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STOCKHOLDER VOTES MOTIVATED BY ADVERSE INTEREST: THE ATTACK AND THE DEFENSE†

*Earl Sneed**

IN the exercise of their limited powers of management, stockholders elect directors; vote for or against charter amendments, sales, mergers, dissolution; and, occasionally, vote on employee benefits, such as pension plans and stock options. In theory, stockholders will vote in a manner beneficial to the corporate whole. All are co-owners and supposedly there is a unity of financial interest. Realistically, in most voting situations there is no unity of interest.¹ When two or more classes of shares exist, the interests of one class may squarely oppose the interests of the other.² Even in a one-class corporation, the majority may advantage itself at the expense of the minority. Because of differing pecuniary drives there are votes cast in adverse interest—votes motivated by a quest for personal and peculiar gain at the expense of other stockholders. While the law of corporations retains the basic concept of majority rule, there are equitable limitations upon the power of the majority.³ Consequently, the actions of the voters in control are always subject to challenge at the suit of the minority.

It is the purpose of this article to study stockholder votes motivated by adverse interest from the standpoint of the attack and the defense. First, the remedies available to the complaining minority are examined. Then follows a study of the indicia of adverse in-

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¹ "The prevalent philosophy is still that of a body in which substantial identity of interest between all parties concerned necessarily exists. This, it is evident, is becoming each day more out of accord with the facts." RIPLEY, *MAIN STREET AND WALL STREET* 75 (1927).

² "In an honestly conducted corporation the interests of all shareholders will for the most part coincide, unless there are different classes of shareholders." TAYLOR, *A TREATISE ON THE LAW OF PRIVATE CORPORATIONS*, 5th ed., 774 (1902). See RIPLEY, *MAIN STREET AND WALL STREET* 127 (1927).

³ LATTIN, *CORPORATIONS* 513 (1959).

terest in specific shareholder actions. Knowledge of the nature and import of these indicia should enable the careful lawyer to avoid or defeat the charge that unconscionable adverse interest vitiated the result of a stockholder vote.

I. THE ATTACK: THE REMEDIES AVAILABLE

The stockholder disagreeing with his covoters on the ground that their actions are motivated by interests adverse to his welfare has an arsenal of weapons at his disposal. Assuming that the remedy of appraisal is not the exclusive remedy in the particular action,⁴ the equitable powers of the courts are his to use. Despite the fact that he is in the minority as to interest, and usually as to numbers, the dissident stockholder has certain procedural advantages.

One possible advantage is that in many situations involving stockholder votes, the presumption of fairness usually accorded the actions of the majority is negated because of the conflicting interests of the dominant group. For example, when the majority stockholders cause their corporation to sell to them, the majority shareholders are on both sides of the bargain, and the burden of showing good faith is on the majority. In such a situation, there is no presumption of fairness.⁵

Another advantage inherent in the plaintiff's position is that in litigating corporate actions involving stockholder voting, the plaintiff is asserting frequently a direct and personal right and is not bringing a derivative suit for and on behalf of the corporation.⁶ Thus, a plaintiff attacking a recapitalization plan requiring a charter amendment may bring a direct action;⁷ so may a dissident stockholder objecting to a merger or consolidation on the ground

⁴ Occasionally appraisal will be the exclusive remedy. The cases are collected in 162 A.L.R. 1237, 1250 (1946). See also STEVENS, *CORPORATIONS* 591-597 (1949).

⁵ See *Pepper v. Litton*, 308 U.S. 295 at 306 (1939); *Hyams v. Calumet & Hecla Mining Co.*, (6th Cir. 1915) 221 F. 529; *Meeker v. Winthrop Iron Co.*, (W.D. Mich. 1883) 17 F. 48; *Klopot v. Northrop*, 131 Conn. 14, 37 A. (2d) 700 (1944).

⁶ The line between the individual or direct personal right of action and the shareholders' derivative action on behalf of the corporation is difficult to draw. LATTIN, *CORPORATIONS* 346 (1959).

⁷ In such a situation, the corporation has no direct interest. It is a contest between classes of stockholders. *Lehrman v. Godchaux Sugars, Inc.*, 207 Misc. 314, 138 N.Y.S. (2d) 163 (1955). But see *Christie v. Fifth Madison Corp.*, 124 N.Y.S. (2d) 492 (1953), in which a suit involving a recapitalization plan was held to be derivative. The cases are distinguishable because in *Christie*, the plaintiff alleged that the plan would erect a debt structure that would destroy the corporation whereas in *Lehrman*, there was no allegation of harm to the corporation. See also *Keller v. Wilson & Co.*, 22 Del. Ch. 175, 194 A. 45 (1937).

of personal loss and not damage to the corporation.⁸ By a direct suit, the plaintiff may force a dissolution,⁹ recover for damage suffered in a freeze-out,¹⁰ or secure the appointment of a receiver on the ground of fraud and mismanagement.¹¹

The right to bring a direct rather than a derivative action is often an advantage because some jurisdictions have erected formidable barriers in the path of those who would bring derivative actions. New York, New Jersey, Pennsylvania, Maryland, and California provide for the posting of security for expenses by the plaintiffs in some or all derivative actions.¹² Plaintiffs in direct actions do not have the same burden because the suit is not "in the right of the corporation."¹³ Plaintiffs bringing derivative actions in federal courts must satisfy federal rule 23 (b) by showing that there was ownership of shares at the time of the wrong, that there was no collusive effort to confer jurisdiction on the federal courts, and that there was an attempt to secure relief within the corporation or that such would be futile.¹⁴ But federal rule 23 (b) does not apply to direct actions,¹⁵ nor do similar provisions adopted by some of the states.¹⁶ So while plaintiffs in direct actions usually must pay their own attorney's fees¹⁷ and cannot seek payment

⁸ *General Inv. Co. v. Lake Shore & M.S. Ry.*, (6th Cir. 1918) 250 F. 160, *affd.* 260 U.S. 261 (1922); *Sobel v. Whittier Corp.*, (E.D. Mich. 1951) 95 F. Supp. 643.

⁹ *Fontheim v. Walker*, 141 N.Y.S. (2d) 62 (1955); *Davidson v. Rabinowitz*, 140 N.Y.S. (2d) 875 (1951). See Hornstein, "A Remedy for Corporate Abuse—Judicial Power To Wind up a Corporation at the Suit of a Minority Stockholder," 40 *COL. L. REV.* 220 at 242-243 (1940).

¹⁰ E.g., *Southern Pacific v. Bogert*, 250 U.S. 483 at 487 (1919).

¹¹ *Rugger v. Mt. Hood Elec. Co.*, 143 Ore. 193, 20 P. (2d) 412 (1933).

¹² For a summary of the various types of security legislation, see note, 52 *COL. L. REV.* 267 (1952).

¹³ *Ames v. Voit*, (S.D. N.Y. 1951) 97 F. Supp. 89 at 92, *revd.* on other grounds *sub nom.* *Ames v. Mengel*, (2d Cir. 1951) 190 F. (2d) 344; *Lazar v. Knolls Co-op. Section No. 2, Inc.*, 205 Misc. 748, 130 N.Y.S. (2d) 407 (1954); *Davidson v. Rabinowitz*, 140 N.Y.S. (2d) 875 at 876 (1951).

¹⁴ Fed. Rules Civ. Proc. 23 (b).

¹⁵ *Sobel v. Whittier Corp.*, (E.D. Mich. 1951) 95 F. Supp. 643. Neither state nor federal laws require a stockholder to seek remedy within the corporation before bringing a direct suit. 13 *FLETCHER, Cyc. CORP.*, perm. ed., §5932 (1943). A stockholder bringing a direct action is not required to have owned stock at the time of the action in question. *Zahn v. Transamerica Corp.*, 162 F. (2d) 36 (1947).

¹⁶ E.g., Delaware Chancery Rule 23 (b) provides that in an action to enforce a secondary right, plaintiff must aver that he was stockholder at the time of the transaction and that he must set forth his efforts to secure from directors or stockholders the action he desires. But rule 23 (b) does not apply to direct actions. *Elster v. American Airlines*, 34 *Del. Ch.* 94 at 98, 100 A. (2d) 219 (1953).

¹⁷ *Alexander v. Atlanta & W.P.R. Co.*, 113 Ga. 193, 38 S.E. 772 (1901); *Joyce v. Congdon*, 114 Wash. 239, 195 P. 29 (1921). Cf. *Holthusen v. Edward G. Budd Mfg. Co.*, (E.D. Pa. 1944) 55 F. Supp. 945; *Hitchcock v. American Pipe & Constr. Co.*, 90 N.J. Eq. 576, 107 A. 267 (1919). See Hornstein, "The Counsel Fee in Stockholder's Derivative Suits," 39 *COL. L. REV.* 784 at 800 (1939).

of the fees by the corporation as can plaintiffs in successful derivative suits, there are fewer procedural obstacles in direct suits.

In sum, the stockholder who challenges corporate action because of selfish interests of those in control normally will have some strategic advantages. In most instances, the burden of showing fairness will be on the defendants and frequently the shareholder's suit will be a direct, and not a derivative action.

A. *Preventing the Transaction: The Prohibitory Injunction*

The stockholder, aggrieved by the threatened action of the group in control, may seek a prohibitory injunction. This is an effective weapon in a complex, fast-moving, corporate controversy because it stops or prevents the threatened action and preserves the status quo.¹⁸ Obviously it is much easier to secure justice through prevention than through the undoing of that which has been done.

The injunctive powers of equity are available when majority action is induced by fraud¹⁹ or when such action is unjustly oppressive²⁰ or when it is violative of the charter provisions pertaining to the powers of the corporation.²¹ On the whole, equity is reluctant to meddle with corporate management, and disputes over policies of business and economics are beyond interference, even though the course charted is unwise and unprofitable.²² In deciding whether to grant or withhold relief, the court will "balance the equities." It will look at the comparative injuries to be sustained, and if the decree would do more harm than good, the injunction will be denied.²³ Therefore, if stopping a majority-approved plan of recapitalization will force the corporation into liquidation, thereby causing great loss to all shareholders, the plaintiff will be denied relief. The possible benefit to the plaintiff is outweighed by the loss to the noncomplaining stockholders.²⁴

¹⁸ Rohrlich, "Suits in Equity by Minority Stockholders as a Means of Corporate Control," 81 UNIV. PA. L. REV. 692 at 723 (1933).

¹⁹ See, e.g., *Kavanaugh v. Kavanaugh Knitting Co.*, 226 N.Y. 185, 123 N.E. 148 (1919); *White v. Kincaid*, 149 N.C. 303, 63 S.E. 109 (1908).

²⁰ *Outwater v. Public Serv. Corp.*, 103 N.J. Eq. 461, 143 A. 729 (1928).

²¹ *Hawes v. Oakland*, 104 U.S. 450 at 453-454 (1881).

²² 13 FLETCHER, *CYC. CORP.*, perm. ed., §5821 (1943).

²³ *Holcomb v. Forsyth*, 216 Ala. 486, 113 S. 516 (1927); *General Inv. Co. v. Bethlehem Steel Corp.*, 88 N.J. Eq. 237, 102 A. 252 (1917).

²⁴ *Blumenthal v. Di Giorgio Fruit Corp.*, 30 Cal. App. (2d) 11, 85 P. (2d) 580 (1938).

In some instances, the court may "balance the equities" by denying the injunction and granting the plaintiff money for his shares. *Paterson v. Shattuck Arizona Copper Co.*, 186 Minn. 611, 244 N.W. 281 (1932); *Ontjes v. Bagley*, 217 Iowa 1200, 250 N.W. 17 (1933).

The injunction may be preliminary or permanent.²⁵ The former is provisional and may be granted prior to a full hearing on the merits. Its purpose is to preserve the status quo until such time as a permanent injunction or other relief is granted or denied.²⁶ If the plaintiff can show that he will be saved irreparable loss, and that relatively little harm will be caused the opposition, an order halting any change in existing rights may be obtained.²⁷ In some instances, bonds are required to insure that no financial detriment will befall the majority or the corporation because of the stoppage of the contemplated action.²⁸ If the bond is not forthcoming, the preliminary will be refused, and the corporation may proceed with its planned action.²⁹

The issuance or denial of the preliminary marks the outcome of a battle but does not end the war.³⁰ The plaintiff may be denied the injunction *pendente lite* yet gain the ultimate victory.³¹ Or he may secure the preliminary and lose the final decision.³² In any event, the dissatisfied shareholder is usually well advised to seek the preliminary injunction. If he does not, the court when making a definitive ruling may use that omission as an indication that the plaintiff was not, in fact, opposed to the challenged move.³³ It seems that he who would oppose stockholder action should be diligent in pursuing the remedy encompassed in the preliminary injunction.

Diligence is important; so is timing. The decisions indicate that it is advantageous from the plaintiff's viewpoint to seek the injunction before, and not after, the stockholder vote on the question. Embattled stockholders who have waited until after the vote and have then sought to restrain dividend payments or other actions taken pursuant to the vote have been singularly unsuccessful.

²⁵ The "permanent" injunction may be limited as to time. In *Boyd v. New York & H. R. Co.*, (S.D. N.Y. 1915) 220 F. 174, New York Central was enjoined from seeking consolidation with the Harlem Railroad during the time of a lease Harlem had granted Central.

²⁶ In addition, there may be a temporary restraining order, which is issued upon an application for an injunction and preserves the status quo until the propriety of granting a preliminary injunction can be determined.

²⁷ *MacArthur v. Port of Havana Docks Co.*, (D.C. Me. 1917) 247 F. 984.

²⁸ *Allied Chem. & Dye Corp. v. Steel & Tube Co.*, 14 Del. Ch. 1, 120 A. 486 (1923).

²⁹ *Barrett v. Denver Tramway Corp.*, (3d Cir. 1944) 146 F. (2d) 701.

³⁰ *Buckley v. Cuban Am. Sugar Co.*, 129 N.J. Eq. 322, 19 A. (2d) 820 (1940) (plan of recapitalization halted until final hearing).

³¹ In *Sander v. Janssen Dairy Corp.*, (D.C. N.J. 1940) 36 F. Supp. 512, the preliminary restraint of a recapitalization plan was denied, but subsequently, in *Kamena v. Janssen Dairy Corp.*, 133 N.J. Eq. 214, 31 A. (2d) 200 (1943), *affd.* 134 N.J. Eq. 359, 35 A. (2d) 894 (1944), the plan was permanently enjoined.

³² E.g., *Cole v. National Cash Credit Assn.*, 18 Del. Ch. 47, 156 A. 183 (1931).

³³ See, e.g., *Ostlind v. Ostlind Valve, Inc.*, 178 Ore. 161, 165 P. (2d) 779 (1946).

ful.³⁴ Undoubtedly the intrinsic merits of the plaintiff's cause are far more important than the timing of his opening attack, but it is apparent that any investor opposed to a management-sponsored proposal would be wise to begin legal action prior to the meeting. If he wins on the merits, he obviates the necessity and expense of the meeting. If he loses, he saves himself and the corporation money, time, and effort. Further, bringing serious opposition into the open by seeking an injunction may cause management to abandon the proposal.³⁵

Sometimes when the plaintiff asks for an injunction prior to the meeting, the court will let the vote be cast with the understanding that if the vote is favorable, implementation of the plan will be stayed pending a final hearing.³⁶ This procedure satisfies the argument of management that the issue will be moot if the stockholders disapprove.³⁷ In most instances, the suggestion that the stockholders might vote down the proposal is cruelly illusory. Before submitting the proposal, management will have the votes in hand, or the votes will be safely predictable because of the proxy system. Be that as it may, some courts insist that the voters express their will before the matter is adjudicated.

While there is always the outside chance that the voters will veto the matter, they usually approve. It is plainly evident that stockholder approval prior to a hearing on the merits of plaintiff's plea for an injunction works to the disadvantage of the plaintiff. Consciously, and perhaps unconsciously, a vote in favor of the proposal influences courts.³⁸ Probably this is so because we live in democratic society, and basic in our training is the belief in the wisdom of the majority.

³⁴ E.g., *Johnson v. Fuller*, (3d Cir. 1941) 121 F. (2d) 618; *Ainsworth v. Southwestern Drug Corp.*, (5th Cir. 1938) 95 F. (2d) 172; *Blumenthal v. Di Giorgio Fruit Corp.*, 30 Cal. App. (2d) 11, 85 P. (2d) 580 (1938); *Federal United Corp. v. Havender*, 24 Del. Ch. 318, 11 A. (2d) 331 (1940); *Morris v. American Pub. Util. Co.*, 14 Del. Ch. 136, 122 A. 696 (1923); *Shaw v. Davis*, 78 Md. 308, 28 A. 619 (1894); *Kreicker v. Naylor Pipe Co.*, 374 Ill. 364, 29 N.E. (2d) 502 (1940); *Faunce v. Boost Co.*, 15 N.J. Super. 534, 83 A. (2d) 649 (1951).

³⁵ E.g., *Hyams v. Calumet & Hecla Mining Co.*, (6th Cir. 1915) 221 F. 529 (proposal abandoned before vote). Cf. *Wick v. Youngstown Sheet & Tube Co.*, 46 Ohio App. 253, 188 N.E. 514 (1932) (injunction unsuccessfully sought before vote on sale of assets; plan abandoned after vote).

³⁶ E.g., *Kamena v. Janssen Dairy Corp.*, 133 N.J. Eq. 214, 31 A. (2d) 200 (1943), *affd.* 134 N.J. Eq. 359, 35 A. (2d) 894 (1944).

³⁷ *MacCrone v. American Capital Corp.*, (D.C. Del. 1943) 51 F. Supp. 462; *Grausman v. Porto Rican Am. Tobacco Co.*, 95 N.J. Eq. 223, 122 A. 815 (1923).

³⁸ See, e.g., *Blumenthal v. Di Giorgio Fruit Corp.*, 30 Cal. App. (2d) 11, 85 P. (2d) 580 (1938) (90% acceptance of recapitalization plan rebutted plaintiff's plea for equitable relief); *Outwater v. Public Serv. Corp.*, 103 N.J. Eq. 461, 143 A. 729 (1928) (determination of fairness is influenced by a heavy vote of approval).

The injunction has been used in an effort to block every type of corporate action requiring stockholder voting. Usually the attack has been made on the proposal as such and not on the right of individual stockholder-voters to cast their votes. When the plaintiff attempts to keep certain stockholders from voting, his cause is based on the plea that the challenged stockholders will vote in response to motives adverse to the good of the corporate whole.³⁹ But equity is reluctant to inquire into motive, for the determination of motivation is a most difficult task.⁴⁰ It is easier to let the challenged stockholders vote, and if the result is oppressively injurious to the complainants, then the proper move is to enjoin the consummation of the plan.⁴¹ While it is true that there have been some instances in which specific shareholders have been kept from voting,⁴² the disfranchisement of specific shareholders by enjoining them from voting is a rare and unusual remedy.

The injunction is a trenchant and precious weapon available to the plaintiff objecting to unfair action threatened or taken by the majority. He who uses it with intelligence and with skill in timing and phrasing can upset the best laid plans of a greedy majority. There is no "doubt as to the general principle that equity will restrain arbitrary and capricious acts on the part of majority shareholders or directors if such acts violate the rights of minority stockholders."⁴³

B. *Undoing the Transaction: Rescission*

The usual course of action of the stockholder who believes that he will be hurt by the announced program of the majority is to ask for an injunction. He may fail to win the injunction and still seek rescission of the majority action. Or a stockholder may not become aware of the extent of the oppression, the nature of the fraud, or the fact of illegality, until after the vote.⁴⁴ Or a

³⁹ E.g., *Windmuller v. Standard Distilling & Distrib. Co.*, (C.C. N.J. 1902) 114 F. 491.

⁴⁰ *Bjorngaard v. Goodhue County Bank*, 49 Minn. 483, 52 N.W. 48 (1892).

⁴¹ *South & North Alabama R. Co. v. Gray*, 160 Ala. 497, 49 S. 347 (1909).

⁴² See, e.g., *Hyams v. Calumet & Hecla Mining Co.*, (6th Cir. 1915) 221 F. 529 (use of votes to create interlocking directorates enjoined); *Memphis & Charleston R. Co. v. Woods*, 88 Ala. 630, 7 S. 108 (1889) (question of monopoly); *Macht v. Merchants Mortgage & Credit Co.*, 22 Del. Ch. 74, 194 A. 19 (1937) (votes purchased).

⁴³ *Mitchell Inv. Co. v. Republic Steel Corp.*, (N.D. Ohio 1944) 63 F. Supp. 323 at 328, affd. (6th Cir. 1945) 152 F. (2d) 105.

⁴⁴ In *Garrett v. Reid-Cashion Land & Cattle Co.*, 34 Ariz. 245, 270 P. 1044 (1928), plaintiffs, two widows and a minor, did not comprehend the nature of their rights until after the sale, which was voided. In *Cole v. Wells*, 224 Mass. 504, 113 N.E. 189 (1916), the plaintiff voted against a sale, asked for appraisal, then discovered fraud and waste and sought to set aside sale. *Held*, appraisal not exclusive.

stockholder may postpone legal action until after the election in the hope that the stockholders will disapprove.⁴⁵ In any of these instances, when the plaintiff seeks to undo what has been done, the remedy sought is redressive — it is an effort to cure past derelictions on the part of the majority.

Sometimes the plaintiff will seek to avoid the transaction because of some fatal weakness on the part of the holder casting a decisive vote. For example, he may attack on the ground that the holder's vote was saturated with adverse interest, and his motive was antithetical to the good of the corporation.⁴⁶ This tactic seldom wins because, as previously mentioned, courts are reluctant to disfranchise because of motive. So, instead of attacking the vote of specific holders, the usual move is to seek rescission on the plea that the action was unauthorized,⁴⁷ or was procured by fraud,⁴⁸ or constituted an abuse of power.⁴⁹

In asking for rescission the plaintiff must act promptly. If he waits too long, the rights of the innocent will intervene and make it difficult and unjust to undo that which has been done.

When new rights have been created in the interim between the challenged action and the plea for rescission, equity may void part of the challenged action and permit the rest to stand.⁵⁰ Or dissident shareholders may recognize the intervention of the claims of others and seek only an accounting and payment for the value of their interests.⁵¹ Frequently the complaining stockholder will seek the alternative of rescission or payment of the value of the shares.⁵² For example, in *May v. Midwest Refining Co.*,⁵³ Standard Oil of Indiana had acquired all but a few shares of Midwest Refining. Then the assets of Midwest were sold to

⁴⁵ See *Eagleson v. Pacific Timber Co.*, (D.C. Del. 1920) 270 F. 1008.

⁴⁶ E.g., *Norton v. Union Traction Co.*, 183 Ind. 666, 110 N.E. 113 (1915).

⁴⁷ E.g., *Brown v. McLanahan*, (4th Cir. 1945) 148 F. (2d) 703 (amendment changing voting voided because unauthorized by voting trust agreement).

⁴⁸ E.g., *Dratz v. Occidental Hotel Co.*, 325 Mich. 699, 39 N.W. (2d) 341 (1949) (merger approved in face of allegation of fraud).

⁴⁹ E.g., *Lillard v. Oil, Paint & Drug Co.*, 70 N.J. Eq. 197, 56 A. 254 (1903) (by-law fixing excessive salary voided because it constituted abuse of power by majority holder).

⁵⁰ E.g., *Morris v. American Pub. Util. Co.*, 14 Del. Ch. 136, 122 A. 696 (1923) (recapitalization plan held valid except portion wiping out preferred accruals).

⁵¹ Asking for an accounting only without a request for rescission signifies ratification of the transaction. See *Heimbauch v. Hitchcock*, 115 Kan. 182, 222 P. 114 (1924). In *Soderstrom v. Kungsholm Baking Co.*, (7th Cir. 1951) 189 F. (2d) 1008, the profits to which the minority were entitled were traced to the ultimate corporation which held them as trustee *ex maleficio*.

⁵² E.g., *Garrett v. Reid-Cashion Land & Cattle Co.*, 34 Ariz. 245, 270 P. 1044 (1928); *Tierney v. United Pocahontas Coal Co.*, 85 W. Va. 545, 102 S.E. 249 (1920). Cf. *Tanner v. Lindell Ry.*, 180 Mo. 1, 79 S.W. 155 (1904).

⁵³ (1st Cir. 1941) 121 F. (2d) 431, cert. den 314 U.S. 668 (1941).

Standard. The plaintiff shareholder in *Midwest* claimed breach of trust and asked, inter alia, for rescission. The court considered the power of an equity court to withhold rescission, even though a case for such relief is made out. Drawing upon the analogy of the balancing of the equities doctrine in specific performance,⁵⁴ the court decided that equity may decline to grant rescission when such relief would create an inequitable result. Therefore, the trial court was upheld in its conclusion that the time and expense involved in "unscrambling an eighty million dollar egg" consisting of vast and diversified properties would be so great that to order such would amount to a denial of justice. In lieu of rescission, the plaintiff was granted the amount he would have received had all of his prayers, other than rescission, been granted.⁵⁵

The outcome of *Midwest* illustrates the broad range of remedies available to the court of equity when the plaintiff-shareholder asks for rescission. If rescission would work undue hardship, if there would be imbalance of the equities, rescission will be denied. This does not mean, however, that the stockholder with the meritorious cause will go without relief. The court may rescind the transaction in whole,⁵⁶ it may order an accounting,⁵⁷ it may direct the payment of the value of the plaintiff's interests,⁵⁸ or it may decree a combination of the several alternatives.

C. *Compelling a Distribution of Assets*

In the rescission cases, equity sometimes orders a money payment on the ground that conditions have changed and rescission would be unjust to those who have acquired subsequent rights.⁵⁹ Compensation in money may be obtained in other ways by dis-

⁵⁴ *Id.* at 438.

⁵⁵ The payment was suggested by Standard. In a novel answer, Standard stated that it had acquired all but sixty-two shares of *Midwest*, fifty held by plaintiff, the remainder by one seeking appraisal. The expense of preparing a defense was so great that Standard would, without admitting liability, pay plaintiff his portion of the recovery under all of his prayers, except rescission and accounting, plus attorney's fees and costs. The trial and appellate courts approved this as an equitable solution.

⁵⁶ E.g., *Brown v. McLanahan*, (4th Cir. 1945) 148 F. (2d) 703 (charter amendment nullified).

⁵⁷ E.g., *Meeker v. Winthrop Iron Co.*, (W.D. Mich. 1883) 17 F. 48 (lease rescinded, receivers appointed, and accounting ordered).

⁵⁸ In *May v. Midwest Ref. Co.*, note 53 *supra*, direct payment to the plaintiff was ordered even though he brought a derivative suit. The court held that plaintiff was acting for the corporation *and* for himself, and since no other stockholders and no creditors were involved, direct payment was proper. There may be situations in which direct recoveries are permitted in derivative suits. For a good discussion of the problem, see *Keenan v. Eshleman*, 23 Del. Ch. 234, 2 A. (2d) 904 (1938).

⁵⁹ E.g., *Jones v. Missouri-Edison Elec. Co.*, (8th Cir. 1906) 144 F. 765.

senting shareholders who are victims of unfair, illegal, or fraudulent majority actions. In some instances, courts have permitted direct suits by minority holders for the recovery of the loss of value of the shares. In other situations, courts have ordered liquidation.

1. *Direct Suits for Damages*

The effectiveness of the direct suit for damages suffered because of oppressive acts of the majority is illustrated in *Lebold v. Inland Steel Co.*⁶⁰ Inland Steel, majority owner of Inland Steamship, dissolved Steamship for the announced purpose of getting rid of the minority holders. The court had earlier refused to block the dissolution but left the door open for plaintiffs to seek relief if they were dealt with unfairly.⁶¹ After the dissolution, the minority sought a money judgment because of the damage suffered when the majority appropriated the business to itself in violation of its fiduciary duties. The court instructed the trial court to fix damages based upon the difference between the amount the plaintiffs received from the sale of the physical assets and the value of the shares as shares in a prosperous concern continuing in business.⁶²

In forthrightly confirming recovery of damages in a direct suit, the court of appeals did not quibble about, in fact did not even mention, the usual rule that a stockholder cannot recover damages personally for a wrong done to the corporation.⁶³ Technically, the injury was to the plaintiff's company, Inland Steamship, because Steamship did not receive full value for its assets. But the court, like other courts before it, followed an apparent exception to the general rule and permitted a direct suit on the theory that the value of the minority's interest in Steamship had been misappropriated by the majority.

Other courts have sanctioned the direct suit on the same basis, namely, that individual property belonging to the plaintiff had been "converted" or "misappropriated" by the illegal, fraudulent, or oppressive action of the majority.⁶⁴ This is, in fact, illogical

⁶⁰ (7th Cir. 1941) 125 F. (2d) 369, cert. den. 316 U.S. 675 (1942).

⁶¹ *Lebold v. Inland S.S. Co.*, (7th Cir. 1936) 82 F. (2d) 351.

⁶² The plaintiffs had received \$700 per share as liquidating dividends based on the sale of the physical assets. Ultimately, the plaintiffs received a total of \$1,350 per share. *Lebold v. Inland Steel Co.*, (7th Cir. 1943) 136 F. (2d) 876.

⁶³ "As a general rule, however, a shareholder is considered to have no direct, individual right of action for corporate wrongs which impair the value of his investment." BALLANTINE, CORPORATIONS 333 (1946).

⁶⁴ *Mills v. Tiffany's, Inc.*, 123 Conn. 631, 198 A. 185 (1938); *Tanner v. Lindell Ry.*, 180 Mo. 1, 79 S.W. 155 (1904) (dictum); *Equitable Trust Co. v. Columbia Nat. Bank*, 145 S.C. 91, 142 S.E. 811 (1928); *Wunsch v. Consolidated Laundry Co.*, 116 Wash. 44, 198 P. 333 (1921).

because the shareholder, as such, does not individually own any of the property which has been sold or transferred by his corporation. All such property belongs to the corporation. And at least one court has denied that a wrongful sale was conversion, on the ground that the plaintiff stockholder never had any legal title to any part of the corporate assets. However, the same court granted a direct recovery and used the theory that the purchasing company held the value of the plaintiff's interest in the selling company in trust for plaintiff's use and benefit.⁶⁵

Whatever legal theory may be used to justify the direct suit, the important fact is that courts have taken a realistic view of majority actions destructive of minority interests and have allowed direct recoveries. Further, there has been no difficulty in finding the purchaser⁶⁶ or the successor corporation⁶⁷ or the instigators of the illegal or fraudulent act⁶⁸ liable to the complainant.

The direct suit may not be available if there are creditors of the plaintiff's corporation. If the cause of action arises because of destruction or wastage of corporate assets, then the sum recovered should go directly to the corporation for the benefit of creditors. If there are no creditors, and if applicable statutes do not make appraisal an exclusive remedy, then the direct suit is an effective and convenient weapon in the hands of the aggrieved stockholder.

2. *Compulsory Liquidation*

The most complete and the most drastic remedy available to the dissident stockholder is the suit to compel a winding up and distribution of the remaining assets of a solvent corporation. In some states this may be accomplished under statutory authority; in others the plaintiff must rely upon the inherent powers of equity.

English law permits the direct suit in cases of oppression and fraud. Section 210 of the English Companies Act of 1948 (11 & 12 Geo. 6, c. 38, §210) provides that a shareholder of a company being operated in an oppressive manner may secure a court order requiring the company to purchase his shares. For a discussion of the first decision by the House of Lords on this provision, see notes, 72 HARV. L. REV. 761 (1959); 21 MOD. L. REV. 653 (1958).

⁶⁵ Nave-McCord Mercantile Co. v. Ranney, (8th Cir. 1928) 29 F. (2d) 383 at 390. See also Ervin v. Oregon Ry. & Nav. Co., (S.D. N.Y. 1886) 27 F. 625.

⁶⁶ Lebold v. Inland Steel Co., (7th Cir. 1942) 125 F. (2d) 369; Equitable Trust Co. v. Columbia Nat. Bank, 145 S.C. 91, 142 S.E. 811 (1928).

⁶⁷ Ervin v. Oregon Ry. & Nav. Co., (S.D. N.Y. 1886) 27 F. 625; Wunsch v. Consolidated Laundry Co., 116 Wash. 44, 198 P. 383 (1921).

⁶⁸ Mills v. Tiffany's, Inc., 123 Conn. 631 at 643-644, 198 A. 185 (1938). Directors who bring about an illegal transfer are personally liable, and any person actively and knowingly participating is equally liable to the minority.

a. *The Inherent Power of Equity To Wind Up.* The inherent power of a court of equity to liquidate or wind up a solvent corporation at the request of a minority stockholder on the ground of mismanagement, fraud, or oppression by the majority is generally conceded today.⁶⁹ In contrast, the inherent power of equity to order a *de jure* dissolution of corporation is still questioned by some authorities.⁷⁰ "Winding up" means the selling of the property, the payment of debts, and the distribution of the remainder to the shareholders. Corporate life remains in the empty shell. In dissolution, the same steps occur, but the end result is the termination of corporate existence. Some courts will sanction winding up, but will deny dissolution.⁷¹ The reason advanced is that technical dissolution can be accomplished only by a suit by the state or by vote of the stockholders.⁷² But since winding up effectively takes the assets from the corporation and distributes the net worth to the owners, the distinction between "winding up" and "dissolution" is more academic than practical. In fact, some courts refer to winding up as a *de facto* dissolution.⁷³

Liquidation is an extreme remedy, and courts are very reluctant to order it. The reasons must be most cogent and urgent. Liquidation will not be granted merely to bail the dissident out of a bad business venture. Nor is the remedy available because of some disagreement over business policy.⁷⁴ Judicial opinion is practically unanimous that liquidation of solvent corporations should be the ultimate remedy, because it involves accentuation of economic waste through forced receivership.⁷⁵ Since winding up is a last-

⁶⁹ *Bailey v. Proctor*, (1st Cir. 1947) 160 F. (2d) 78, cert. den. 331 U.S. 834 (1947) (equity has inherent power to liquidate corporation where fraud, mismanagement, or abuse of trust exists whether or not there is insolvency); *Tower Hill-Connellsville Coke Co. of W. Va. v. Piedmont Coal Co.*, (4th Cir. 1933) 64 F. (2d) 817, cert. den. 290 U.S. 675 (1933); *Red Bud Realty Co. v. South*, 153 Ark. 380, 241 S.W. 21 (1922); *Bilby v. Morton*, 119 Okla. 15, 247 P. 384 (1926); *Patton v. Nicholas*, 154 Tex. 385, 279 S.W. (2d) 848 (1955); *Goodwin v. Milwaukee Lithographing Co.*, 171 Wis. 351, 177 N.W. 618 (1920). The parent case is *Miner v. Belle Isle Ice Co.*, 93 Mich. 97, 53 N.W. 218 (1892).

⁷⁰ E.g., "In the absence of authority, which is frequently found conferred by statute, a court of equity may not dissolve a corporation at the suit of . . . a shareholder. . . . But the power of equity courts to liquidate and wind up the affairs of a corporation at the suit of a shareholder is recognized." STEVENS, CORPORATIONS 956 (1949).

⁷¹ See *Tower Hill-Connellsville Coke Co. of W. Va. v. Piedmont Coal Co.*, (4th Cir. 1933) 64 F. (2d) 817 at 827, cert. den. 290 U.S. 675 (1933).

⁷² STEVENS, CORPORATIONS 958 (1949).

⁷³ *Nashville Packet Co. v. Neville*, 144 Tenn. 698 at 703, 235 S.W. 64 (1921).

⁷⁴ *Stott Realty Co. v. Orloff*, 262 Mich. 375, 247 N.W. 698 (1933); *Fontheim v. Walker*, 282 App. Div. 373, 122 N.Y.S. (2d) 642 (1953).

⁷⁵ *Patton v. Nicholas*, 154 Tex. 385 at 398, 279 S.W. (2d) 848 (1955). See *Bailey v. Proctor*, (1st Cir. 1947) 160 F. (2d) 78 at 82, cert. den. 331 U.S. 834 (1947); *Mills Dev. Corp. v. Shipp & Head, Inc.*, 126 Fla. 490, 171 S. 533 (1936).

resort remedy,⁷⁶ courts will seek less stringent alternatives before ordering liquidation, such as compulsory dividends,⁷⁷ payment of damages,⁷⁸ or reduction and distribution of capital.⁷⁹

Liquidation may be the only solution when the wrongs are continuous and systematic, and there is no real hope for future betterment. If so, the usual pattern is to appoint a receiver who is charged with responsibility for termination of the affairs of the corporation.⁸⁰ The end result is the payment to the dissident of his portion of the net assets.

While the cases involving liquidation at the suit of a minority holder are reasonably numerous, there appear to be none in which dissolution has been ordered because of oppressive or fraudulent action stemming from a stockholder vote. The usual factual situation in the reported cases involves wastage of corporate assets and plundering by the majority. Since depredations of this nature can and do result from stockholder votes in adverse interest, it is believed that, in the proper case, equity would order liquidation because of undue exertion of selfish interest in the corporate voting.

b. *Statutory Dissolution at the Suit of the Minority.* Some states have statutes authorizing minority stockholders to sue for involuntary dissolution.⁸¹ If the equity court has any qualms about its inherent power to order winding up, statutory authority will quiet those fears. However, the grounds set forth in the statute must fit the situation. In some instances, the statutory grounds for dissolution may be narrow.⁸² Other statutes grant the courts a wide range of discretion by stating that dissolution may be ordered for "sufficient cause,"⁸³ if "it is beneficial to the interest of the shareholders,"⁸⁴ or if "reasonably necessary for the protection of the rights of stockholders."⁸⁵ Under the broad type of statute,

⁷⁶ See Hornstein, "A Remedy for Corporate Abuse—Judicial Power To Wind up a Corporation at the Suit of a Minority Stockholder," 40 COL. L. REV. 221 at 236 (1940).

⁷⁷ Patton v. Nicholas, 154 Tex. 385, 279 S.W. (2d) 848 (1955).

⁷⁸ Stebbins v. Michigan Wheelbarrow & Truck Co., (6th Cir. 1914) 212 F. 19.

⁷⁹ Riley v. Callahan Mining Co., 28 Idaho 525, 155 P. 665 (1916).

⁸⁰ See Henry v. Ide, 208 Ala. 33 at 41, 93 S. 860 (1922); Brent v. B. E. Brister Sawmill Co., 103 Miss. 876, 60 S. 1018 (1913); Goodwin v. Milwaukee Lithographing Co., 171 Wis. 351, 177 N.W. 618 (1920).

⁸¹ See comment, 41 MICH. L. REV. 714 at 721 (1943).

⁸² See, e.g., Ariz. Rev. Stat. (1955) §10-381 (failure to appoint agent; law violation; disposition of all property, etc.).

⁸³ E.g., Conn. Gen. Stat. (1958) §33-115; W. Va. Code (1955) §3093.

⁸⁴ E.g., Okla. Stat. (1951) §1.195(3); Wash. Rev. Code (1951) §23.01.540.

⁸⁵ E.g., N.H. Rev. Stat. (1955) §294.97.

it would seem that the dissident can base his plea on the ground of unfairness, fraud, or illegality. Then if he meets the statutory requisites, he may ask for dissolution.⁸⁶

D. *Summary*

We have seen now that a dissident shareholder who is not limited to the right of appraisal and who wishes to attack a majority action may have certain tactical advantages. When the majority is on both sides of the bargain, there is no presumption of fairness in favor of the majority proposal. In many situations, the plaintiff may bring a direct suit thereby escaping the restrictions several states impose on those who would bring a derivative action.

Whether or not the dissatisfied shareholder has procedural advantages, he does have a variety of possible remedies. He may seek a prohibitory injunction or he may wait and ask for rescission. Under certain circumstances, he may bring a direct suit for damages. In extreme cases, equity may order liquidation, either under its inherent power or under a statutory grant of authority.

In sum, an aggrieved shareholder wishing to attack the majority vote on the grounds of undue exertion of adverse interest has potent weapons at his disposal.

II. THE DEFENSE: AVOIDANCE OF INDICIA OF ADVERSE INTEREST

We now turn to an examination of the indicia of adverse interest as they appear in corporate activities requiring shareholder approval.

The reported cases disclose that dissentient stockholders and courts seize upon the presence or absence of certain facts as being indicative of an unconscionable exertion of adverse interest. It is the purpose of this section to catalog these objective manifestations of selfish interest, and their opposites, in order that lawyers and corporate executives may avoid or neutralize the adverse indicia during the planning and presentation phases of management proposals.

In the consideration of corporate activities requiring stockholder votes, emphasis is on the end to be obtained, not the means.

⁸⁶ Some statutes specify that the plaintiffs must own a definite percentage of shares. E.g., Nev. Rev. Stat. (1957) §78.650 (10%). Sometimes the plaintiff must have owned his shares for a certain time. E.g., Cal. Corp. Code (Deering, 1953) §4650 (six months).

For example, there are various ways to rid the corporation of unwanted stockholders, e.g., merger, sale, amendment, and so on, but the end result is the same.

A. *Corporate Actions Resulting in Direct Personal Gain*

1. *Purchase by Stockholders of Assets Sold by the Corporation*

At common law, unanimous consent of all stockholders was required before a prosperous corporation could sell all or a major portion of its assets.⁸⁷ The impracticability of such a rule brought statutory changes providing that a majority or two-thirds may sell. When a specified majority has power to sell, or to dissolve with a sale following, those who own or control the necessary votes have opportunity to seek a direct, personal gain, for the general rule now is that the majority stockholder may purchase the assets of the selling corporation.⁸⁸

There are three typical fact situations in which the holder may exert an adverse interest by voting approval of a sale to the voter. The first is to employ the statutory procedure of selling the assets by vote of the required number.⁸⁹ The second procedure is similar. Those in control sell to themselves, then ratify the transaction by casting their own votes in favor.⁹⁰ The third situation involves dissolution followed by a sale to the controlling stockholder.⁹¹ Whatever the fact situation, majority and controlling shareholders are on both sides of the bargain and the burden is on them to prove the fairness of the sale. Such transactions are not necessarily evil.⁹² To the contrary, the result is often fair to all con-

⁸⁷ *Butler v. New Keystone Copper Co.*, 10 Del. Ch. 371, 93 A. 380 (1915); *Patterson v. Shattuck Arizona Copper Co.*, 186 Minn. 611, 244 N.W. 281 (1932); *In re Clark's Will*, 257 N.Y. 132, 178 N.E. 766 (1931); *Cardiff v. Johnson*, 126 Wash. 454, 218 P. 269, 222 P. 902 (1923).

⁸⁸ *May v. Midwest Ref. Co.*, (1st Cir. 1941) 121 F. (2d) 431, cert. den. 314 U.S. 668 (1941). Cf. *Robb v. Eastgate Hotel, Inc.*, 347 Ill. App. 261, 106 N.E. (2d) 848 (1952); *Price v. Holcomb*, 89 Iowa 123, 56 N.W. 407 (1893). *Contra*, *Chicago Hansom Cab Co. v. Yerkes*, 141 Ill. 320, 30 N.E. 667 (1892).

⁸⁹ E.g., *Johnson Hotel Lawrence Corp.*, 337 Ill. 345, 169 N.E. 240 (1929) (sale to majority approved).

⁹⁰ E.g., *Ostlind v. Ostlind Valve, Inc.*, 178 Ore. 161, 165 P. (2d) 779 (1946) (sale of part of assets approved).

⁹¹ The classic example is *Ervin v. Oregon Ry. & Nav. Co.*, (S.D. N.Y. 1886) 27 F. 625, in which majority voted to dissolve a prosperous company then purchased its assets for \$2,300,000, assets the court found to be worth \$5,500,000. The minority received additional compensation.

⁹² In many instances, courts have sustained sales in which dominant stockholders are on both sides of the bargain. See, e.g., *McDermott v. O'Neil Oil Co.*, 200 Wis. 423, 228 N.W. 481 (1930).

cerned and it is only when the thrust of adverse interest becomes unconscionable that courts rise to protect the complaining stockholders.

The most important indicator of fairness, and one mentioned in virtually all of the cases involving litigated purchases by dominant stockholders, is adequacy of price. It would seem that any group with fiduciary responsibilities would know that they cannot purchase with impunity assets worth \$5,500,000 for \$2,300,000,⁹³ buy a building for \$2,500 *vis-à-vis* a bona fide offer for \$3,500,⁹⁴ secure a lease for \$22,500 against a well-secured bid of \$30,000,⁹⁵ or grant mining rights for a tenth of what others would pay.⁹⁶ These would appear to be "easy" cases, yet they were converted to the point of decisions by appellate courts. The self-dealers pressed the businessman's concept that when the legislature grants the power, there is unbridled freedom to use it. But the courts imposed the now well-recognized equitable limitations on the power of the majority.

After the "easy" cases, the determination of an adequate price becomes more difficult. At first blush it would seem that a value set by an outside appraiser would be virtually final. However, an appraiser employed by the control group carries the same stigma as his employer. He is working both sides of the street by representing both buyer and seller. Courts view his findings with considerable cynicism, if not utter disregard.⁹⁷ Undoubtedly, the most convincing way to arrive at an unchallengeable price is to offer the property for public sale. If no offer higher than that of the defending stockholder is received, courts will usually sustain the transaction.⁹⁸ Sometimes no one is interested except the insiders.⁹⁹ If no competitive bids are requested, that fact works against affirmance.¹⁰⁰ Whether value is fixed by an outside appraiser, by negotiation, or by public offering, if the enterprise is

⁹³ *Ervin v. Oregon Ry. & Nav. Co.*, (S.D. N.Y. 1886) 27 F. 625.

⁹⁴ *Wheeler v. Abilene Nat. Bank Bldg. Co.*, (8th Cir. 1908) 159 F. 391.

⁹⁵ *Schmid v. Lancaster Ave. Theatre Co.*, 244 Pa. 373, 91 A. 363 (1914).

⁹⁶ *Franklin v. Havalena Mining Co.*, 16 Ariz. 200, 141 P. 727 (1914).

⁹⁷ See, e.g., *Robb v. Eastgate Hotel, Inc.*, 347 Ill. App. 261, 106 N.E. (2d) 848 (1952).

⁹⁸ See, e.g., *Lane & Co. v. Maple Cotton Mills*, (4th Cir. 1915) 226 F. 692; *McDermott v. O'Neil Oil Co.*, 200 Wis. 423, 228 N.W. 481 (1930); *Price v. Holcomb*, 89 Iowa 123, 56 N.W. 407 (1893).

⁹⁹ E.g., *McDermott v. O'Neil Oil Co.*, 200 Wis. 423, 228 N.W. 481 (1930).

¹⁰⁰ *Robb v. Eastgate Hotel, Inc.*, 347 Ill. App. 261, 106 N.E. (2d) 848 (1952). In *Wheeler v. Abilene Nat. Bank Bldg. Co.*, (8th Cir. 1908) 159 F. 391, the court ordered the bid price tested by a public sale.

sold *in toto*, account must be taken of the worth of good will and going-concern value.¹⁰¹

The objective fact of next importance is the economic condition of the selling corporation. When a company is heading toward financial disaster, salvage operations are in order. Expediency may justify a sale to fiduciaries that would be condemned if the corporation were completely solvent and hopeful. Courts are prone to approve sales to insiders made by entities in economic straits,¹⁰² and are understandably reluctant to bless sales to insiders of assets of prosperous concerns.¹⁰³

Courts pay heed to other circumstances. If the selling-purchasing group is open and aboveboard, with no secrets, such is in their favor.¹⁰⁴ The absence of any appearance of an attempt to freeze out the minority and carry on the business in another form is a positive factor.¹⁰⁵ The presence or absence of a statute permitting a dissenter to ask for an appraisal and purchase of his shares seems to make little difference. This is because appraisal is generally not an exclusive remedy when fraud is charged.¹⁰⁶ Consequently, the availability of appraisal will not block a suit based on unconscionable selling of assets. And sometimes the buyer-seller may win because it is uneconomic and absurd to untangle that which has already been accomplished. So the courts order an additional payment to the complainants and the transaction stands.¹⁰⁷

In sum, if the dominant group wants to complete an unassailable purchase of assets from the corporation it controls, then that group must do everything possible to build a record free from the

¹⁰¹ Operating businesses should have a value above and beyond the countable assets. See *Ervin v. Oregon Ry. & Nav. Co.*, (S.D. N.Y. 1886) 27 F. 625. Cf. *May v. Midwest Ref. Co.*, (1st Cir. 1941) 121 F. (2d) 431, cert. den. 314 U.S. 668 (1941).

¹⁰² E.g., *Lane & Co. v. Maple Cotton Mills*, (4th Cir. 1915) 226 F. 692; *Johnson v. Hotel Lawrence Corp.*, 337 Ill. 345, 169 N.E. 240 (1929); *Price v. Holcomb*, 89 Iowa 123, 56 N.W. 407 (1893); *Merriman v. National Zinc Corp.*, 82 N.J. Eq. 493, 89 A. 764 (1914). But see *Chicago Hansom Cab Co. v. Yerkes*, 141 Ill. 320, 30 N.E. 667 (1892), in which corporation was failing, yet sale to insider was voided.

¹⁰³ *Ervin v. Oregon Ry. & Nav. Co.*, (S.D. N.Y. 1886) 27 F. 625.

¹⁰⁴ *McDermott v. O'Neil Oil Co.*, 200 Wis. 423, 228 N.W. 481 (1930). Cf. *Weisbecker v. Hosiery Patents, Inc.*, 356 Pa. 244, 51 A. (2d) 811 (1947).

¹⁰⁵ *Stebbins v. Michigan Wheelbarrow & Truck Co.*, (6th Cir. 1914) 212 F. 19 (minority not permitted in successor corporation and awarded additional money); *Lane & Co. v. Maple Cotton Mills*, (4th Cir. 1915) 226 F. 692 (minority invited to participate; sale approved).

¹⁰⁶ *May v. Midwest Ref. Co.*, (1st Cir. 1941) 121 F. (2d) 431, cert. den. 314 U.S. 668 (1941); *Robb v. Eastgate Hotel, Inc.*, 347 Ill. App. 261, 106 N.E. (2d) 848 (1952); *Cole v. Wells*, 224 Mass. 504, 113 N.E. 189 (1916).

¹⁰⁷ *May v. Midwest Ref. Co.*, (1st Cir. 1941) 121 F. (2d) 431, cert. den. 314 U.S. 668 (1941).

indicia of adverse interest. The ideal record would be a purchase made at or subsequent to a public offering, an offering generated by sound business reasons and made after full disclosure of all pertinent facts. Anything less may result in a finding of violation of fiduciary obligations.

2. *Sales of Property by the Stockholder to the Corporation*

Similar in result to the purchase of assets owned by the corporation, but different in procedure, is the sale of personally-owned property to the corporation. When all or substantially all of the assets are sold, statutes normally provide that the stockholders must approve either the sale or the dissolution prior to the sale. In contrast, when property is purchased, the stockholders rarely vote on the matter. This is because of the basic rule that the directors manage the company, and, as managers, the directors, not the stockholders, do the buying. But sometimes, because of the conflicting interests, directors will submit the question of purchase for prior approval or subsequent ratification by the stockholders. When this happens, the stockholders have opportunity to vote on a purchase by the corporation from influential, and probably dominant, stockholders.

When the price is fair and the property is needed, it is probable that the court will hold that the selling shareholder can vote to ratify the purchase from himself.¹⁰⁸ Frankness and the absence of secret profits are validating factors.¹⁰⁹ The economic condition of the entity is important. A failing enterprise may need diversification, and a purchase from a shareholder, which will provide the profit potential, stands an excellent chance of approval.¹¹⁰

The decisions involving votes on purchases by the corporation from stockholders make it evident that it is proper and legal for a stockholder to vote his stock for the purchase of property in which he has an interest. However, approval by a majority is not always enough. If the purchase is to withstand challenge by a militant and dissatisfied minority, the consideration must be reasonable, the property needed, and the transaction free from secret profits and unconscionable motives.

¹⁰⁸ *Bjorngaard v. Goodhue County Bank*, 49 Minn. 483, 52 N.W. 48 (1892); *Gamble v. Queens County Water Co.*, 123 N.Y. 91, 25 N.E. 201 (1890).

¹⁰⁹ See *Hellier v. Baush Mach. Tool Co.*, (1st Cir. 1927) 21 F. (2d) 705 at 708.

¹¹⁰ *Ibid.*

3. *Executive Compensation — Salaries, Bonuses, and Stock Options*

Normally directors fix executive compensation, and stockholders have no vote on the matter. But more and more are stockholders being called upon to approve or ratify bonus or stock-option plans. While ratification usually creates a strong presumption of validity, ratification in and of itself does not render the plan inviolate. There can be no wastage of corporate assets through exorbitant salaries and benefits.¹¹¹ But ratification is the most effective means of avoiding the stigma of adverse interest in a compensation proposal.

In the leading case of *Gottlieb v. Heyden Chem. Corp.*,¹¹² a stock-option plan had been approved by the stockholders of a Delaware corporation. When the plaintiff challenged the validity of the plan, the defendant-directors, who were beneficiaries under the proposals, contended that shareholder ratification settled the matter. The Supreme Court of Delaware admitted that this was an appealing argument:

“Ratification by stockholders, indeed, is frequently decisive of controversies in this field of law. . . . But unless ratification is unanimous, it can never constitute the only requisite to validity. An unconscionable deal between directors personally and the corporation they represent could not become conscionable merely because most of the stockholders were either indifferent or actually in sympathy with the directors’ scheme. Certainly gifts to themselves or to their business associates will not avail against the vote of any qualified objector.”¹¹³

The words in *Gottlieb* about the effect of ratification puzzled litigants and lawyers. On petition for reargument,¹¹⁴ the court clarified its previous statements by saying that where the directors vote themselves stock options and do not obtain ratification, the burden is on the directors to prove their utmost good faith. When there is ratification, the burden of proof is shifted to the objector, who must convince the court that no one of ordinarily sound

¹¹¹ *Rogers v. Hill*, 289 U.S. 582 at 591 (1933).

¹¹² 33 Del. Ch. 82, 90 A. (2d) 660 (1952).

¹¹³ *Id.* at 90-91.

¹¹⁴ *Gottlieb v. Heyden Chem. Corp.*, 33 Del. Ch. 177, 91 A. (2d) 57 (1952). On petition for reargument, the defendant directors said that the original option (note 112 *supra*) had destroyed all practical distinctions between cases where directors grant stock options to themselves without stockholder ratification and cases where ratification is obtained. *Id.* at 178.

business judgment would view the consideration furnished by the individual directors as being a fair exchange for the options.¹¹⁵

In *Gottlieb*, the court carefully emphasized that the beneficiaries of the plan did not control the stockholders. Therefore, ratification by the stockholders placed the burden on the objector to prove that the plan was beyond the realm of good business judgment, that is, that the plan constituted waste, and that reasonable men, fully informed and acting in good faith, would not differ on that position.¹¹⁶

This view gives a great advantage to management in publicly-held corporations. The propensity of stockholders to follow the lead of management and send in their proxies in favor of management proposals is a well-known and well-documented phenomenon in modern corporations.¹¹⁷ So even though management does not directly own or control a voting majority, ratification of compensation plans is easy to obtain, and ratification places a tough obstacle in the path of a dissenter.¹¹⁸

When directors do control the winning vote, the conflicting interests of the controlling stockholders nullify the effect of the ratification, and the directors still have the burden of proving the inherent fairness of the compensation, be it salary, bonus, or stock option. The control group can sustain their action by proving the adequacy of the amount and kind of consideration given for the compensation and the openness and honesty of their disclosures to the noncontrolling shareholders.¹¹⁹

¹¹⁵ 33 Del. Ch. at 178-179, 91 A. (2d) 58; *accord*, *Eliasberg v. Standard Oil Co.*, 23 N.J. Super. 431, 92 A. (2d) 862 (1952), *affd. mem.* 12 N.J. 467, 97 A. (2d) 437 (1953). Cf. *Kerbs v. California Eastern Airways*, 33 Del. Ch. 69, 90 A. (2d) 652 (1952) (ratification cures voidable action of directors).

¹¹⁶ 33 Del. Ch. 177 at 181, 91 A. (2d) 57 (1952). On decision following reargument, the court remanded the cause for trial to give plaintiff opportunity to prove that the values of the options granted and services to be rendered by the officers as consideration therefor were so disproportionate that reasonable men would not differ in their condemnation of the bargain as unfair. *Gottlieb v. Heyden Chem. Corp.*, 33 Del. Ch. 283, 92 A. (2d) 594 (1952).

¹¹⁷ See, e.g., BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 139 (1932); LIVINGSTON, *THE AMERICAN STOCKHOLDER* 13-48 (1958); Dodd, "The Modern Corporation, Private Property, and Recent Federal Legislation," 54 HARV. L. REV. 917 at 919-920 (1941).

¹¹⁸ Subsequent to *Gottlieb v. Heyden Chem. Corp.*, 33 Del. Ch. 82, 90 A. (2d) 660 (1952), Del. Gen. Corp. Laws §157 was amended (July 8, 1953) to require a showing of actual fraud in order to void the judgment of the directors as to the value of rights of stock options so authorized.

¹¹⁹ The principles of *Kerbs v. California Eastern Airways*, 33 Del. Ch. 69, 90 A. (2d) 652 (1952), and *Gottlieb v. Heyden Chem. Corp.*, 33 Del. Ch. 177, 91 A. (2d) 57 (1952) are summarized in *Kaufman v. Shoenberg*, 33 Del. Ch. 211, 91 A. (2d) 786 (1952). One of the principles is that "absent *independent* stockholder ratification, interested directors have the burden of showing that the consideration to be received constitutes a fair exchange for the options." (Emphasis supplied.) *Id.* at 220-221.

B. *Corporate Actions Resulting in Personal Gain Through Increase in Share Values*

1. *Elimination of Accrued Dividends*

When a corporation emerges from a business recession, and profits replace deficits, pressures build up for the renewal of dividends. If the corporation has preferred shares with cumulative dividends, the owners of preferred want the accumulated dividends.¹²⁰ The holders of common shares press management to do something about the preferred accruals, accruals which must be paid before dividends can be resumed on the common. In result, any management desirous of staying in office must seek ways and means of eliminating the accruals.¹²¹

The importance of this problem in the years following the great depression of the thirties is reflected in the many law review articles in which eminent and thorough scholars examined the legal, financial, and policy aspects of accruals.¹²² It is not the intent here to replot that ground. Instead, the problem will be examined from the aspect of the indicia of adverse interest which were manifested when stockholders were presented with a plan of recapitalization, the ultimate intent of which was the elimination of accruals.¹²³

¹²⁰ See, e.g., *Barrett v. Denver Tramway Corp.*, (3d Cir. 1944) 146 F. (2d) 701. Organized in 1925, the transit system paid dividends in diminishing amounts from 1926 to 1931; then stopped dividends, but war conditions caused a sudden and tremendous increase in earnings. The preferred stockholders agitated for the payment of dividends. *Id.* at 704.

¹²¹ See, e.g., *Hubbard v. Jones & Laughlin Steel Corp.*, (W.D. Pa. 1941) 42 F. Supp. 432. "During the last half of 1936, and the first half of 1937, business began to improve; and the Company was faced with the problem of paying off or refunding the dividend arrearages." *Id.* at 435-436.

¹²² Some of the representative articles are Becht, "Alterations of Accrued Dividends," 49 MICH. L. REV. 363, 565 (1951); Dodd, "Accrued Dividends in Delaware Corporations—From Vested Right to Mirage," 57 HARV. L. REV. 894 (1944); Dodd, "Fair and Equitable Recapitalizations," 55 HARV. L. REV. 780 (1942); Lattin, "A Primer on Fundamental Corporate Changes," 1 WEST. RES. L. REV. 3 (1949); Latty, "Fairness—The Focal Point in Preferred Stock Arrearage Elimination," 29 VA. L. REV. 1 (1942); Meck, "Accrued Dividends on Cumulative Preferred Stocks: The Legal Doctrine," 55 HARV. L. REV. 71 (1941).

The problem of accruals is a diminishing one. There are few recent cases—probably because prosperity has enabled corporations to pay or refund. Accruals on preferred shares listed on the New York Stock Exchange decreased by \$717,074,169 or nearly 82% from 1948 to 1958. THE EXCHANGE, March 1958, p. 18.

¹²³ The question of adverse interest is important only in cases in which the stockholders have the power to effectuate a change through their vote. Therefore, the numerous cases holding that stockholders did not have the statutory or charter power to eliminate accruals are disregarded. Likewise, the cases in which the plaintiff lost because of some weakness on his part, such as laches, are immaterial. This leaves for consideration the reported instances in which the majority had the power to eliminate accruals and the plaintiff was in a position to challenge the action and did so on the ground of unfairness or fraud.

The accrual problem may be solved by either a compulsory or an optional exchange of shares. The compulsory plan, which results in a total elimination of accruals, may be accomplished by a charter amendment or a merger, either of which will cancel the old shares and replace them with new ones.¹²⁴ The optional technique calls for the issuance of new shares which "top" the old shares with dividend and other priorities. The intent is to make the old shares so unattractive for the future that the owner will accept the offer to exchange the old for the new. The result is the drastic diminution, if not the total elimination, of accruals. Of the two methods, and considering only the instances in which statutory power was present, the optional plan has received almost universal acceptance by the courts.¹²⁵ This is not surprising. It is "voluntary" in the sense that the holders are at liberty to retain their presently-owned preferred shares. On the other hand, corporations have had surprisingly good success with the compulsory exchange of shares brought about by amendment¹²⁶ or merger.¹²⁷

¹²⁴ In *Keller v. Wilson & Co.*, 21 Del. Ch. 391, 190 A. 115 (1936), an amendment canceling accruals was held invalid. But the same result was permitted in *Havender v. Federal United Corp.*, 24 Del. Ch. 318, 11 A. (2d) 331 (1940) by merger. The inconsistency of this position is illuminated in *Hottenstein v. York Ice Mach. Corp.*, (3d Cir. 1943) 136 F. (2d) 944.

¹²⁵ In the following instances plans for "topping" previously issued preferred shares were upheld: *Barrett v. Denver Tramway Corp.*, (3d Cir. 1944) 146 F. (2d) 701 (Delaware corporation); *Johnson v. Fuller*, (3d Cir. 1941) 121 F. (2d) 618 (Pennsylvania corporation); *Ainsworth v. Southwestern Drug Corp.*, (5th Cir. 1938) 95 F. (2d) 172 (Texas corporation); *Blumenthal v. Di Giorgio Fruit Corp.*, 30 Cal. App. (2d) 11, 85 P. (2d) 580 (1938) (Delaware corporation); *Shanik v. White Sewing Mach. Corp.*, (Del. 1941) 19 A. (2d) 831 (Delaware corporation); *Morris v. American Pub. Util. Co.*, 14 Del. Ch. 136, 122 A. 696 (1923) (Delaware corporation); *Kreiker v. Naylor Pipe Co.*, 374 Ill. 364, 29 N.E. (2d) 502 (1940), *affd.* 312 U.S. 659 (1941) (Illinois corporation); *Francke v. Axton-Fisher Tobacco Co.*, 289 Ky. 687, 160 S.W. (2d) 23 (1942) (Kentucky corporation); *Johnson v. Lamprech*, 133 Ohio St. 567, 15 N.E. (2d) 127 (1938) (Ohio corporation).

In the following instance, a similar plan was enjoined: *Buckley v. Cuban Am. Sugar Co.*, 129 N.J. Eq. 322, 19 A. (2d) 820 (1940).

In *Yoakam v. Providence Biltmore Hotel Co.*, (D.C. R.I. 1929) 34 F. (2d) 533, creation of prior preferences by a Delaware corporation was approved, but elimination of a sinking fund was held invalid.

¹²⁶ In these cases amendments canceling accruals were held valid: *McQuillen v. National Cash Register Co.*, (4th Cir. 1940) 112 F. (2d) 877, *cert. den.* 311 U.S. 695 (1940) (Maryland corporation); *Western Foundry Co. v. Wicker*, 403 Ill. 260, 85 N.E. (2d) 722 (1949) (Illinois corporation); *Sherman v. Pepin Pickling Co.*, 230 Minn. 87, 41 N.W. (2d) 571 (1950) (Minnesota corporation); *Franzblau v. Capital Sec. Co.*, 2 N.J. Super. 517, 64 A. (2d) 644 (1949) (New Jersey corporation); *McNulty v. W. & J. Sloane*, 184 Misc. 835, 54 N.Y.S. (2d) 253 (1945) (New York corporation).

In *Kamena v. Janssen Dairy Corp.*, 133 N.J. Eq. 214, 31 A. (2d) 200 (1943), *affd.* 134 N.J. Eq. 359, 35 A. (2d) 894 (1944), a plan for cancellation was held unfair.

¹²⁷ In these cases mergers undertaken to cancel accruals were approved: *Langfelder v. Universal Labs.*, (3d Cir. 1947) 163 F. (2d) 804 (Delaware corporations); *Hottenstein v. York Ice Mach. Corp.*, (3d Cir. 1943) 136 F. (2d) 944 (Delaware corporations); *Hubbard*

In the over-all picture, if the power to eliminate accruals is present, the method selected, whether optional or compulsory, does not make too much difference, provided certain other facts are present. The most important of these is business necessity. Practically all courts record the financial condition of the company. While the corporation need not be on the brink of bankruptcy,¹²⁸ a serious financial crisis helps justify the taking of expected accruals from the preferred. Any evidence indicating that the corporation has been, is now, or is likely to be in trouble is useful in demonstrating the need for the plan.¹²⁹ When a business is caught in the "whirlpool of the prevailing depression," and the directors are facing "probable bankruptcy and dissolution,"¹³⁰ any reasonable plan for saving the corporation, brightening the future, and salvaging the interests of the stockholders has an excellent chance of withstanding an attack by disgruntled stockholders.¹³¹ And if the recapitalization scheme has been worked out after consulta-

v. Jones & Laughlin Steel Corp., (W.D. Pa. 1941) 42 F. Supp. 432 (Pennsylvania corporations); Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 32 A. (2d) 148 (1943) (Delaware corporations); Federal United Corp. v. Havender, (Del. 1940) 11 A. (2d) 331 (Delaware corporations); Donohue v. Heuser, (Ky. App. 1951) 239 S.W. (2d) 238 (consolidation with another Kentucky corporation); Dratz v. Occidental Hotel Co., 325 Mich. 699, 39 N.W. (2d) 341 (1949) (Delaware corporations); Windhurst v. Central Leather Co., 101 N.J. Eq. 543, 138 A. 772 (1927), affd. 107 N.J. Eq. 528, 153 A. 402 (1931) (New Jersey corporations); Anderson v. International Minerals & Chem. Corp., 295 N.Y. 343, 67 N.E. (2d) 573 (1946) (consolidation of a New York and a Colorado corporation under New York laws); Anderson v. Cleveland Cliffs Iron Co., (Ohio C.P. 1948) 87 N.E. (2d) 384 (Ohio corporations); Adams v. United States Distrib. Co., 184 Va. 134, 34 S.E. (2d) 244 (1945) (Virginia corporation merged into Delaware corporation).

In Craddock-Terry Co. v. Powell, 181 Va. 417, 25 S.E. (2d) 363 (1943), a Virginia corporation sold all assets to a new Virginia corporation. This eliminated accruals, but was held to be a liquidation of old company and entitled dissenting holder of preferred to the liquidation preferences provided in the charter.

In Colgate v. United States Leather Co., 73 N.J. Eq. 72, 67 A. 657 (1907), consolidation of two New Jersey corporations was enjoined as unfair.

¹²⁸ See, e.g., the following instances in which the plan was approved, and the corporation had a surplus at the time: Anderson v. Cleveland-Cliffs Iron Co., (Ohio C.P. 1948) 87 N.E. (2d) 384; Johnson v. Lamprecht, 133 Ohio St. 567, 15 N.E. (2d) 127 (1938).

¹²⁹ In Sander v. Janssen Dairy Corp. (D.C. N.J. 1940) 36 F. Supp. 512, the court refused to halt a plan for recapitalization. One of the reasons was that management deposed that the future was not promising because of government regulation, price-fixing, and other contemplated burdens. *Id.* at 514.

¹³⁰ See Blumenthal v. Di Giorgio Fruit Corp., 30 Cal. App. (2d) 11 at 18, 85 P. (2d) 580 (1938).

¹³¹ See, e.g., Hottenstein v. York Ice Mach. Corp., (3d Cir. 1943) 136 F. (2d) 944, in which a merger fabricated for the purpose of canceling accruals was upheld. In the opinion, Judge Biggs said, "As a practical matter we know that it is difficult to refinance corporate indebtedness when there are heavy arrearages of accumulated dividends outstanding. A corporation so situated reasonably may expect litigation and its concomitant miseries. Bankers are loath to float security issues under such circumstances." *Id.* at 952-953.

tion with bankers,¹³² or underwriting experts,¹³³ and if prominent businessmen testify as to its fairness,¹³⁴ these are factors buttressing the plan. Contrariwise, if the corporation has a hopeful balance sheet, and the accruals are bothersome but not overwhelming, these are indicia of adverse interest and the plan is ripe for upsetting as unfair.¹³⁵

An element of obvious consequence in determining the fairness of plans for elimination of accruals is the *quid pro quo* to be given the preferred in exchange for the accruals. The normal pattern is to exchange so many "old" preferred shares with accruals for so many "new" preferred shares. The ratios are tailor-made to fit each existing situation, and no useful purpose would be served in attempting to examine the numerous variants. But it is interesting to observe that the offering of a "sweetener" or "kicker," in addition to the new preferred shares, seems to win the favor of the judiciary. The most glamorous persuader is the granting of voting power, sometimes even to the point of vesting control in the preferred.¹³⁶ Realists viewing the publicly-held corporation might say that potential voting control in the publicly-held corporation is a snare of delusive value, and that scattered, unorganized owners strike a poor bargain when they accept voting power as partial payment for dollars due in accruals. Be that as it may, transference of the potential control from the junior shares to the preferred makes more palatable the deprivation of accruals. In this country there continues to be a curious adherence to the idea that voting power in a large corporation is a power of real or

¹³² See *Windhurst v. Central Leather Co.*, 101 N.J. Eq. 543, 138 A. 772 (1927), *affd.* 107 N.J. Eq. 538, 153 A. 402 (1931).

¹³³ See *Hubbard v. Jones & Laughlin Steel Corp.*, (W.D. Pa. 1941) 42 F. Supp. 432.

¹³⁴ See *Donohue v. Heuser*, (Ky. App. 1951) 239 S.W. (2d) 238.

¹³⁵ A good example was the attempt of Cuban American Sugar Co. to eliminate accruals through the voluntary exchange of new preferred for old. The arrearages were \$3,984,767, but the earned surplus was \$16,403,778. Current assets were \$12,904,614, of which \$3,697,000 was in cash and marketable securities. Current liabilities were \$1,100,000. *Buckley v. Cuban Am. Sugar Co.*, 129 N.J. Eq. 322, 19 A. (2d) 820 (1940). See also *Kamena v. Janssen Dairy Corp.*, 133 N.J. Eq. 214, 31 A. (2d) 200 (1943), *affd.* 134 N.J. Eq. 359, 35 A. (2d) 894 (1944), in which the officers told stockholders the company was in "A-1 condition" and the books disclosed a surplus, a surplus which management denied because of confessed overvaluation of good will. The compulsory exchange of shares was ruled inequitable.

¹³⁶ See, e.g., *Hottenstein v. York Ice Mach. Corp.*, (3d Cir. 1943) 136 F. (2d) 944; *McQuillen v. National Cash Register Co.*, (D.C. Md. 1939) 27 F. Supp. 639, *affd.* (4th Cir. 1940) 112 F. (2d) 877, *cert. den.* 311 U.S. 695 (1940).

In *Porges v. Vadsco Sales Corp.*, 27 Del. Ch. 127, 32 A. (2d) 148 (1943), the court said, "Complainant ignores the important fact that the old common stockholders have voting control, and that by the merger, control would pass to the holders of the old preferred stock." *Id.* at 134.

even monetary consequence. Other "sweeteners" catching the attention of the courts are increases in dividend rates,¹³⁷ cash payments,¹³⁸ bonds,¹³⁹ debentures,¹⁴⁰ sinking fund provisions, preemptive rights, and conversion privileges.¹⁴¹ All add an "extra" flavor to the new shares received in exchange for the original cumulative preferred and the appendage of accruals.

The label of fairness is easier to come by if the proposal to eliminate the accruals has been openly conceived and honestly and completely presented to the stockholder-voters.¹⁴² In *Barrett v. Denver Tramway Corp.*,¹⁴³ the plaintiffs assailed the method of presenting the plan to the stockholders as part and parcel of their charge of unconscionable adverse interest. The complainants had a point. Company counsel had advised the directors that the charter must be amended before preferred dividends could be paid from current profits. Management repeated this information to the stockholders when asking for an affirmative vote on the amendments. In truth, it was a nice legal question whether the amendments were necessary. Perhaps Delaware law would have permitted dividends from current net profits without the necessity of charter amendments. Fortunately for the proponents of the plan, the trial court found that no fraud, actual or constructive, had been practiced in the preparation and adoption of the plan, and that the legal effects had been fairly presented. The appellate court ended the matter by deciding that the record sustained the findings.¹⁴⁴ The moral of this phase of *Barrett* is that those who would recapitalize must be very meticulous about what is said and the way it is said when soliciting the vote of stockholders. Those who attack on grounds of unfairness very properly and wisely seize each and every misstep as convincing evidence of oppression.

¹³⁷ See *Franzblau v. Capital Sec. Co.*, 2 N.J. Super. 517, 64 A. (2d) 644 (1949).

¹³⁸ See *Francke v. Axton-Fisher Tobacco Co.*, 289 Ky. 687, 160 S.W. (2d) 23 (1942); *Franzblau v. Capital Sec. Co.*, 2 N.J. Super. 517, 64 A. (2d) 644 (1949); *Vulcan Corp. v. Westheimer & Co.*, (Ohio App. 1938) 34 N.E. (2d) 278, app. dismissed 135 Ohio St. 136, 19 N.E. (2d) 901 (1939).

¹³⁹ E.g., *Dratz v. Occidental Hotel Co.*, 325 Mich. 699, 39 N.W. (2d) 341 (1949).

¹⁴⁰ E.g., *Johnson v. Fuller*, (E.D. Pa. 1940) 36 F. Supp. 744, affd. (3d Cir. 1941) 121 F. (2d) 618.

¹⁴¹ E.g., *Porges v. Vadsco Sales Corp.*, 27 Del. Ch. 127, 32 A. (2d) 148 (1943).

¹⁴² See *McQuillen v. National Cash Register Co.*, (D.C. Md. 1939) 27 F. Supp. 639 at 646, affd. (4th Cir. 1940) 112 F. (2d) 877 (no conspiracy to deceive preferred); *Porges v. Vadsco Sales Corp.*, 27 Del. Ch. 127 at 130, 32 A. (2d) 148 (1943) (pertinent facts adequately disclosed); *Dratz v. Occidental Hotel Co.*, 325 Mich. 699 at 719, 39 N.W. (2d) 341 (1949) (plan not secretly conceived nor hastily consummated).

¹⁴³ (3d Cir. 1944) 146 F. (2d) 701.

¹⁴⁴ *Id.* at 706.

In sum, management and counsel seeking a dissident-proof plan for the elimination or reduction of accruals on preferred shares would do well to give the shareholders the choice of retaining their present shares or being "topped" with a prior preferred. The advocates should pound hard on the business necessity for the move and the interest society has in the continuing prosperity of corporate business entities. The plan should be developed in consultation with experienced bankers and business experts. The *quid pro quo* for the old shares with accruals must be reasonable under the circumstances, and something "different" should be added because a higher dividend rate, a conversion privilege, a bit of cash, a debenture, or an increase in voting power will enhance the attractiveness of the plan. Lastly, the plan should be carefully, fully, and frankly explained to the stockholders. If all this is done, the dissident stockholder will have little chance of upsetting the plan on the ground of an unconscionable exertion of adverse interest.

2. *Advantageous Exchange of Shares*

Sometimes share exchanges are brought about by stockholder votes motivated by self-interests adverse to those of the holders whose shares are being exchanged. The technique may involve a charter amendment. More probably the merger process is followed. Normally, there is no question of the statutory and charter power to accomplish the move, and the question is one of fairness.

Some of the strong-arm power plays of prior decades seem flagrantly unfair by today's standards. One wonders how any majority group could hope to sustain a scheme whereby they purchased the bonds of their solvent and promising corporation at an undisclosed discount, then proposed a merger with a wholly-owned subsidiary in which the bonds were to be traded for shares at exchange values fixed by the majority. In a classic understatement, the court suggested that there was a reasonable probability that the controlling stockholders were advancing their own interests at the expense of the minority.¹⁴⁵

Leaving the obvious, the question of invalidating adverse interest becomes more difficult. When the new shares are to be distributed to the holders of both preferred and common, the ratio is important. There is a complex question of valuation. In working

¹⁴⁵ MacArthur v. Port of Havana Docks Co., (D.C. Me. 1917) 247 F. 984.

out an exchange formula, weight must be given the attributes of both the preferred and common, such as the proportionate ownership of net assets, the dividend expectations, the preferences, and the voting powers. In addition to an equitable numerical distribution of shares among shareholders, the res given in exchange for the present shares must be substantially equivalent in kind to the thing surrendered. In other words, there must be fairness in both quantity and quality.

The case of *Outwater v. Public Serv. Corp.*¹⁴⁶ presents a wide range of problems on equivalencies. The plaintiffs held non-redeemable, voting, preferred shares in a subsidiary which was to be merged into the parent. The dividends on the existing preferred were derived from rentals paid by the parent to the subsidiary. The merger provided that, in return for their existing shares, plaintiffs were to receive cumulative, nonvoting preferred, redeemable after three years at the option of the issuer. The merger was legal in form, the plaintiffs did not contest the fairness of the exchange prices, the loss of voting power was held to be of no consequence, and the dividend yield was slightly higher. While the quantity equivalent was satisfied, the quality equivalent was not. The dividends of the existing preferred were prior to all other obligations of either parent or subsidiary, and payment was virtually guaranteed because of the lease rental obligation of the parent. After the merger, a large debt would precede dividend priorities. The most serious inequity was the lack of permanency accorded the new shares. They were redeemable at the option of the parent after three years. Thus the merger was nothing less than a forced sale to the majority at a price fixed by it and payable at its pleasure.¹⁴⁷ The merger was enjoined because it was oppressive. Availability of appraisal did not counteract the unfairness.

Outwater v. Public Serv. Corp. stresses permanency of investment. Undoubtedly, the privilege of keeping funds invested in a going and profitable enterprise is an important element in the determination of fairness. However, the exigencies of business may offset the sanctity of permanency and justify the exchange of

¹⁴⁶ 103 N.J. Eq. 461, 143 A. 729 (1928), *affd.* 104 N.J. Eq. 490, 146 A. 916 (1929).

¹⁴⁷ *Id.* at 466.

noncallable shares for redeemable ones.¹⁴⁸ It may be that the dividend arrearages are so heavy that the noncallable feature is of no value.¹⁴⁹ Or if the corporate charter is about to expire, and the charter is amended to extend life, there can be no complaint if the preferred is made callable. The preferred could have been extinguished by allowing the charter to expire.¹⁵⁰ Absent such overpowering reasons, the deprivation of permanency of investment signifies oppression.

Over-all, the economic need of the corporation is the most potent factor in the determination of fairness in the exchange of shares.¹⁵¹ If the shift is necessary for continued existence, or even growth, if the distribution of the new shares is equitable, if the shares received are substantially equivalent in quantity and quality to the shares given up, then the plan probably will win the badge of fairness. If the exchange is engineered for the convenience or enrichment of the control faction, and there is no urgency, these facts are indicia of unconscionable adverse interest and the chances of a successful challenge are good.

3. *Shift of Assets from One Corporation to Another*

A parent corporation, a group of investors, or even an individual may control two or more corporations. In such factual situations, it may be to the advantage of the controlling element to shift assets from one entity to the other. Innumerable are the ways of doing so,¹⁵² but the principal methods involving stockholder voting are consolidation,¹⁵³ merger,¹⁵⁴ sale or lease of all or part of the assets,¹⁵⁵ dissolution,¹⁵⁶ and contracts for services ratified by the stockholders.¹⁵⁷

¹⁴⁸ The exchange cannot be made by amendment unless there is statutory power to do so. See, e.g., *Breslav v. New York & Queens Elec. Light & Power Co.*, 249 App. Div. 181, 291 N.Y.S. 932 (1936), *affd.* 273 N.Y. 593, 7 N.E. (2d) 708 (1937); *Yukon Mill & Grain Co. v. Vose*, (Okla. 1949) 206 P. (2d) 206.

¹⁴⁹ *Donohue v. Heuser*, (Ky. App. 1951) 239 S.W. (2d) 238 at 243.

¹⁵⁰ *Cowan Salt Lake Hardware Co.*, 118 Utah 300, 221 P. (2d) 625 (1950).

¹⁵¹ E.g., *MacFarlane v. North Am. Cement Corp.*, 16 Del. Ch. 172 at 181, 157 A. 396 (1928) (corporation in such straits that it had nothing to lose by merger).

¹⁵² E.g., in *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939), Standard, majority holder in Deep Rock, caused Deep Rock to enter into unprofitable refining leases, management contracts, and debt arrangements, all to the benefit of Standard.

¹⁵³ E.g., *Jones v. Missouri-Edison Elec. Co.*, (8th Cir. 1906) 144 F. 765.

¹⁵⁴ E.g., *Garrett v. Reid-Cashion Land & Cattle Co.*, 34 Ariz. 245, 270 P. 1044 (1928).

¹⁵⁵ E.g., *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590 (1921) (sale of all assets); *Meeker v. Winthrop Iron Co.*, (W.D. Mich. 1883) 17 F. 48 (lease of all assets); *Klopov v. Northrop*, 131 Conn. 14, 37 A. (2d) 700 (1944) (sale of part of assets).

¹⁵⁶ E.g., *Lebold v. Inland Steel Co.*, (7th Cir. 1941) 125 F. (2d) 369, cert. den. 316 U.S. 675 (1942).

¹⁵⁷ *Hyams v. Calumet & Hecla Mining Co.*, (6th Cir. 1915) 221 F. 529.

Two common characteristics are inherent in these cases. The first is that the control group will have a greater interest in the corporation receiving the alleged benefit than it will have in the corporation transferring its property. Therefore, if the control group does want to sacrifice one corporation, its loss in the transferor corporation will be more than offset by its gain in the transferee corporation. For this reason, the mathematics of the situation gives an aura of righteousness to the complaint of the minority holder that his corporation is being damaged for the preferment of another corporation. The second characteristic is that the burden of proving the fairness of the transaction will rest on the control group. Not only does the dominant group have fiduciary obligations,¹⁵⁸ but those controlling the vote are on both sides of the bargain, the usual presumption of validity accorded majority action¹⁵⁹ is gone, and the burden of proving fairness is on those exercising common control.¹⁶⁰ This gives the complaining stockholder a significant advantage. He sets forth his allegations and the onus of proving fairness falls upon those engineering the transaction.

Despite the burden of showing equitable treatment in a situation that is prima facie wrong, those in control do succeed in sustaining transactions in which one corporation allegedly benefits at the expense of another. Seldom is the result based solely upon the premise that when the legislature places power in the hands of the majority, such power is for the majority to use, oppression to the minority notwithstanding. The classic example of the philosophy of unbridled ruthlessness is the early twentieth century case of *Windmuller v. Standard Distilling & Distributing Co.*¹⁶¹ Standard had guaranteed the preferred dividends of Spirits and when Standard decided to dissolve prosperous Spirits to get rid of the burdensome guaranty, the plaintiffs, holders of preferred in Spirits, sought to keep the majority from voting. The court replied that stockholders may vote as they please for the purpose of their own selfish interests.¹⁶² To the claim of inequity,

¹⁵⁸ *Pepper v. Litton*, 308 U.S. 295 at 308 (1939); *Southern Pac. Co. v. Bogert*, 250 U.S. 483 (1919).

¹⁵⁹ "Where a majority of the stockholders . . . speak for the corporation by taking action under appropriate statutory and charter provisions, a presumption of fairness arises in favor of such action." *Bailey v. Tubize Rayon Corp.*, (D.C. Del. 1944) 56 F. Supp. 418 at 422. See also *Cole v. National Cash Credit Assn.*, 18 Del. Ch. 47, 156 A. 183 (1931).

¹⁶⁰ *Hyams v. Calumet & Hecla Mining Co.*, (6th Cir. 1915) 221 F. 529; *Klopot v. Northrop*, 131 Conn. 14, 37 A. (2d) 700 (1944).

¹⁶¹ (C.C. N.J. 1902) 114 F. 491.

¹⁶² *Id.* at 494.

the court employed the "wolf-trap" theory by saying that when the plaintiffs accepted their shares they knew that the laws of New Jersey permitted two-thirds in interest to put the corporation out of existence and that is what the majority was going to do.¹⁶³

There are no exact modern counterparts of *Windmuller*. But occasionally, when a court holds that the complaining shareholder has the right to appraisal, and no other right, the result and the language of the court may bring memories of *Windmuller*. In a controversy involving the interpretation of California statutes,¹⁶⁴ the plaintiff, owner of shares in Associated Oil, contended that a consolidation of Associated and Tidewater Oil was unfair because the shares he was offered were of less value than the shares to be surrendered. The majority shareholders in Associated had a large interest in Tidewater and would gain by sacrificing their interest in Associated to the advantage of Tidewater. The United States court of appeals stated that the pertinent California statutes say to a stockholder:

"When you buy stock in a California corporation you are advised that your associate shareholders holding two-thirds of the shares may consolidate your corporation with another into a third corporation, offer you what they please of its shares in exchange for those you hold, and, if you do not like the offer, may buy out your shares at their fair market value at the time they vote the consolidation. . . . There is no underlying 'natural right' of a shareholder to follow his investment into a consolidated corporation."¹⁶⁵

The plea of fraud was of no avail. The plaintiff lost because the power to consolidate was absolute, save for the appraisal privilege.¹⁶⁶

Appraisal is not usually the exclusive remedy, and courts do consider the equities when fraud is alleged because the control group is sacrificing one corporation for the benefit of another. In sustaining the questioned action, a key factor in beating the challenge of a dissident is the adequacy in character and amount of the consideration passing from the allegedly favored corporation to the complainant's corporation. In sales and leases the price

¹⁶³ *Id.* at 495.

¹⁶⁴ *Beechwood Sec. Corp. v. Associated Oil Co.*, (9th Cir. 1939) 104 F. (2d) 537.

¹⁶⁵ *Id.* at 540.

¹⁶⁶ The court recognized that under statutes of other states, appraisal would not be exclusive and the shareholder has the right to litigate the question of fraud. *Ibid.*

paid must be fair.¹⁶⁷ If the amount received in a transfer is inadequate,¹⁶⁸ even though it matches or exceeds that received at a judicially ordered public sale, the protestant will win.¹⁶⁹ In mergers involving corporations under common control, the shares received in return for the old must be substantial equivalents.¹⁷⁰ There can be no forced exchange of a top-grade conservative investment for a speculative share.¹⁷¹ Nor can the dissidents' aliquot right to control be lessened by self-dealers. In contracts, the amount the plaintiff's organization is to pay must be consistent with current practices and the entire arrangement beneficial to the paying corporation.¹⁷²

While adequacy of consideration is of the essence in these cases in which the dominant group is both bargainer and bargainee, courts pay heed to other aspects. Complete disclosure by management carries weight;¹⁷³ so does approval by an outside governmental agency.¹⁷⁴ Courts are understandably more solicitous about the welfare of unsophisticated and unsuspecting minorities than they are about the fortunes of experienced investors.¹⁷⁵ The availability of appraisal tends to lessen the plaintiff's chance to upset a sale by the majority to its other corporation.¹⁷⁶

In sum, when assets are shifted from one corporation to another, and a single unified interest controls both entities, the dissident claiming his corporation is being hurt for the benefit of another is in a strong position. This is so because the control

¹⁶⁷ *Homer v. Crown Cork & Seal Co.*, 155 Md. 66, 141 A. 425 (1928) (sale of all assets approved); *Shaw v. Davis*, 78 Md. 308, 28 A. 619 (1894) (lease upheld).

¹⁶⁸ See *Citizens Sav. & Trust Co. v. Illinois Cent. R. Co.*, (7th Cir. 1910) 182 F. 607 (plaintiff seeking to cancel lease, demurrer overruled); *Meeker v. Winthrop Iron Co.*, (W.D. Mich. 1883) 17 F. 48 (lease declared fraudulent); *Tierney v. United Pocahontas Coal Co.*, 85 W. Va. 545, 102 S.E. 249 (1920). In *Tierney* the sale of all assets at a grossly low figure entitled plaintiff to money judgment based on actual value and not sale price.

¹⁶⁹ See *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590 (1921).

¹⁷⁰ E.g., *Colby v. Equitable Trust Co.*, 124 App. Div. 262, 108 N.Y.S. 978, *affd. mem.* 192 N.Y. 535, 84 N.E. 1111 (1908) (merger approved).

¹⁷¹ *Boyd v. New York & H. R. Co.*, (S.D. N.Y. 1915) 220 F. 174 (merger enjoined).

¹⁷² See *Thurmond v. Paragon Colliery Co.*, 82 W. Va. 49, 95 S.E. 816 (1918) (commission contract upheld as fair).

¹⁷³ *Homer v. Crown Cork & Seal Co.*, 155 Md. 66, 141 A. 425 (1928) (sale approved); *Colby v. Equitable Trust Co.*, 124 App. Div. 262, 108 N.Y.S. 978, *affd. mem.* 192 N.Y. 535, 84 N.E. 1111 (1908) (merger approved).

¹⁷⁴ *Colby v. Equitable Trust Co.*, note 170 *supra*.

¹⁷⁵ See *Garrett v. Reid-Cashion Land & Cattle Co.*, 34 Ariz. 245, 270 P. 1044 (1928). Two widows and a minor were the minority owners. Their lack of business knowledge was one of the reasons for granting them relief from the self-dealing of the majority.

¹⁷⁶ See *Homer v. Crown Cork & Seal Co.*, 155 Md. 66 at 86, 141 A. 425 (1928).

group is on both sides and the burden is on them to prove fairness. Further, if the control group has a larger interest in the enterprise dealing with the plaintiff's corporation, which is usually the case, there is an immediate suspicion that the control group is sacrificing its smaller interest (and the plaintiff) for the aggrandizement of the larger. To offset this initial advantage which belongs to the unhappy stockholder, control groups seeking to exchange assets among their corporations must allocate the consideration with consummate care and skill, and they must do everything possible to avoid all indicia of adverse interest.

4. *Ridding the Corporation of Unwanted Stockholders — the "Freeze-Out"*

The motives causing the majority to seek riddance of minority holders are varied. The motives range from pure selfishness, as expressed by a spokesman for a majority who said it "griped them to see that the minority stockholders were enjoying any profit,"¹⁷⁷ to outright business necessity, as when the minority refuses to vote for continuance of existence.¹⁷⁸ In between the extremes there are reasons of varying validity. Motivation may stem from the ubiquitous problems of taxation. If the majority owners are in the upper income tax brackets, they may wish to shed the corporate form because of the double taxation of corporate profits. If the entity is a personal holding company, or is approaching that status, the problem of paying or avoiding the surtax may make it uneconomic to continue the existing arrangement.¹⁷⁹ In addition to the worries of taxation, there are the burdens of management. The fiduciary obligations placed upon those in control may impel toward elimination of the "beneficiaries," i.e., the minority holders. Some businessmen become weary of the responsibility of looking after other people's money. The majority faction may want freedom from the continuous annoyance of a cantankerous and troublesome minority owner. While riddance of the irritable co-owner may not be an absolutely legal reason for a freeze-out, it is a thoroughly understandable one.

¹⁷⁷ *Lebold v. Inland Steel Co.*, (7th Cir. 1941) 125 F. (2d) 369 at 372, cert. den. 316 U.S. 675 (1942). The speaker was Randall, vice-president and director of Inland Steel and Inland Steamship. Steel had voted to dissolve its 80% owned subsidiary. Steamship then purchased the assets and carried on the business. The minority received going-concern value for each share and not the value based on sale price of physical assets.

¹⁷⁸ E.g., *Rossing v. State Bank*, 181 Iowa 1013, 165 N.W. 254 (1917).

¹⁷⁹ See I.R.C., §§541-547 as to tax on undistributed personal holding company income.

Whatever the motive may be, the objective is the same — force out the minority and carry on the business, either in different corporate guise or in an unincorporated form. In the freeze-out there is no intent on the part of the dominant group to quit or to sell out and place its money in a different venture. The intent is to get rid of the minority — to deprive them of their opportunity to stay with the enterprise.

The dissentient has good cause for complaint. The case for the unwanted stockholder has been stated with fervor in a situation in which eastern investors purchased all but a few shares in a Washington state light company. The newcomers then voted to sell the assets to one of their number who in turn transferred the assets to a new corporation to carry on the same business in the same old way. Then dissolution of the original company was attempted. The court would not countenance a maneuver so obviously intended to rid the corporation of an uncongenial minority stockholder.¹⁸⁰ In holding for the minority the court said:

“It is not enough to say that appellant received all his stock was worth. He embarked in this business, and had a right to stay in the business during the expressed life of the corporation. . . . The result of a successful practice such as is attempted here will be that minority stockholders will always be at the mercy of the majority. If the enterprise fails, they bear their proportion of the losses. If, on the other hand, it succeeds, as soon as it passes the experimental stage, and the opportunity is presented to finally reap the reward of a judicious investment, they are coolly ejected from the corporation by a majority of the stockholders, who appropriate to themselves the accruing profits. In other words, they might be termed experimental dupes, who are subjected to the necessity of contributing to the losses, but denied the privilege of sharing the profits.”¹⁸¹

The ways and means of eliminating the unwanted stockholder are simply variants of the same theme — the sale of assets. Either there is a dissolution with a sale¹⁸² or a sale followed by a dissolution¹⁸³ or a merger with the minority receiving redeemable shares

¹⁸⁰ *Theis v. Spokane Falls Gas Light Co.*, 34 Wash. 23 at 30, 74 P. 1004 (1904).

¹⁸¹ *Id.* at 30-31.

¹⁸² E.g., *Weisbecker v. Hosiery Patents, Inc.*, 356 Pa. 244, 51 A. (2d) 811 (1947).

¹⁸³ E.g., *Wall v. Anaconda Copper Mining Co.*, (D.C. Mont. 1914) 216 F. 242.

in lieu of their noncallable securities.¹⁸⁴ In any event, the assets of the original corporation end up in the hands of the majority or its alter ego, which is probably another corporation, and the business goes on as before.

What are the aspects of the situation that help win a lawsuit when the plaintiff alleges a "freeze-out"? What are the indicia of adverse interest? The cases offer clues. Here again the plaintiff has an initial advantage because the majority holders are selling to themselves and the burden of proving fairness is on the majority. Further, there is a natural antipathy toward the strong who have the power to oppress the weak. Judge Lindley expressed the sentiment in *Lebold v. Inland Steel Co.*,¹⁸⁵ when he wrote that legal power vested in the majority does not give a right to appropriate a business to the detriment of the minority, nor does statutory power provide "superior sanctity" nor the "attributes of tyranny."¹⁸⁶

The motive, then, of the controlling stockholders in bringing about the merger, sale, or dissolution has an important bearing on the outcome of the cases.¹⁸⁷ It is probable that almost all business deals are motivated by selfish reasons. Be that as it may, judges are human, and the degree of selfishness may well determine the court's reaction. If a transaction has all the earmarks of unbridled greed, then the majority is going to have a difficult time in sustaining its actions against an oppressed minority. On the other hand, if the transaction reflects business acumen compatible with the customs and morals of the contemporary commercial community, then the court will be prone to go along. Various facets of the controversy illumine the degree of selfishness characterizing the motive.

The financial condition of the company is pertinent. The dissolution or sale of a prosperous business makes it appear that the sole purpose is to deprive the minority of its share of a thriving

¹⁸⁴ E.g., *Matteson v. Ziebarth*, (Wash. 1952) 242 P. (2d) 1025; *Outwater v. Public Service Corp.*, 103 N.J. Eq. 461, 143 A. 729 (1928).

¹⁸⁵ (7th Cir. 1941) 125 F. (2d) 369, cert. den. 316 U.S. 675 (1942).

¹⁸⁶ *Id.* at 373.

¹⁸⁷ See Lattin, "Equitable Limitations on Statutory or Charter Powers Given to Majority Stockholders," 30 MICH. L. REV. 645 at 649 (1932).

enterprise.¹⁸⁸ *Contra*, merging or selling a failing business makes sense and provides a badge of good faith.¹⁸⁹

Along with the financial condition, the internal situation of the corporation is important. If there is discord, especially when the complainant has instigated and nurtured the discord, there is good reason for changing the existing pattern.¹⁹⁰ And if the plaintiff is a blackmailer — if he has offered to trade his opposition for money — that fact works for management.¹⁹¹

The conduct of the majority affords keen insights into the degree of selfishness motivating the control group. An open proclamation that the sole interest of the majority is to force dissolution and go forward with the business without being “griped” at seeing the minority share in the profits does not endear the majority to a court of equity.¹⁹² When such a declaration is coupled with a disdainful and patronizing attitude toward those being frozen out,¹⁹³ courts probably are more inclined to find that management is “faithless” to the company and to the minority.¹⁹⁴ Buying the assets through a straw-man does not win friends.¹⁹⁵ But full disclosure of all relevant facts does influence courts.¹⁹⁶ Out-and-out falsehoods are ruinous, and predictions of diminishing revenues and bad times ahead, calculated to secure votes for sale and dissolution,¹⁹⁷ do not further the cause of those who would sustain the freeze-out.

¹⁸⁸ See *Kavanaugh v. Kavanaugh Knitting Co.*, 226 N.Y. 185, 123 N.E. 148 (1919) (dissolution enjoined). Cf. *Meyerhoff v. Bankers' Sec., Inc.*, 105 N.J. Eq. 76, 147 A. 105 (1929) (unfair to deprive minority of opportunity to stay with prosperous business).

¹⁸⁹ E.g., *Funderburk v. Magnolia Sugar Co-op.*, (La. App. 1942) 8 S. (2d) 374 (transfer of assets upheld).

¹⁹⁰ See *Rossing v. State Bank*, 181 Iowa 1013, 165 N.W. 254 (1917) (dissolution upheld). The plaintiff had blocked an effort to secure a new charter and had organized a rival bank.

¹⁹¹ In *Matteson v. Ziebarth*, (Wash. 1952) 242 P. (2d) 1025, the plaintiff blocked a plan to reorganize a failing business, then requested \$4,000 for his vote on a subsequent plan.

¹⁹² See *Lebold v. Inland Steel Co.*, (7th Cir. 1941) 125 F. (2d) 369 at 372, cert. den. 316 U.S. 675 (1942). In earlier litigation on this matter, Randall, vice-president of Inland Steel, majority owner of Inland Steamship, was quoted as saying “in his opinion, the Steel Company had been ‘suckers’ and had acted foolishly in permitting the minority to continue to participate in the profits.” *Lebold v. Inland S. S. Co.*, (7th Cir. 1936) 82 F. (2d) 351 at 353.

¹⁹³ In *Lebold v. Inland Steel Co.*, note 192 *supra*, management refused to “rehash” the reason for dissolution, and stated that they were not obligated to answer any questions about the parent company. *Id.* at 371-372.

¹⁹⁴ E.g., *Nave-McCord Mercantile Co. v. Ranney*, (8th Cir. 1928) 29 F. (2d) 383.

¹⁹⁵ E.g., *Weisbecker v. Hosiery Patents, Inc.*, 356 Pa. 244, 51 A. (2d) 811 (1947).

¹⁹⁶ See, e.g., *Matteson v. Ziebarth*, (Wash. 1952) 242 P. (2d) 1025.

¹⁹⁷ See *Ervin v. Oregon Ry. & Nav. Co.*, (S.D. N.Y. 1886) 27 F. 625 at 627.

Of equal importance to motive in the freeze-out cases is the amount to be paid the minority. The majority is buying from itself, a situation permitted but not given the unmitigated blessing of the courts. Such sales are subject to close and rigorous scrutiny.¹⁹⁸ Consequently, the value placed upon the minority shares must be above challenge. Obviously the challenge will be successful if the amount is grossly under the fair market price.¹⁹⁹ Likewise, a challenge will be sustained if the majority places one value on the assets for the purpose of buying out the minority, and then places a different and higher value on these same assets when listing them on the accounting statement of the successor corporation.²⁰⁰ The setting of values by management-appointed experts does not necessarily win the battle. Courts may believe that such experts are biased in favor of their employers.²⁰¹ But someone must determine values, and outside engineers and professional appraisers are probably the best available sources. In contests over values, the majority may be well advised to offer to submit the matter to arbitration. Such an offer indicates good faith.²⁰²

If the business is established and profitable, the worth of "going-concern value" and "good will," if either or both are present, must be included in determining the adequate price for minority interests. The importance of including going-concern value when computing the amount due the minority is shown in the two most famous freeze-out cases, *Ervin v. Oregon Ry. & Nav. Co.*²⁰³ and *Lebold v. Inland Steel Co.*²⁰⁴ In these cases, separated by half a century in time, the managements encountered identical difficulties on the question of values. The amounts offered the minorities were based on the prices the physical assets would bring upon a cessation of business. Yet the businesses were to be continued with those same assets and nothing was tendered the minority for going-concern value. In *Ervin*, the court said that

¹⁹⁸ *May v. Midwest Ref. Co.*, (1st Cir. 1941) 121 F. (2d) 431, cert. den. 314 U.S. 668 (1941).

¹⁹⁹ *Hinds v. Fishkill & Matteawan Equitable Gas Co.*, 96 App. Div. 14, 88 N.Y.S. 954 (1904).

²⁰⁰ *Stebbins v. Michigan Wheelbarrow & Truck Co.*, (6th Cir. 1914) 212 F. 19.

²⁰¹ See *Ervin v. Oregon Ry. & Nav. Co.*, (S.D. N.Y. 1886) 27 F. 625 at 633.

²⁰² In *Lebold v. Inland S.S. Co.*, (7th Cir. 1936) 82 F. (2d) 351, the court said that it would be more favorably impressed with protestations of good faith if the officers of the dominant company had shown a willingness to submit to arbitration the value of the shares of the minority. *Id.* at 355.

²⁰³ (S.D. N.Y. 1886) 27 F. 625.

²⁰⁴ (7th Cir. 1941) 125 F. (2d) 369, cert. den. 316 U.S. 675 (1942).

management could not adjust its interest on the basis of carrying on the business and at the same time insist that the interests of the minority be adjusted on the basis of a dissolution and an ending of the operations.²⁰⁵ In *Lebold*, the court held there was value over and above the physical assets, that such was obvious because a very prosperous business was still being conducted by the defendants. Therefore, the minority was entitled to going-concern value.²⁰⁶

Other courts, especially when dealing with mercantile establishments, have stressed that the worth of good will must be counted when the majority deprives the minority of the opportunity of continuing in the business.²⁰⁷ When a wholesale grocery business has had a successful operation for fifty years, with a current list of fifteen hundred loyal and regular customers, and carries on in the same way in the same place with only a slight change of name, good will has real value. The stockholder frozen out of such an enterprise has a just claim for compensation for a portion of that good will.²⁰⁸

The giving of book value, which ordinarily is the aliquot portion of costs, plus additions and appreciations, less depreciation and obsolescence, is not an absolute indication of value. The shares of many corporations sell for less, many for more, than book value. A completely fair price based upon an inclusion of all aspects of value is an absolute must if the majority expects to prevail against the complainants.

Freeze-outs can be worked. The very nature of the move engenders suspicion and the term itself carries unpleasant and sinister connotations. Therefore, those who would rid a prosperous, or even a hopeful corporation of unwanted stockholders would do well to base their actions upon some acceptable business reason, be very frank and honest, and above all, lean over backwards to give the ousted holders an abundantly adequate price for their shares.

C. Summary

Specific areas of stockholder decisions reached through voting have now been examined. The study has centered on common

²⁰⁵ 27 F. 625 at 630.

²⁰⁶ 125 F. (2d) 369 at 374.

²⁰⁷ *Godley v. Crandall & Godley Co.*, 212 N.Y. 121, 105 N.E. 818 (1914).

²⁰⁸ *Nave-McCord Mercantile Co. v. Ranney*, (8th Cir. 1928) 29 F. (2d) 383.

factual situations, i.e., purchase and sale of assets, executive benefits, elimination of accruals, share exchanges, shifting of assets, and freeze-outs. In these basic fact patterns certain allegations of undue adverse interest seem indigenous to the particular action. For example, in the purchase of assets from the corporation, the dominant stockholder is universally accused of buying too low. If he sells to the corporation, the price is too high. In freeze-out situations, the typical complaint is that the majority is motivated by the completely selfish desire to deprive the minority of the opportunity to share in the future growth and prosperity of a very promising enterprise. In fact, in each of the shareholder actions enumerated it is probable that the attack of the dissenters will be based upon a predictable set of allegations.

The effort herein has been to catalog the indicia giving rise to these allegations in each category of shareholder actions, thereby enabling careful planners to avoid or defeat pleas of invalidity based upon charges of adverse interest.

It is submitted that if management is to sustain a shareholder vote, there must be (1) a modicum of business reason stimulating the move, (2) openness of purpose and honesty of presentation, (3) motives compatible with prevailing business ethics and mores, and (4) fair exchange values. If any of these elements are lacking, the proposition is open for a successful challenge based upon the plea of unconscionable adverse interest, and the dissident has potent weapons available for the attack.