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Corporations - Shareholders - Use of Corporate Funds for Proxy Contest Expenses

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CORPORATIONS—SHAREHOLDERS—USE OF CORPORATE FUNDS FOR PROXY CONTEST EXPENSES—Following a proxy contest in which the insurgent faction of stockholders was successful, the new board of directors paid out $28,000 to members of the old board to cover expenses incurred by them, and also used $127,000 to reimburse the prevailing group. The latter expenditure was approved by a sixteen-to-one majority vote of the stockholders. Plaintiff brought a derivative action seeking restoration of both amounts. The trial court dismissed the complaint, and the appellate division affirmed this judgment.[1] On appeal to the New York Court of Appeals, *held,* affirmed, three judges dissenting. Corporate diectors may make reasonable expenditures in connection with proxy contests which involve issues of policy, and stockholders may reimburse successful contestants for similar expenses. Each allegedly improper expenditure must be challenged specifically. *Rosenfeld v. Fairchild Engine and Airplane Corp.,* (N.Y. 1955) 128 N.E. (2d) 291.

Against a background of proxy contests which approached the intensity and expense of political campaigns,[2] the judges of the New York Court of Appeals, in a three-way opinion, added their views to those previously expressed as to the propriety of defraying such expenses with corporate funds. It is settled that management may draw upon the corporate treasury for certain costs incident to obtaining proxies when policy matters[3] are at issue.[4]

[10] See Bicks and Friedman, "Regulation of Federal Election Finance: A Case of Misguided Morality," 28 N.Y. UNIV. L. REV. 975 (1953).

[11] Id. at 995.

Mailing of proxy forms, providing for their return,[5] and publication of newspaper notices of prospective meetings[6] are activities for which reimbursement may be made. By emphasizing the need for securing a quorum, one court has also upheld payment of fees to professional proxy solicitors.[7] The justification of these expenditures is put in terms of facilitating proxy voting and informing shareholders with respect to the corporate affairs to be decided.[8] Earlier New York precedent draws the line at this point, holding that measures intended primarily to persuade or influence shareholders may not be financed by company funds.[9] One member of the majority in the principal case concurred only because he did not believe the propriety of specific items[10] had been properly challenged[11] and apparently agreed with the dissent that only expenditures reasonably related to the informative function should be allowed. Thus, the rule of *Lawyers' Advertising Co. v. Consolidated Railway Lighting and Refrigerating Co.*[12] continues to be the law in New York. Nevertheless, the language of the prevailing opinion suggests a much more lenient standard. Reference is made to the need for management to "freely answer the challenges of outside groups" and to spend in "defense of . . . corporate policies" and for the purpose of "persuading the stockholders . . . and soliciting their support."[13] While recognizing an over-all test of reasonableness, the opinion refers to the problem of stockholder indifference in "these days of giant corporations with vast numbers of stockholders . . . ."[14] Such expressions serve to emphasize the observation, first made in the earliest English precedent for manage-

tion, see Latcham and Emerson, "Proxy Contest Expenditure and Shareholder Democracy," 4 WEST. RES. L. REV. 5 at 9, 10 (1952).

4 Peel v. London and North Western Ry. Co., note 3 supra; Hall v. Trans-Lux Daylight Picture Screen Corp., note 3 supra; Steinberg v. Adams, (D.C. N.Y. 1950) 90 F. Supp. 604. See also Hand v. Missouri-Kansas Pipe Line Co., (D.C. Del. 1944) 54 F. Supp. 649.

5 Peel v. London and North Western Ry. Co., note 3 supra; Bounds v. Stephenson, (Tex. Civ. App. 1916) 187 S.W. 1031).

6 Lawyers' Advertising Co. v. Consolidated Railway Lighting and Refrigerating Co., 187 N.Y. 395, 80 N.E. 199 (1907).

7 In re Zickl, 73 N.Y.S. (2d) 181 (1947). In Steinberg v. Adams, note 4 supra, such expenditures were approved without special discussion.

8 See the cases cited in note 4 supra.

9 Lawyers' Advertising Co. v. Consolidated Railway Lighting and Refrigerating Co., note 6 supra. For approval of this position, see Latcham and Emerson, "Proxy Contest Expenditure and Shareholder Democracy," 4 WEST. RES. L. REV. 5 at 11 (1952).

10 Included among management's expenses were outlays for chartered aircraft and limousines, entertainment, public relations counsel, and professional proxy solicitors. Principal case at 295.

11 None of the judges specifically approved the several expense items. While three favored a broader rule than was argued for by the plaintiff, they made it clear that failure of the plaintiff to challenge the reasonableness of particular items was fatal to his case. The concurring judge limited himself to quoting from Lawyers' Advertising Co. v. Consolidated Railway Lighting and Refrigerating Co., note 6 supra, which adheres to the "information only" rule.

12 Note 6 supra.

13 Principal case at 293.

14 Principal case at 292.

ment's use of corporate funds, that the question of what expenses are reasonably necessary to get the best expression of shareholder opinion is a matter of "opinion and custom."[15] It may well be that the liberal view of the prevailing opinion as to what is "necessary" to obtain meaningful shareholder participation is consonant with the increased use of mass communications media and modern public relations techniques in proxy battles.

It is apparent that those categories of expenditures which are disapproved as not serving a corporate purpose when incurred by management must be disapproved for the same reason when undertaken by the opposition. However, whether reimbursement is to be allowed the insurgents for approved objectives, such as informing the shareholders, depends upon whether the non-management status of the insurgents is fatal to their claim upon the company treasury. Three judges in the principal case emphasized that since the "outs" have no responsibility for operating the company and thus do not share management's duty to acquaint the stockholders as to corporate matters, payment to them is ultra vires, and can not be approved by the stockholders. In the only other precedent for allowing opposition reimbursement, the court saw no basis for drawing a distinction between the two groups.[16] It would seem that the opposition may contribute as much to the shareholders' knowledge of the issues in controversy as does management. The rule should not favor a one-sided presentation. Granting that the insurgents are not under a *duty* to act, subsequent ratification by the corporation may supply *authority* as to those acts which serve a corporate purpose.[17] Possibly the adoption of the opposition slate would suffice to ratify the acts of the insurgents and would justify payment for reasonable expenditures.[18] A formal resolution affirming reimbursement, apparently required by the federal court in *Steinberg v. Adams*,[19] and by the New York court in the principal case, is not without significance, however. In the

[15] Peel v. London and North Western Ry. Co., note 3 supra, at 20.

[16] Steinberg v. Adams, note 4 supra, noted in 61 YALE L.J. 229 (1952), and 36 CORN. L.Q. 558 (1951). Another recent case on this point is Cullom v. Simmonds, 285 App. Div. 1051, 139 N.Y.S. (2d) 401 (1955), holding allegations that expenditures were unreasonable and that no true policy dispute existed stated a cause of action against newly elected directors who reimbursed the expenses of the winning faction.

In the Steinberg case, Judge Rifkind appealed to the analogy of reimbursement to a shareholder who successfully brings a derivative action for the benefit of the corporation. The analogy applies to successful proxy contestants only if the shareholders' choice is taken as conclusive evidence of what is good for the corporation. Perhaps Judge Rifkind correctly thought it should be, in view of the practical impossibility of making an independent finding in this regard. The analogy is criticized by the dissenters in the principal case. See also the discussion in 36 CORN. L.Q. 558 (1951).

[17] 2 FLETCHER, CYC. CORP. §764 (1954). Talbot v. Harrison, 150 Misc. 798, 270 N.Y.S. 171 (1932), affd. 240 App. Div. 957, 268 N.Y.S. 875 (1933), illustrates an analogous situation. Acting outside the scope of his duties, an officer of the company developed a secret rubber reclamation process. It was held that royalty payments agreed to by the board of directors were not ultra vires and could be ratified by a majority of the shareholders.

[18] Stockholder ratification may take place by a vote at a stockholder meeting or by implication through accepting benefits or acquiescing in action taken. Rosehill Cemetery Co. v. Dempster, 223 Ill. 567, 79 N.E. 276 (1906); San Diego v. Pacific Beach Co., 112 Cal. 53, 44 P. 333 (1896); 2 FLETCHER, CYC. CORP. §764, p. 1109 (1954).

[19] Note 4 supra.

usual situation the new directors are personally interested in reimbursement so that specific shareholder approval would affirm what would otherwise constitute a voidable act.[20]

If reimbursement to successful[21] insurgents is to be allowed, that part of the prevailing opinion which approves of expenditures purely in defense of existing policies, as distinguished from informing shareholders or promoting widespread participation, may well be questioned. The prospect for recoupment would spur the opposition to greater effort, and if management were free to meet opposition publicity, move for move, in its own defense, the result would be a public relations arms race financed by the corporate treasury. Expenditures by either side which cannot be reasonably related to facilitating proxy voting or to stimulating informed shareholder participation should continue to be subject to challenge by individual stockholders on the ground that they do not serve a corporate purpose.[22]

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[20] Pollitz v. Wabash R. Co., 207 N.Y. 113, 100 N.E. 721 (1912). Analogously, contracts between a corporation and its directors are voidable unless ratified or acquiesced in by the stockholders. 3 FLETCHER, CYC. CORP. §979 (1947).

[21] For an argument that losing opposition groups should also be financed by the corporation, see Friedman, "Expenses of Corporate Proxy Contests," 51 COL. L. REV. 951 at 958 et seq. (1951).

[22] The newly adopted revisions of Securities and Exchange Act Regulation X-14 [SEC Exchange Act Release Jan. 16, 1956, 21 Fed. Reg. 577 (Jan. 26, 1956)] and the hearings on corporate proxy contests initiated in 1955 by the Senate Securities Subcommittee [see S. Rep. 1306, 84th Cong., 1st sess. (1955)] suggest increasing concern as to these matters. However, neither the SEC revisions nor the bill to which the hearings pertain [S. 879, 84th Cong., 1st sess. (1955)] deal directly with the question of corporate withdrawals for proxy expenditures. For a discussion of previously existing provisions, see Friedman, "SEC Regulation of Corporate Proxies," 63 HARV. L. REV. 796 (1950); Bayne, Caplin, Emerson and Latcham, "Proxy Regulation and the Rule-Making Process: The 1954 Amendments," 40 VA. L. REV. 387 (1954).