follow-up offers are made at significantly lower prices than the original offers. These statutes basically require follow-up transactions within two years to be at the original offer price. However, they apparently do not reach private sale of control transactions by a small group of controlling shareholders. The Hawaii statute applies only to "takeover bids" that are defined to be offers, excluding "an isolated offer to purchase shares from individual stockholders and not made to stockholders generally."<sup>117</sup> Indiana similarly applies its statutes (requiring follow-up offers at "substantially equivalent terms")<sup>118</sup> only to offers to acquire shares "pursuant to a tender offer or request or invitation for tenders."<sup>119</sup>

## IV. CONCLUSION

Much of the legal literature relating to the "sale of control" cases is dated and relies heavily on broad philosophical arguments based on cases decided during the 1950's and 1960's. Whatever the original meaning of these cases, they have not led to the judicial development of a general principle requiring sharing of control premiums foreseen by the writers during the 1960's. Indeed, the "long settled law" that control premiums generally may be obtained by controlling shareholders without any requirement of sharing them with other shareholders appears to be indeed "settled" as of 1985. Economists applaud this result. On the other hand, there are exceptions to this "long settled" rule which have sufficient breadth and flexibility that abusive transactions can apparently be attacked suc-

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117. HAWAII REV. STAT. §§ 417E-1(7), (8) (1976).

118. Ind. Gen. Corp. Law, IND. CODE ANN. § 23-2-3.1-8.4 (West Supp. 1983).

119. *Id.* § 23-2-3.1-1.

cessfully. Lawyers, I assume, applaud this result even though economists may not like this kind of *ex post* analysis. Not finding the economists' objections to these exceptions particularly persuasive,<sup>120</sup> I conclude that the legal system appears, by chance and by common sense, to have reached a reasonably optimum point on the "efficiency/injustice" scale on this relatively narrow issue.

Finally, the modern law of sale of control transactions has developed unanswered issues arising under post-*Mite* state tender offer statutes that await resolution. These issues may be resolved either in a broad constitutional attack against all such statutes or in their individual application to specific cases for which the statutes do not appear to have been designed. The application of these statutes to the sale of control issues under consideration here appear to be unintentional and, as a result, potentially quixotic. If statutes of these types are ultimately upheld, they should be limited to the situations to which they are directed and not applied indiscriminately to private sale of control cases.

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120. The attack on the looting exception by economists appears to be unpersuasive, since it is based on assumption and assertion. *See supra* text accompanying notes 51-53. I assume that the great insight of the economists—that legal rules should be judged from an "ex ante" as well as an "ex post" perspective—does not mean that all "ex post" prescriptions are automatically uneconomic.