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CORPORATE PROXY CONTESTS: EXPENSES OF MANAGEMENT AND INSURGENTS*

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I

One of the most important advantages available to management in a proxy contest is its ready access to the corporate treasury to defray many of the expenses of waging the contest. These expenses have tended to become more and more substantial as campaigns have become more intense and elaborate. The fees of lawyers, accountants, security analysts, public relations experts and professional proxy solicitors, together with the expenses of printing, mailing, telephones, telegraph, travel and administrative personnel run into many thousands of dollars. However, the right to use corporate funds for such purposes is not unlimited, and management should be familiar with the limitations under which it must operate before it embarks on an extensive, and usually expensive, campaign.

General Principles and Requirements

The right of management to use corporate funds in a proxy contest is not regulated by state or federal statute.[1] Consequently, we must look to common law principles and judicial authority.

The principles applicable to the right of an incumbent management to use corporate funds in a proxy contest are substantially the same as those generally applicable to the use of corporate property. One of these general principles is that corporate property may be used only for a corporate purpose; that is, in furtherance of the interests or activities of the corporation. Any other purpose is considered "ultra vires."[2]

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† See Contributors' Section, Masthead, p. 74 for biographical data.

1 An exception exists in the power of the Securities and Exchange Commission to regulate proxy solicitation expenses under Section 12(e) of the Public Utilities Holding Company Act, 49 Stat. 824 (1935), 15 U.S.C. § 79l(c) (1952), discussed p. 14 infra.

2 "When acts of corporations are spoken of as ultra vires, it is not intended that they are unlawful or even such as the corporation cannot perform, but merely those which are not within the powers conferred upon the corporation by the act of its creation, and are in violation of the trust reposed in the managing board by the shareholders, that the affairs

A related principle is that an incumbent management may not use corporate funds for personal as distinguished from corporate purposes; and that the expenditure of corporate funds by a management for the sole or primary purpose of retaining control of the corporation is illegal.[3]

The application of these general principles to proxy contests has presented problems; and the problems have multiplied as proxy contests have increased in scope, intensity and importance, involving elaborate campaigns, public relations counsel, professional proxy solicitors and other specialists.

There is general agreement that a corporate management is under a duty to arrange for the holding of stockholders' meetings, the sending of notices pertaining to the meetings, and informing the stockholders with respect to corporate affairs and matters to be considered at such meetings.[4] Accordingly, it is well recognized that management has the right to expend corporate funds, in reasonable amounts, for such limited corporate purposes.[5] This right exists regardless of the absence or imminence of a contest,[6] although the question of "reasonableness" of ex-

shall be managed and the funds applied solely for carrying out the objects for which the corporation was created." Whitney Arms Co. v. Barlow, 63 N.Y. 62, 68 (1875). As to misuse of term "ultra vires," see 7 Fletcher's Cyclopedia Corporations § 3399 (Perm. ed. 1952). "The expression 'ultra vires' has been used by courts and writers in various meanings resulting in much confusion." Ballantine, Corporations § 89 (1946).

[3] Lawyers' Advertising Co. v. Consolidated Ry. L. & R. Co., 187 N.Y. 395, 80 N.E. 199 (1907); Peel v. London & Northwestern Ry., [1907] 1 Ch. D. 5 (C.A. 1906): ". . . but where the expenditures are solely for the personal interest of the directors to maintain themselves in office expenditures made in their campaign for proxies are not proper." Hall v. Trans-Lux Daylight Picture Screen Corp., 20 Del. Ch. 78, 171 Atl. 226 (Ch. 1934). See also cases cited infra note 5.

[4] 5 Fletcher's Cyclopedia Corporations §§ 1997, 2006, 2007 et seq. (Perm. ed. 1952). When directors adopt a policy and that policy is questioned by others, they have "the positive duty to inform the shareholders" of their reasons for the policy and why they think the policy should be continued. Peel v. London & Northwestern Ry. [1907] 1 Ch. D. 5 (C.A. 1906).

[5] Steinberg v. Adams, 90 F. Supp. 604 (S.D.N.Y. 1950); Hand v. Missouri-Kansas Pipe Line Co., 54 F. Supp. 649 (D.C. Del. 1944); Hall v. Trans-Lux Daylight Picture Screen Corp., 20 Del. Ch. 78, 171 Atl. 226 (Ch. 1934); Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955); McGoldrick v. Segal, 124 N.Y.L.J. 461, col. 2 (Sup. Ct. N.Y. County 1950), aff'd without opinion, 99 N.Y.S.2d (1st Dep't 1950); In re Zickl, 73 N.Y.S.2d 181 (Sup. Ct. N.Y. County 1947); Peel v. London & Northwestern Ry., [1907] 1 Ch. D. 5 (C.A. 1906). See also, Empire Southern Gas Co. v. Gray, 29 Del. Ch. 95, 46 A.2d 741 (Ch. 1946); Lawyers' Advertising Co. v. Consolidated Ry. L. & R. Co., 187 N.Y. 395, 80 N.E. 199 (1907); Kadel v. Segal Lock & Hardware Co., 130 N.Y.L.J. 488, col. 4 (Sup. Ct. N.Y. County 1953); Appeal Printing Co. v. Segal Lock & Hardware Co., 128 N.Y.L.J. 1563, col. 3 (N.Y. City Ct. 1952).

[6] "If directors of a corporation may not in good faith incur reasonable and proper expenses in soliciting proxies in these days of giant corporations with vast numbers of stockholders, the corporate business might be seriously interfered with because of stockholder in-

penditures is likely to be influenced by the existing facts and circumstances.

The problems become more complex when a contest is waged and where an incumbent management undertakes to defend its record and policies in order to obtain stockholders' support and thereby continue in control of the corporation.

A supposedly easy line of demarcation was adopted in the 1906 English case of *Peel v. London & Northwestern Railway*.[7] In upholding management's use of corporate funds in a contest, the Court pointed out that the questions at issue were "questions of policy affecting the conduct of the business of the corporation, and had nothing whatever to do with the directors as individuals."[8]

Most American cases which have considered the right to use corporate funds in a proxy contest have adopted the requirement that the contest involve corporate policy rather than a struggle for personal power or position.[9] The cases decided under Delaware law have generally taken this "policy" approach and have sanctioned management's use of corporate funds in defending its "policies" and in vying for stockholder approval and support.[10] A Delaware Court, in stating the principle, said:

> I gather the principle from these authorities to be that where reasonable expenditures are in the interest of an intelligent exercise of judgment on the part of the stockholders upon policies to be pursued, the expenditures are proper; but where the expenditures are solely in the personal interest of the directors to maintain themselves in office, expenditures made in their campaign for proxies are not proper.[11]

As will be seen in the next section, this approach, followed by a finding that matters of policy were involved, has resulted in a reluctance on the part of the courts to interfere with or disallow expenditures which the directors believed to be reasonably necessary to conduct a proxy contest involving issues of policy.[12]

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difference and the difficulty of procuring a quorum, *where there is no contest*." Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 172-73, 128 N.E.2d 291, 292 (1955) (emphasis added).

[7] [1907] 1 Ch. D. 5 (C.A. 1906).

[8] Id. at 18.

[9] Steinberg v. Adams, 90 F. Supp. 604 (S.D.N.Y. 1950); Hall v. Trans-Lux Daylight Picture Screen Corp., 20 Del. Ch. 78, 171 Atl. 226 (Ch. 1934); Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955).

[10] Steinberg v. Adams, 90 F. Supp. 604 (S.D.N.Y. 1950) (applying Delaware law); Hand v. Missouri-Kansas Pipe Line Co., 54 F. Supp. 649 (D.C. Del. 1944); Empire Southern Gas Co. v. Gray, 29 Del. Ch. 95, 46 A.2d 741 (Ch. 1946); Hall v. Trans-Lux Daylight Picture Screen Corp., 20 Del. Ch. 78, 171 Atl. 226 (Ch. 1934).

[11] Hall v. Trans-Lux Daylight Picture Screen Corp., 20 Del. Ch. 78, 84, 171 Atl. 226, 228 (Ch. 1934).

[12] See lower court decision by Referee in Rosenfeld v. Fairchild Engine & Airplane Corp.,

However, at least one court, applying the Delaware law and following the policy approach, has criticized the latter as being artificial and unsound. The Federal Court in the case of *Steinberg v. Adams*,[13] stated:

> The simple fact, of course, is that generally policy and personnel do not exist in separate compartments. A change in personnel is sometimes indispensable to a change of policy. A new board may be the symbol of the shift in policy as well as the means of obtaining it.[14]

The New York cases and doctrine are more uncertain, primarily because of the "Delphic Oracle" decision and the opinions by the Court of Appeals in 1955 in *Rosenfeld v. Fairchild Engine & Airplane Corporation*.[15] Prior to the decision in the *Fairchild* case, the only New York Court of Appeals case dealing with the problem was *Lawyers' Advertising Co. v. Consolidated Railway Lighting & Refrigerating Co.*, decided in 1907.[16]

In the *Lawyers' Advertising* case, the corporation was sued for the cost of four newspaper advertisements ordered by the corporation's secretary. The first advertisement was inserted on order of the board of directors and carried the notice of a special meeting to resolve a conflict which had developed between the board and the president. Proxies were being solicited by both groups. The other three advertisements were inserted by the secretary without specific board authorization *and dealt with the contest issues and urged the stockholders to return the directors' proxies*. The Court held that the corporation was liable only for the first notice, because publication of the other three notices was not authorized by the board of directors; *but then the Court also stated that publication could not have been lawfully authorized even if the attempt were made*. The Court mentioned that these three notices were not "legitimately incidental to the meeting or necessary for the protection of the stockholders" because they were an "urgent solicitation that these proxies should be executed and returned for use by one faction in its contest, and we think there is no authority for imposing the expense

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116 N.Y.S.2d 840 (Sup. Ct. Nassau County 1954) (applies "business judgment" rule in refusing to pass on reasonableness of the proxy solicitation expenses).

13 90 F. Supp. 604 (S.D.N.Y. 1950), 36 Cornell L.Q. 558 (1951), 49 Mich. L. Rev. 605 (1951), 61 Yale L.J. 229 (1952).

14 90 F. Supp. at 608. See also dissent in Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 176, 128 N.E.2d 291, 295 (1955), in which the dissenting judge comments on and approves the above view as to the impracticability of distinguishing between matters of policy and matters purely personal in proxy contests.

15 309 N.Y. 168, 128 N.E.2d 291 (1955). Notes, 41 Cornell L.Q. 714 (1956); 56 Colum. L. Rev. 633 (1956); 69 Harv. L. Rev. 1132 (1956); 31 N.Y.U.L. Rev. 825 (1956).

16 187 N.Y. 395, 80 N.E. 199 (1907).

of its publication upon the company."[17] The Court further stated that it was

> . . . too dangerous a rule to permit directors in control of a corporation and engaged in a contest for the perpetuation of their offices and control, to impose upon the corporation the unusual expense of publishing advertisements or, by analogy, of dispatching special messengers for the purpose of procuring proxies in their behalf.[18]

Subsequent cases decided by lower New York Courts attempted to distinguish the *Lawyers' Advertising* case and tended to follow the more liberal approach of the Delaware cases based on a finding that the contest involved issues over policy.[19]

In 1955, the New York Court of Appeals rendered a four to three decision in *Rosenfeld v. Fairchild Engine & Airplane Corp.*[20] The plaintiff in that case brought a derivative stockholder's action to compel the return of $261,522 paid out of the corporate treasury to reimburse both sides for their expenses in a proxy contest. The incumbent board, while still in office, spent $106,000 of corporate funds in defense of its position. After the insurgents won the contest, the new board paid $28,000 to the old board to cover a balance of such expenses. In addition, $127,556 was paid to the insurgents to compensate them for their expense in conducting the proxy fight. This payment was approved by the new board and expressly ratified by a large majority of the stockholders. The items which were reimbursed included expenditures for printing, stationery, postage, public relations counsel, professional proxy solicitors, legal counsel, entertainment, chartered airplanes and limousines. The plaintiff did not question the reasonableness of the *amounts* spent for the various items, but argued that the use of corporate funds to pay such items was utterly illegal and ultra vires. The trial judge (Official Referee) dismissed the complaint on several grounds, including failure of proof, ratification by stockholders, and judicial unwillinguess to substitute its own judgment for the directors' business judgment.[21] The appellate division, on appeal, affirmed the judgment of dismissal because of (1) failure to prove impropriety of specific items and (2) stockholders' ratification.[22]

On appeal to the highest court of New York, the Court of Appeals,

[17] Id. at 399, 80 N.E. at 201.

[18] Ibid.

[19] Kadel v. Segal Lock & Hardware Co., 130 N.Y.L.J. 488, col. 4 (Sup. Ct. N.Y. County 1953); Appeal Printing Co. v. Segal Lock & Hardware Co., 128 N.Y.L.J. 1563, col. 3 (N.Y. City Ct. 1952); McGoldrick v. Segal, 124 N.Y.L.J. 461, col. 2 (Sup. Ct. N.Y. County 1950) aff'd without opinion sub nom. Blum v. Segal, 277 App. Div. 963, 99 N.Y.S.2d 850 (1st Dep't 1950); In re Zickl, 73 N.Y.S.2d 181 (Sup. Ct. N.Y. County 1947).

[20] 309 N.Y. 168, 128 N.E.2d 291 (1955). See also notes cited supra note 15.

[21] 116 N.Y.S.2d 840 (Sup. Ct. Nassau County 1952).

[22] 284 App. Div. 201, 132 N.Y.S.2d 273 (2d Dep't 1954), 24 U. Cin. L. Rev. 606 (1955).

four to three, upheld the dismissal of the complaint.[23] Three of the four prevailing judges[24] who voted to affirm the lower courts did so on the ground that management, in a contest over "policy," could expend reasonable sums to defend its position; and that the reasonableness of the particular items was not involved because plaintiffs did not undertake to prove the unreasonableness of such items.[25] The same three judges were of the same opinion with respect to the expenses of the successful insurgents, basing their affirmance on the approval by a majority of the stockholders of those expenses.

The fourth judge[26] who joined in affirming the lower courts, based his opinion solely on the ground that plaintiff failed to prove that the particular items of expenditure were improper. He mentioned that payment by the corporation of the expenses of one faction in a contest for the control of the corporation was ultra vires and cites the *Lawyers' Advertising* case as authority. Moreover, he stated that if an item was improper or illegal, ratification by stockholders (unless unanimous) would be of no effect.[27]

The three dissenting judges[28] were of the opinion that the complaint should not have been dismissed, and that the trial court should have required the directors to justify the various expenditures. They stated that, in their opinion, the right of incumbent directors to use corporate funds in a proxy contest should be limited to expenses covering the giving of notice of the meeting and informing the stockholders of the issues; and should not include other "campaign" expenses. They criticized the distinction between "policy" and "personnel" as being impracticable because of the impossibility of separating the two. They further stated that the insurgents, even if successful, should not be entitled to any reimbursement whatsoever, regardless of stockholder approval.[29]

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23 309 N.Y. 168, 128 N.E.2d 291 (1955). See also notes cited supra note 15.

24 Conway, Ch. J., Froessel, J. (who wrote the opinion), and Burke J.

25 The court distinguishes Lawyers' Advertising Co. v. Consolidated Ry. L. & R. Co., supra, by stating that in that case it was expressly found that the proxy contest there involved was "by one faction in its contest with another for the control of a corporation . . . a contest for the perpetuation of their officers and control." 309 N.Y. 168, 172, 128 N.E.2d 291, 292 (1955).

26 Desmond, J.

27 309 N.Y. 168, 174, 128 N.E.2d 291, 294 (1955). The concurring judge continued to state his general views on the questions of corporate reimbursement of proxy solicitation expenses by quoting extensively from the Lawyers' Advertising case, and ended with this final comment: "[S]ince expenditures which do not meet the test of propriety are intrinsically unlawful, it could not be any answer . . . that the stockholder vote which purported to authorize them was heavy or that the change in management turned out to be beneficial to the corporation." Id. at 176, 128 N.E.2d at 295.

28 Van Voorhis, J. (who wrote the dissenting opinion), Dye, J. and Fuld, J.

29 309 N.Y. 168, 176, 128.N.E.2d 291, 295 (1955).

Thus, only three of the four judges who approved the dismissal of the complaint in the *Fairchild* case expressly adopted the "policy" approach of the Delaware cases. The fourth judge, who concurred only in result, did not expressly adopt this approach, but indicated approval of the strict and limited doctrine of the *Lawyers' Advertising* case. The three dissenting judges expressly rejected the "policy" approach and continued to apply the strict limitations of the *Lawyers' Advertising* case.

It is difficult to predict how the New York courts hereafter will interpret and apply the doctrine of the *Fairchild* case. Clarification by the Court of Appeals undoubtedly is necessary. It may well be that the enactment of a statute, after careful study of this complex problem, will be the more satisfactory solution. In the meanwhile, it is probable that the immediate effect of the *Fairchild* case will be to cause the New York courts to scrutinize more closely all expenditures in proxy contests, both as to nature and amount; and that incumbent managements must be prepared to justify the reasonableness of such expenditures.

The possible differences between the New York and Delaware rules give rise to the important question of which law is to control. Suppose a derivative action is brought in a New York State court or in a federal court on behalf of a corporation organized in Delaware?

The rule as applied by the federal district court in the *Steinberg* case is that the law of the state of incorporation governs.[30] The basis of this rule is the proposition that internal corporate matters such as duties, powers and fiduciary relation of directors, as well as the rules of "ultra vires," are normally decided under the law of the domicile of the corporation.[31]

Permissible Expenditures by Management

The nature and extent of the expenses which management, in a proxy contest, may pay out of corporate funds, will depend to a certain extent upon the general doctrine applied.

If the "policy" approach is taken, as applied by the Delaware courts

30 90 F. Supp. 604 (S.D.N.Y. 1950). "The instant case is concerned with the Delaware corporation and the laws of that state determine the scope of the corporation's power." Id. at 605.

31 "Purely internal corporate affairs and management are governed by the law of the state of creation." 17 Fletcher's Cyclopedia Corporations § 8326 (Perm. ed. 1933); Restatement, Conflict of Laws § 197 (1934). "When a corporation goes into another sovereignty or state and is permitted to do business there, its powers under its charter provisions are controlled by the law of domicile." 6 Id. § 2501; but note conflicting decisions as to the various aspects of this subject, 6 Id. Chapter 24. It is to be noted that the Fairchild Engine & Airplane Company is a Maryland corporation. This fact is not mentioned in any of the decisions, nor does it appear to have been specifically pleaded. This may be explained by the lack of Maryland law on this subject.

and the three of the four prevailing judges of the New York Court of Appeals in the *Fairchild* case,[32] "corporate directors have the right to make reasonable and proper expenditures, subject to the scrutiny of the courts when duly challenged, from the corporate treasury for the purpose of persuading the stockholders of the correctness of their position and soliciting their support for policies which the directors believe, in good faith, are in the best interests of the corporation."[33]

On the other hand, if the doctrine applied is that of the *Lawyers' Advertising* case,[34] approved by the three dissenting judges in the *Fairchild* case and to a certain extent by the fourth judge who concurred only in result with the other three prevailing judges, management's permissible expenditures would be limited to reasonable sums incurred for the purpose of "informing the stockholders fully and fairly concerning the affairs and policies of the corporation, which may well include an explanation of the reasons on account of which its policies have been undertaken" and employment of solicitors to obtain proxies from apathetic stockholders "so as to insure a quorum."[35]

When we consider the propriety of specific items customarily expended by a management in a proxy contest, we find that the cases are enlightening only to a limited extent.

1. *Notice of Meeting and Proxy Statement.* It is considered axiomatic that an incumbent management is under a duty to arrange for stockholders' meetings and to inform the stockholders with respect to special corporate affairs to be discussed at that meeting.[36] This duty exists even where there is no proxy contest.[37] Consequently, all authorities, regardless of doctrine, agree that management may incur reasonable expenses in connection with giving notice of the meeting and informing the stockholders, by proxy statement or otherwise, with respect to the corporation's affairs and issues to be considered.[38] These would include printing and postage expenses, both for mailing of the material and return of proxies,[39] and also publication of the notice of the meeting[40] and any adjournments of the meeting.

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32 Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955).

33 Id. at 173, 128 N.E.2d at 293.

34 Lawyers' Advertising Co. v. Consolidated Ry. L. & R. Co., 187 N.Y. 395, 80 N.E. 199 (1907).

35 309 N.Y. at 186-87, 128 N.E.2d at 301.

36 5 Fletcher's Cyclopedia Corporations § 1997 (Perm. ed. 1952).

37 Ibid. See Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955) (both the prevailing and dissenting judges agreed as to this question).

38 See note 5 supra.

39 Peel v. London & Northwestern Ry., [1907] 1 Ch. D. 5 (C.A. 1906).

40 Lawyers' Advertising Co. v. Consolidated Ry. L. & R. Co., 187 N.Y. 395, 80 N.E. 199 (1907). See also Bounds v. Stephenson, 187 S.W. 1031 (Tex. Civ. App. 1916).

2. *Expenses of Conducting the Meeting.* Since the management is required to arrange for the holding of stockholders' meetings, it would seem that reasonable expenses in connection with the actual conduct of the meeting would also be proper. These would include rental for a meeting place if reasonably necessary or desirable under the circumstances; stenographic charges to keep a record of the proceedings; lunch or refreshments for stockholders attending the meeting; and the expenses of the inspectors of election, and those assisting them, in connection with the examination and counting of the proxies and tabulation of the vote.

3. *Proxy Solicitors.* The use of professional solicitors in large proxy contests has become almost universal. As far as the conduct of the contest is concerned, they perform a necessary and valuable service.[41]

It appears that, regardless of doctrine, proxy solicitors may be employed to contact apathetic stockholders to obtain their proxies in order to insure a quorum.[42] However, the employment of proxy solicitors in a proxy contest for the purpose of persuading or reminding the stockholders to send in their proxies to the management has raised problems.

In the *Fairchild* case, the cost of proxy solicitors was included among the expenses which were attacked by the plaintiff. The plaintiff did not question the amount of the expense, but claimed that it was illegal. Three of the four prevailing judges held that since no question of reasonableness was raised, the expenses incurred were not illegal. The fourth of the prevailing judges merely took the position that the plaintiff had failed to sustain the burden of proof when he failed to introduce evidence attacking specific items.[43]

A lower New York court in 1947 approved the expenditure of corporate funds to pay proxy solicitors. In *In re Zickl,*[44] the insurgents sought to have the re-election of the management's slate of directors set aside on the ground that the management had spent $3,000 of corporate funds in following up solicitation by paid proxy solicitors. The court held that such use of corporate funds was not only proper, but was contemplated by the SEC proxy rules which provide for certain detailed disclosure if professional solicitors are employed.[45]

[41] The study of 48 contests in 1951 and 1952 disclosed that twelve non-management groups had employed professional solicitors. Emerson & Latcham, "Proxy Contests: A Study in Shareholder Sovereignty," 41 Calif. L. Rev. 393, 418 (1953). Professional solicitors were employed by both sides in the 1954 contest involving the New York Central & New Haven Railroads. They were also employed by both sides in the 1955 Montgomery Ward contest.

[42] Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955).

[43] Judge Desmond did, however, quote language from the Lawyers' Advertising case which disapproved of "special messengers." Id. at 176, 128 N.E.2d at 295.

[44] 73 N.Y.S.2d 181 (Sup. Ct. N.Y. County 1947).

[45] Schedule 14A, Item 3, 17 C.F.R. p. 232 (1949). The court's reasoning was sharply

On the other hand, there has been considerable criticism or condemnation of the use of corporate funds to pay for proxy solicitors.[46] The New York Court of Appeals in the *Lawyers' Advertising* case, by way of dictum, indicated that it disapproved "of dispatching special messengers for the purpose of procuring proxies in their (management's) behalf."[47] The opinion of the three dissenting judges in the *Fairchild* case makes it clear that they considered it illegal for corporate funds to be used to employ proxy solicitors for any purpose other than that of contacting apathetic stockholders to insure a quorum. Their opinion said:

> There is a difference between hiring solicitors merely to follow up proxy notices so as to obtain a quorum, and a high pressure campaign to secure votes by personal contact.[48]

The opinion further stated:

> The way is open and will be kept open for stockholders and groups of stockholders to contest corporate elections, but if the promoters of such movements choose to employ the costly modern media of mass persuasion, they should look for reimbursement to themselves and to the stockholders who are aligned with them.[49]

And, again:

> . . . nor is there any reason on account of which stockholders who have neglected to sign proxies through apathy may not be solicited so as to insure a quorum, which would ordinarily occur in instances where there is no contest, but beyond measures of this character, the purely campaign expenses of a management group do not serve a corporate purpose, and paying them is *ultra vires*.[50]

Writers on the subject appear to agree in viewing the expenses of professional proxy solicitors as "unreasonable."[51] One writer makes the following comment:

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criticized by one writer who pointed out the existence of the disclosure rule did not indicate the Commission's approval of professional solicitation, for it merely required full disclosure that that method was employed. See Mintz, "Use of Corporate Funds to Pay for Proxies and Other Expenses in Fight over Corporate Management," 8 N.Y.U. Intra. L. Rev. 90, 92 (1953). Accord, Latcham & Emerson, "Proxy Contest Expenses and Shareholder Democracy," 4 Western Res. L. Rev. 5 (1952); Note, 61 Yale L.J. 229, 236 (1951).

[46] See Pittsburgh Steel v. Walker, 92 Pitt. L.J. 464 (C.P. Allegheny County 1944) (dismissing preliminary objections to bill in equity which alleged management's improper use of corporate funds in employing professional proxy solicitors to have themselves elected at the annual meeting).

[47] 187 N.Y. 395, 399, 80 N.E. 199, 200 (1907).

[48] 309 N.Y. 168, 182, 128 N.E.2d 291, 295 (1955).

[49] Id. at 186, 128 N.E.2d at 301.

[50] Id. at 187, 128 N.E.2d at 301.

[51] Latcham & Emerson, "Proxy Contest Expenses and Shareholder Democracy," 4 Western Res. L. Rev. 5 (1952); Friedman, "Expenses of Corporate Proxy Contests," 51 Colum. L. Rev. 951 (1951); Mintz, "Use of Corporate Funds for Proxies and Other Expenses in Fight over Corporate Management," 8 N.Y.U. Intra. L. Rev. 90 (1953).

> The information whose dissemination to stockholders justifies corporate financing of management proxy expenses can be presented adequately through distribution of printed matter, and there is no need for amplification by individual contact. And, once the stockholders have been fully informed, the process of vigorous persuasion that is the task of the paid solicitor goes beyond the bounds of proper corporate expenditures.[52]

As mentioned above, a lower New York court referred to the SEC proxy rules as indicating the Commission's approval of the employment of professional proxy solicitors.[53] Some insight into the Commission's view on this matter can be had from a study of a Commission decision in 1946 under the Public Utility Holding Company Act. It must be pointed out, however, that the power of the Commission to regulate proxy solicitations of public utility holding companies under section 12(e) of that Act[54] is more extensive than its power over companies under section 14(a) of the Securities Exchange Act of 1934.[55] The broader scope of the regulation is seen in Rule U-65[56] which limits management's solicitation expenses to the ordinary expenditures of preparing and mailing the proxies and statements plus other expenditures not in excess of $1,000 for any one year. However, the Commission can by order approve additional expenditures if the management files a declaration listing the proposed expenditures and requesting Commission approval.

In a 1946 case,[57] the management of a holding company filed such a declaration estimating its solicitation expenses to be $21,000, including a $3,500 fee and $5,000 disbursements to a professional proxy soliciting firm. The declaration was opposed by a group of stockholders who planned to solicit proxies in opposition to the management. In its decision, the Commission pointed out that Rule U-65 was promulgated for the purpose of "preventing excesses and abuses in the expenditure of corporate funds in a proxy campaign."[58] The Commission found that no adequate cause had been shown for permitting the management to expend corporate funds to employ paid solicitors to aid the management in waging its fight against the opposite faction, and therefore, its expenditures were limited to those allowed by Rule U-65.[59]

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52 Friedman, supra note 51, at 954-55.

53 In re Zickl, 73 N.Y.S.2d 181 (Sup. Ct. N.Y. County 1947).

54 49 Stat. 824 (1935), 15 U.S.C. § 79l(e) (1952).

55 48 Stat. 895 (1934), 15 U.S.C. § 78n(a) (1952).

56 17 C.F.R. § 250.65 (1949).

57 Matter of Standard Gas & Elec. Co., 24 S.E.C. 337 (1946), SEC Holding Co. Act. Rel. No. 7020, Dec. 2, 1946.

58 Id. at 341. A Commission release indicates that the employment of professional solicitors was the expenditure specifically aimed at in the adoption of Rule U-65. SEC Holding Co. Act. Rel. No. 2681, April 9, 1941.

59 The Commission infers that it would approve the employment of professional solicitors

This 1946 case indicates that the Commission did not then believe the employment of professional solicitors to be a "reasonable" expense under the circumstances. However, it must be remembered that Commission policies have been altered with changes in personnel, and there is no certainty that this decision represents the current Commission view.

Although no case has specifically so decided, it appears that under the Delaware rule reasonable expenditures may be made for professional proxy solicitors.[60] In New York, however, under the *Fairchild* case, there is considerable doubt as to the propriety of employing solicitors for anything but quorum purposes. Yet it seems that the courts in New York will feel obliged to recognize corporate realities and permit expenditure of reasonable sums for such purpose. If the courts do not do so, the legislature may well do so by statutory enactment.[61]

4. *Public Relations Experts.* The propriety of charging the corporation for the expense of a public relations firm is not clear. The items challenged by the plaintiff in the *Fairchild* case included expenses of public relations counsel. Three of the four prevailing judges in the *Fairchild* case apparently believed that payment of public relations experts is not necessarily illegal but is subject to scrutiny as to "reasonableness." The three dissenting judges undoubtedly disapproved of the use of corporate funds to pay such expenses. The fourth of the prevailing judges, who concurred in result only, did not express his views with respect to individual items, but quoted from the language of the *Lawyers' Advertising* case. Since the court in the *Lawyers' Advertising* case indicated that it disapproved of the use of proxy solicitors, it probably would place public relations experts in the same category.

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if it were shown that their services were necessary to insure a quorum at the meeting. It is true that if the proxies are solicited for a routine meeting where there is no opposition to management, stockholder indifference may result in failure to secure sufficient proxies to meet the quorum required. However, if a contest is in progress and the stockholders are bombarded with charges and counter-charges, it is doubtful if any such problem could develop. Certain other types of corporate action require the approval of a specified percentage of the outstanding stock. Some examples are an alteration of voting rights, merger, consolidation, and sale of assets. In these situations, the services of professional proxy solicitors may be essential, even if no opposition has developed, and the use of corporate funds for solicitors is clearly justified. See Friedman, supra note 51, at 954.

60 See Hand v. Missouri-Kansas Pipe Line Co., 54 F. Supp. 649 (D. Del. 1944) (stating that no Delaware case has decided on propriety of using professional proxy solicitors). But see Steinberg v. Adams, 90 F. Supp. 604 (S.D.N.Y. 1950); Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955).

61 A bill was recently introduced in the New York Legislature, however, which would have exactly the opposite effect, viz. to prevent the expenditure of corporate assets in the solicitation of stockholders. New York State Bar Ass'n Circular No. 97, Jan. 30, 1956. This bill has been characterized as an "extreme reaction," Note, 69 Harv. L. Rev. 1132, 1134 (1956), and in the opinion of the authors stands very little chance of adoption.

Those writers who condemn professional solicitors as a non-essential, high pressure campaign tactic,[62] would probably classify public relations counsel in the same way. Their argument would be that corporate funds are properly expended to inform the stockholders of the contest issues and this dissemination of information can be accomplished adequately without the assistance of public relations experts. On the other hand, it is conceivable that in a situation involving a large corporation, with many thousands of stockholders who are widely scattered, the services of a public relations expert may be found to be reasonably necessary for effective dissemination of information to the stockholders. Undoubtedly, this would depend on the facts and circumstances of the particular case.

5. *Legal Counsel.* There is very little discussion in the cases with respect to the propriety of payment of the fees of legal counsel in a proxy contest. It would seem, however, that management clearly has the right to use corporate funds for the payment of reasonable fees in such a situation. The services and advice of counsel are usually necessary in connection with the calling of the meeting, preparation and filing of proxy statements, determining the validity of proxies, and the conduct of the meeting.[63] Such services appear to be closely related to the performance of management's duty to give notice of the meeting, to inform the stockholders of the corporation's affairs and issues to be considered, and to convene and hold the meeting.

Theoretically, management would have no right to use corporate funds to pay for legal services rendered solely or primarily for "personal campaigu purposes."[64] As a practical matter, however, it probably would be very difficult, in most cases, to so isolate and identify legal services.

6. *Accountants and Security Analysts.* None of the cases has discussed the propriety of using corporate funds for the payment of fees of accountants or security analysts in a proxy contest. Situations may well arise where the employment of accountants or security analysts will be deemed reasonably necessary to inform the stockholders of the corporation's affairs and the issues presented. Obviously this will depend upon the nature of the contest and the specific issues raised.

7. *Corporate Employees.* In bitterly contested or close contests,

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[62] See supra notes 51, 52, 53.

[63] But see Kadel v. Segal Lock & Hardware Co., 138 N.Y.L.J. 488, col. 4 (Sup. Ct. N.Y. County 1953), where the Court questioned the propriety of charging to the corporation the expenses of a legal proceeding, on behalf of management, to enjoin the voting of certain proxies.

[64] Kadel v. Segal Lock & Hardware Co., 138 N.Y.L.J. 488, col. 4 (Sup. Ct. N.Y. County 1953). See Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955) (both the prevailing and dissenting judges agreed on this question).

managements of large corporations have often used the services of various employees in their organization. These services have ranged all the way from the performance of clerical and ministerial duties to public relations work and the solicitation of proxies. Efforts have been made by insurgent groups to obtain a court order restraining the corporation from using employees for campaign purposes.[65] It would seem that the diversion of corporate employees from the performance of their regular corporate duties to active participation in the campaign may well be criticized as an improper use of corporate "assets."

YARDSTICK OF REASONABLENESS

The requirement of "reasonableness," as to both nature and amount of expenditures, is imposed under the cases following the "policy" approach. It also is imposed, but to a more limited extent, under the *Lawyers' Advertising* case as approved by the dissenting judges and the fourth concurring judge in the *Fairchild* case.[66] The courts emphasized that the expenditures by management in a proxy contest are subject to judicial scrutiny with respect to their reasonableness.

However, the yardstick of "reasonableness" is, of necessity, most indefinite and elastic. It obviously will be said to vary with the facts and circumstances of each case. It is probable that some courts will resort to an approach similar to the "business judgment" approach in stockholders' derivative actions and will be reluctant to superimpose their own views as to reasonableness except in clear and manifestly flagrant cases. An example of such reluctance may be found in the opinion of the Official Referee in the *Fairchild* case. He said:

> If any of these defendants had a personal interest in what was transpiring, and which interest was adverse to that of the corporation, then the courts might be justified in appraising the reasonableness of the expenditures made by them. However, I know of no case which justifies a judge sitting as trier of the facts to substitute his judgment for the so-called "business judgment rule". . . . Whether or not the expenditures made were reasonable depends upon so many elements that it is impossible to define them all. One must consider the size of the corporation, its capitalization, the number of shares outstanding, the number of shareholders, the benefits flowing to them as a result of the contest. And if one were to delve further one would also have to consider the reasonableness of the compensation paid to the attorneys, to the soliciting agencies and to the public relations counsel.[67]

[65] In the 1955 Libby, McNeill & Libby proxy contest, an action was brought but was discontinued due to lack of time. See also Matter of Standard Gas & Elec. Co., supra note 57, where the Commission directed that the use of corporate employees come within $1,000 maximum expenses allowed to management for proxy solicitation under the Public Utilities Holding Company Act of 1935.

[66] 309 N.Y. 168, 176, 128 N.E.2d 291, 295 (1955).

[67] 116 N.Y.S.2d 840, 849 (Sup. Ct. Nassau County 1952).

Although both the appellate division and Court of Appeals indicated that the reasonableness of expenditures would very definitely be subject to court scrutiny, it nevertheless is probable that some judges will approach the determination of reasonableness with the same reluctance as did the Official Referee in the *Fairchild* case; they will feel impelled to hold an expenditure to be unreasonable only when the facts clearly so indicate. Morover, as indicated by the opinion of all four prevailing judges in the *Fairchild* case, the burden of going forward to prove unreasonableness is on the plaintiff, and the incumbent directors are not required to justify their expenditures until the plaintiff has come forward with proof of unreasonableness.[68]

It thus appears that a stockholder who undertakes to challenge the reasonableness of expenses incurred by management in a proxy contest must be fully prepared to go forward with clear, detailed and persuasive evidence in support of his position.

II

As already indicated, the expenses of conducting a proxy contest usually are very substantial. Management, subject to certain limitations, has ready access to the corporate treasury. The insurgents, however, must defray their own expenses. To what extent are they entitled to reimbursement if (a) they are successful; (b) they are partially successful; (c) they are unsuccessful?

Reimbursement of Successful Insurgents

The right of successful insurgents to be reimbursed for their reasonable expenses in a proxy contest has been decided in ouly two cases. In each case, reimbursement was ratified by a majority of the stockholders, and in each case such reimbursement was upheld.

The first case was *Steinberg v. Adams*,[69] decided in 1950 by a federal court in New York on the basis of Delaware law. This case resulted from the 1947 contest for control of the Thompson-Starrett Company, which was won by the insurgent group of stockholders. During the contest, the management group spent $20,110 of corporate funds for its expenses. After taking control, the insurgents reimbursed themselves out of corporate funds for $27,755 they had spent in the contest. This action of the new board was ratified by a majority vote of the stockholders.

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[68] 309 N.Y. 168, 176, 128 N.E.2d 291, 295 (1955). The three dissenting judges would bave placed the burden of going forward on the incumbent directors. For further discussion of the burden of proof in these cases, see Note, 41 Cornell L.Q. 714, 720-21 (1956). This Note approves the position taken by the dissent.

[69] 90 F. Supp. 604 (S.D.N.Y. 1950). Comment, 49 Mich. L. Rev. 605 (1951); Note, 36 Cornell L.Q. 558 (1951).

A stockholders' derivative action was instituted, seeking judgment in favor of the corporation against both the defeated and elected directors for the amount of the corporate funds thus expended. The court, therefore, was presented with the propriety of the use of corporate funds by both the defeated management and the successful opposition. Both parties to the action moved for summary judgment. The judge denied both motions because he found there was a material issue of fact: namely, did the contest involve material issues of corporate policy or was the struggle just for control of the corporation?

The judge easily disposed of the question of management's expenses by citing the many cases which have upheld management's right to use corporate funds. However, since none of these cases authorized the reimbursement of successful insurgents, that question had to be determined de novo. The judge's reasoning, approving such reimbursement, was as follows:

> No case has been called to my attention which, in a "policy" controversy, either allowed or disallowed the reimbursement of an insurgent group for the expenses incurred by it in bringing about a change of management. My own choice is to draw no distinction between the "ins" and the successful "outs." I see no reason why the *stockholders* should not be free to reimburse those whose expenditures succeeded in ridding a corporation of a policy frowned upon by a majority of the stockholders. Once we assert that incumbent directors may employ corporate funds in policy contests to advocate their views to the stockholders even if the stockholders ultimately reject their views, it seems permissible to me that those who advocate a contrary policy and succeed in securing approval from the stockholders should be able to receive reimbursement, *at least where there is approval by both the board of directors and a majority of the stockholders*. An analogy may be found in the reimbursement of the successful stockholder who brings a derivative action for the benefit of the corporation. There he is reimbursed regardless of the views of the stockholders. (Emphasis added.)[70]

The second case dealing with the right of successful insurgents to reimbursement is the *Fairchild* case, decided by the New York Court of Appeals in 1955 on the basis of New York law, and discussed above.[71] In this case, it has been seen, the new board of directors, elected by the insurgents, voted to reimburse the insurgents for their expenses aggregating $127,556, and the stockholders, at the next annual meeting, approved such reimbursement.

The Court of Appeals, by a four-to-three decision affirmed the dismissal of the complaint by the lower courts. Three of the four prevail-

[70] Id. at 607-08. The apparent inconsistency in the italicized material is explained infra pp. 22-23.

[71] See p. 8 supra.

ing judges, without attempting to discuss the legal problems involved, merely stated:

> It is also our view that the members of the so-called new group could be reimbursed by the corporation for their expenditures in this contest by affirmative vote of the stockholders. With regard to these ultimately successful contestants, as the Appellate Division below has noted, there was, of course, "no duty . . . to set forth the facts, with corresponding obligation of the corporation to pay for such expense". However, where a majority of the stockholders chose—in this case by a vote of 16 to 1—to reimburse the successful contestants for achieving the very end sought and voted for by them as owners of the corporation, we see no reason to deny the effect of their ratification nor to hold the corporate body powerless to determine how its own monies shall be spent.
>
> The rule then which we adopt is simply this: . . . The stockholders, moreover, have the right to reimburse successful contestants for the reasonable and bona fide expenses incurred by them in any such policy contest, subject to like court scrutiny.[72]

The fourth of the prevailing judges, concurring in the affirmance of the lower courts, made no mention whatsoever of the problem whether insurgents, as a matter of law, could be reimbursed. He merely stated:

> Some of the payments attacked in this suit were, on their face, for lawful purposes and apparently reasonable in amount, but, as to others, the record simply does not contain evidentiary bases for a determination as to either lawfulness or reasonableness.[73]

It would seem, however, that if he believed that reimbursement of successful insurgents was utterly unlawful (as did the three dissenting judges) he would have so stated—particularly in view of his later statement that if an expenditure was "intrinsically unlawful," heavy stockholder approval or corporate benefit would make no difference. Moreover, if he considered such payments unlawful, there would have been no need to produce evidence with respect to the illegality of such reimbursement. It thus appears that this fourth judge also was of the opinion that reimbursement of successful insurgents, when ratified by a majority of stockholders, and subject to the limitation of reasonableness, was lawful.[74]

The three dissenting judges were of the opinion that such reimbursement of successful insurgents was absolutely illegal. They based their position on both legal and public policy grounds.[75] They stated that the

[72] Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 173, 128 N.E.2d 291, 293 (1955).

[73] Id. at 175, 128 N.E.2d at 294.

[74] Accord: Note, 41 Cornell L.Q. 714, 717 (1956).

[75] "The corporation lacks power to defray the expenses of the insurgents in their entirety. The insurgents were not charged with responsibility for operating the company." 309 N.Y. 168, 185, 128 N.E.2d 291, 295 (1955).

insurgents, as distinguished from the management, were under no duty to inform the stockholders or manage the corporation; that a change in management was not a determination on the merits of management; that it was a matter of business jugment and that the courts could not "indulge in a speculative inquiry" into whether the corporation benefited by the change in management; that if the insurgents "choose to employ the costly modern media of mass persuasion"[76] they should look to themselves for reimbursement; and that if reimbursement was conditioned on success, it would lead to taking of greater risks and greatly increase the cost of stockholders' meetings.[77]

It thus appears that, under the law of Delaware and probably New York, successful insurgents may be reimbursed out of corporate funds for their expenses in a proxy contest, provided such reimbursement is ratified by a majority of the stockholders and subject to the limitation that such expenses were reasonable, both as to nature and amount.[78] Undoubtedly, this right of reimbursement is also subject to the amorphous requirement that the expenses were incurred in connection with a contest over policy rather than merely for personal control.

No doubt, there is fertile ground for criticism of the legal theories on which such right to reimbursement is based. While question may be raised whether such reimbursement serves a "corporate purpose" as heretofore defined, it can be said that if a corporate purpose is served by management's expenditure of funds in order to explain and defend its position in a contest involving "policy," then a similar corporate purpose is served by reimbursing successful insurgents who incurred expenses in attacking and exposing management's record and "policy." In both cases, it may be argued that the corporate purpose served is that of informing the stockholders and bringing about an examination of corporate policy and affairs, which thereby facilitate a more intelligent exercise of judguent on the part of better informed stockholders. This theory rather conveniently closes its eyes to the fact that the effort to gain or retain control for personal reasons is often an important, if not the primary, motive.

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[76] Id. at 185, 128 N.E.2d at 295.

[77] Id. at 186, 128 N.E.2d at 296.

[78] See also Cullom v. Simmonds, 285 App. Div. 1051, 139 N.Y.S.2d 401 (2d Dep't 1955). In a stockholder action to recover solicitation expenses reimbursed to the successful insurgents by the new board of directors, the court, in a memorandum opinion, held sufficient a complaint which alleged that there were no matters of "policy" involved in the contest, and that specific expenditures were unreasonable. Although the complaint also alleged that the stockholders had not approved the reimbursement, the court did not pass on the necessity or effect of this allegation. This decision appears consistent with the majority opinion in the Fairchild case, discussed supra p. 8.

It may also be argued that if reimbursement of successful insurgents serves a corporate purpose and is lawful, then ratification by the stockholders is unnecessary. Stockholder ratification of an unlawful payment, unless unanimous, is of no effect;[79] and by parity of reasoning, it would seem that if a payment is lawful, ratification is unnecessary. This thought seemed to be present in the federal court's reasoning in the *Steinberg* case, when it said:

> Once we assert that incumbent directors may employ corporate funds in policy contests to advocate their views to the stockholders even if the stockholders ultimately reject their views, it seems permissible to me that those who advocate a contrary policy and succeed in securing approval from the stockholders should be able to receive reimbursement, at least where there is approval by both the board of directors and a majority of the stockholders. An analogy may be found in the reimbursement of the successful stockholder who brings a derivative action for the benefit of the corporation. There he is reimbursed regardless of the views of the stockholders.[80]

The reference to stockholder approval seems to have been merely an added reason. The reference to reimbursement in a stockholder's derivative action, which is granted without stockholder approval, suggests that such approval likewise may not be a necessary condition to reimbursement of successful insurgents.

The decisions in the *Steinberg* and *Fairchild* cases indicate that while the courts struggled with the older concepts of corporate purpose, they felt obliged to adjust those concepts to cope with the practical necessities arising from modern corporate practice. The fact that a majority of stockholders have approved the use of corporate funds to reimburse successful insurgents adds a strong practical sanction, even though a considerable body of respected authority holds that a majority of stockholders cannot ratify an illegal act over the objection of a single dissident.[81] The courts apparently believe that sufficient protection against abuse is afforded to minority stockholders by the requirement of "reasonableness" which only the courts ultimately can determine. The courts thus have evolved a doctrine which is a departure from former concepts, but which is designed to meet the practical problems of modern corporations.

As indicated above, there may be room for logical argnment that since

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79 Continental Securities Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912).

80 Steinberg v. Adams, 90 F. Supp. 604, 608 (S.D.N.Y. 1950).

81 Pollitz v. Wabash Ry., 207 N.Y. 113, 100 N.E. 721 (1912); Continental Securities Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912); Schwab v. E. G. Potter Co., 129 App. Div. 56, 113 N.Y. Supp. 439 (1st Dep't 1908); Davis v. Congregation Beth Tephila Israel, 40 App. Div. 424, 57 N.Y. Supp. 1015 (1899); 2 Fletcher's Cyclopedia Corporations §§ 764, 767, 3432, 5795 (Perm. ed. 1954).

the reasonable expenditures of successful insurgents served a corporate purpose, the board of directors alone, and without approval of the stockholders, may authorize reimbursement for such expenses. However, no court as yet has so held; and it is doubted whether any court will be willing to sanction such reimbursement without stockholder approval.

Another interesting situation is presented where the insurgents are only partially successful. The insurgents, by reason of cumulative voting, may succeed in electing certain of its candidates, who may constitute a minority, or even a majority, of the board. Or the contest may result in a compromise in which membership on the board will be divided between management and the insurgents, with either the management or insurgents having the majority. Or the insurgents may fail to elect any member of the board but succeed in having certain resolutions adopted. Would the insurgents, in any of these situations, be entitled to reimbursement for their reasonable expenses in carrying on the contest?

No case presenting such facts has been decided. It would seem, nevertheless, that the doctrine and considerations favoring reimbursement to wholly successful insurgents should be equally applicable to partially successful insurgents, provided, again, that the stockholders approve such reimbursement. Reimbursement, without stockholder approval, would, in most cases, be undesirable and unwise.

Reimbursement of Unsuccessful Insurgents

Suppose insurgents conduct a proxy contest and are defeated by the management. Do they have a right to be reimbursed for their reasonable expenses? Suppose the board of directors, believing that the corporation benefited from the contest, approves such reimbursement. Suppose the stockholders approve such reimbursement.

There is only one case where a court considered the right to reimbursement of unsuccessful insurgents for their expenses in a proxy contest. In *Phillips v. United Corp.*,[82] a minority stockholder sued the corporation for, *inter alia,* $13,000, the amount he had spent in a prior proxy contest which had been won overwhelmingly by the management. The court found that no case or statute sustained the right of the plaintiff to sue the corporation on any such claim, and added "it would be difficult to find any reason for saddling plaintiff's proxy expenses on the corporation."

The opinion of the three prevailing judges in the *Fairchild* case referred specifically to reimbursement of *successful* insurgents. There was no reference to unsuccessful insurgents and very little discussion of the

[82] Civ. No. 40-497 (S.D.N.Y. May 26, 1948), appeal dismissed, 171 F.2d 180 (2d Cir. 1948).

legal theory supporting even the conclusion that successful insurgents may be reimbursed.

The Federal Court in the *Steinberg* case, which approved reimbursement of successful insurgents, referred only to reimbursing "those whose expenditures succeeded in ridding a corporation of a policy frowned upon by a majority of the stockholders."[83]

There are a number of law review articles, however, which suggest reimbursement for unsuccessful insurgents. The rationale for granting such reimbursement was well expressed in an article appearing in the Columbia Law Review:

> Yet it seems apparent that a full and fair presentation of the issues in a contested corporate election cannot be made if the stockholders are given only one side of the picture. And since the management whose policies are under attack naturally feels called upon to justify them, its version of the issues is more than likely to be colored to play up the favorable aspects.... Presentation of the latter is therefore left mainly to the opposition. Accordingly, the very reason that originally moved the courts to authorize management expenditures—the need for informing the stockholders—further requires that minority stockholders be accorded similar rights. For it is only through knowledge of both sides of the question, including development of all the arguments pro and con, that the stockholders will be placed in a position to make an informed judgment as to what course of conduct is in the best interests of the company.[84]

The same kind of reasoning is used by another writer, who points out that management's use of corporate funds is sustained because it promotes intelligent exercise of shareholders' judgment and expression of their views. But, he argues, "informed shareholder action cannot result from a one-sided presentation, or no presentation at all."[85]

It is readily apparent, however, that the recognition of the right to reimbursement on the part of unsuccessful insurgents can lead to many practical difficulties, and open up a veritable "Pandora's box." Obviously, wholly irresponsible contests should not be encouraged. On the other hand, in other situations, intelligent criticism, even if unsuccessful, can be beneficial and serve a useful corporate purpose.

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83 Steinberg v. Adams, 90 F. Supp. 604, 607 (S.D.N.Y. 1950).

84 Friedman, "Expenses of Corporate Proxy Contests," 51 Colum. L. Rev. 951, 958 (1951). See also Latcham & Emerson, "Proxy Contest Expenses and Shareholder Democracy," 4 Western Res. L. Rev. 5, 13 (1952); Mintz, "Use of Corporate Funds to Pay for Proxies and Other Expenses in Fight Over Corporate Management," 8 N.Y.U. Intra. L. Rev. 90, 96 (1953); Notes, 41 Cornell L.Q. 714, 719-20 (1956); 69 Harv. L. Rev. 1132, 1133-34 (1956).

85 Note, 61 Yale L.J. 229, 236 (1952). This writer also points out that some of the insurgents' campaign proposals may be adopted by the corporation even though the management wins the contest, and that the good of the corporation may be served by consideration of the views of the unsuccessful insurgents even though those views are ultimately rejected.

Authors of legal articles who have advocated reimbursement of unsuccessful insurgents have proposed various formulae which would limit the granting of reimbursement.

One writer would condition reimbursement on the ability of the insurgents to obtain a specified percentage of the votes cast in the election of directors (or on a proposal)—perhaps 10% or 15%.[86] As an alternative to the fixed percentage basis for reimbursement, another writer proposes a formula for "proportional reimbursement."[87] The formula is:

$$\frac{\text{Management expense allowed}}{\text{Votes secured by management}} = \frac{X}{\text{Votes secured by non-management}}$$

X represents the amount of the unsuccessful insurgents' expenses which would be reimbursed from corporate funds, but in no event would more than actual expenses be allowed.

It seems that as a matter of policy, as decided in *Phillips v. United Corp.*,[88] a corporation should not be *required* to reimburse unsuccessful insurgent stockholders. However, if the board of directors finds that the insurgents, by conducting the contest, rendered beneficial service to the corporation, and if the stockholders approve, there should be no objection to reimbursing the insurgents for their reasonable expenses in rendering such service.

Reimbursable Expenditures of Insurgents

The above discussion has indicated the extent to which judicial authority in Delaware and New York has recognized the right of successful insurgents to receive reimbursement after approval by the board of directors and ratification by a majority of the stockholders.

Manifestly, any such right to reimbursement for expenses is subject to the same "policy" requirement and to the same limitations as to "reasonableness" as exist in the case of expenses which management may incur. Consequently, the discussion with respect to the expenses which management properly may incur, is generally applicable to the reimbursable expenses of successful insurgents.[89] This includes expenditures for printing and mailing of material discussing corporate affairs and issues, professional proxy solicitors, public relations counsel, legal coun-

[86] Friedman, supra note 84, at 963.

[87] Emerson & Latcham, "Proxy Contests: A Study in Shareholder Sovereignty," 41 Calif. L. Rev. 393, 436 (1953).

[88] Civ. No. 40-497 (S.D.N.Y. May 26, 1948), appeal dismissed, 171 F.2d 180 (2d Cir. 1948).

[89] See pp. 11-17 supra.

sel, accountants and security analysts. All such expenses, it should be emphasized, are subject to judicial scrutiny from the point of view of the "policy" requirement and reasonableness as to nature and amount. Some mention, however, should be made of certain types of expenditures which are peculiar to the campaign of insurgents.

One of the first hurdles which an insurgent group often must overcome is that of securing a list of stockholders. If management furnishes the list pursuant to the option given it by Rule X-14a-7 of the SEC Proxy Rules,[90] the expense of compiling the list must be borne by the insurgents. If the list is secured pursuant to the provisions of state law permitting stockholder inspection of the stock books, money must be spent for the clerical assistance necessary to copy the names and addresses and compile the list. Moreover, management, at the outset, may refuse to supply a stock list or make the stock books available. In such event, the insurgents will be obliged to seek a court order compelling the management to submit the books to inspection. This will involve attorneys' fees and court costs. It would appear that all reasonable expenses incurred by insurgents in obtaining the list of stockholders, including attorneys' fees, directly related to the effort to communicate with stockholders and inform them of corporate affairs, should properly be included in the bill for reimbursement.

An insurgent group, in certain situations, may have greater need than management for the services of accountants and security analysts. A frequent method of criticizing a management's record is that of comparing its earnings record with the records of other companies in a similar line of business for the purpose of showing that the earnings of the corporation should have been greater. Such an approach often will require the services of trained accountants or analysts.

Moreover, the insurgents may accuse the management of manipulating the valuation of inventories in such a way as to overstate profits. Ascertaining these facts and explaining them to the stockholders require the extensive services of well-qualified accountants.

It may well be argued that if successful insurgents, in a contest involving "policy," are entitled to reimbursement for reasonable expenses incurred in informing the stockholders about the corporate affairs, fees paid to accountants or analysts for services such as those described above should be included among the expenses which may be so reimbursed.

The same may be said with respect to personnel who assist the insurgents and inspectors of election in examining and counting the proxies. In any large contest, it is customary for both management and insurgents

[90] 17 C.F.R. § 240.14a-7 (1949).

to appoint one or more persons to assist the inspectors of election. The examination and counting of proxies often takes many days and sometimes weeks. Representatives for each of the factions, who work with and assist the inspectors of election, perform valuable and important services. Their expenses, which normally are very moderate, may well be considered reasonable expenses incurred in connection with the actual conduct of the meeting.

III

It is readily apparent that the problems related to management's right to incur expenses in a proxy contest and the insurgents' rights to receive reimbursement for their expenses are extremely complex. Difficult questions of legal theory and public policy are presented which neither statute nor case law adequately answer. The courts, on a case-to-case basis, are ill-fitted to supply the over-all answers and doctrines which are urgently required. The answers should be furnished by the legislatures in the form of comprehensive legislation which can be drawn only after a complete investigation and study.