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C H A P T E R 6

Corporations

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§6.1. Use of corporate assets for benefit of controlling stockholders. Controlling stockholders in a corporation are frequently tempted to use corporate assets for their personal benefit, particularly in the closely held company. In three decisions during the 1958 SURVEY year such allegedly improper use was challenged, in two instances by minority stockholders and in a third by a trustee in bankruptcy. Although only one of the challenges was successful, all three cases illustrate techniques employed by dominant stockholders in acquiring or perpetuating control over corporate enterprises.

In both *Braunstein v. Devine*¹ and *Widett v. Pilgrim Trust Co.*² individuals owning all or substantially all of the capital stock of the corporations in question sold their shares to buyers who were unable or unwilling to pay the entire purchase price in cash. In *Braunstein* the buyers, as directors of the corporation, caused it to borrow funds which were used in part payment of the buyers' personal obligation to pay for the stock. The method employed in the *Widett* case was similar; the buyers gave their own note for the balance of the purchase price but secured it with a chattel mortgage on the corporation's property. Subsequently corporate funds were used in partial satisfaction of the buyers' note. For reasons set forth below the minority stockholder who attacked the payments in the *Braunstein* case was successful, while the trustee in bankruptcy who sought to recover the payments made in the *Widett* case was denied relief.

*McPhail v. L. S. Starrett Co.*³ arose in the Federal District Court for the District of Massachusetts, but since it involved a domestic corporation and an analysis of Massachusetts corporate law, it is relevant to this discussion. In the case the plaintiff, the largest single stockholder

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§6.1. ¹ 1958 Mass. Adv. Sh. 671, 149 N.E.2d 628. For further comment on this case, see §6.2 *infra*.

² 336 Mass. 738, 148 N.E.2d 167 (1958). For further comment on this case, see §6.3 *infra*.

³ 157 F. Supp. 560 (D. Mass. 1957), *aff'd*, 257 F.2d 388 (1st Cir. 1958). For further comment on this case, see §6.4 *infra*.

of a corporation whose shares were listed on the New York Stock Exchange, attacked the validity of a stock option plan under which employees designated by management were given options to purchase shares upon extremely generous instalment terms. The plaintiff asserted that the plan had been conceived by management principally for the purpose of putting additional votes into friendly hands and thus constituted an unlawful manipulation of voting power for the benefit of management. Although the plaintiff was unsuccessful on the merits, the case shows how a perfectly legitimate device, such as an employees' stock option plan, under some circumstances may be perverted to improper ends.

§6.2. Acquiescence as bar to minority stockholder's suit. Although the use of corporate funds to pay the personal obligations of the majority stockholders in the *Braunstein* case¹ was clearly improper, the conduct of the complaining minority stockholder nearly barred him from maintaining his suit. After the payments in question had been made, the defendants made a full report of what had transpired at two successive annual stockholders' meetings. At both meetings the plaintiff asked several questions and made a number of motions which were voted down. Thereafter at each meeting a vote was passed ratifying ". . . all action taken and all things done by the officers and directors of this corporation for the year just past,"² including the corporate payments subsequently challenged by the plaintiff. The ratification resolutions were unanimously adopted by all the stockholders present, including a minority who had no connection with the payments, but the plaintiff neither voted for nor against the resolutions. The lower court found that the plaintiff's conduct constituted ratification and barred him from maintaining the suit as a matter of law. On appeal this ruling was reversed on the ground that in the particular circumstances the plaintiff's failure to vote did not indicate an assent to the action of the stockholders but rather a realization that a negative vote or vocal objection would have had little or no effect on the other stockholders.³

Although it is generally held that a stockholder in a derivative suit cannot attack directors' actions in which he has acquiesced,⁴ most of the cases so holding involve situations in which the plaintiff either participated in the alleged wrongdoing or assented to a continuing course of conduct.⁵ In *Braunstein* the misuse of corporate funds was a *fait accompli* when reported to the plaintiff. Thus no estoppel could be asserted against him as might have been the case if the defendants' improper actions had continued subsequent to and in reliance upon the alleged acquiescence on the part of the plaintiff.

§6.2. ¹ *Braunstein v. Devine*, 1958 Mass. Adv. Sh. 671, 149 N.E.2d 628.

² 1958 Mass. Adv. Sh. at 674, 149 N.E.2d at 630.

³ 1958 Mass. Adv. Sh. at 675, 149 N.E.2d at 631.

⁴ *Uccello v. Golden Foods, Inc.*, 325 Mass. 319, 90 N.E.2d 530 (1950); *Dunphy v. Traveller Newspaper Assn.*, 146 Mass. 495, 16 N.E. 426 (1888).

⁵ See, e.g., cases cited in note 4 *supra*.

There are surprisingly few reported decisions which serve as a guide to a shareholder with reference to his conduct at a stockholders' meeting.⁶ Most of the cases dealing with acquiescence involve inaction or informal conduct by the stockholder unrelated to a stockholders' meeting, which a court construes as evidence of assent.⁷ Clearly in the *Braunstein* case the plaintiff would have been better advised to have voted specifically against the ratification resolutions. By failing to vote his conduct was sufficiently ambiguous to induce the trial court to rule against him, so that a case which might have been won in the first instance had to be carried to the appellate court in order for the plaintiff to sustain his position.

§6.3. Use of corporate funds to satisfy stockholders' obligations.

The bootstrap operation by which the purchasers of the capital stock of a corporation use the corporation's own funds to pay for the shares bought by them withstood attack in *Widett v. Pilgrim Trust Co.*,¹ although the identity of the parties had a direct bearing on the result. Here the unsuccessful plaintiff was a trustee in bankruptcy rather than a minority stockholder, and the defendant that received the allegedly improper payments was a bank, to whom the note of the purchasers had eventually been transferred. Nevertheless, the basic holding of the case is that the mortgage on the corporation's property securing the buyers' note was a valid corporate obligation,² and the manner in which the Supreme Judicial Court reached this interesting conclusion requires a somewhat detailed recital of the facts.

George owned all of the capital stock of two corporations: Tremont, which operated a restaurant on Tremont Street, Boston; and Atlantic, which operated a restaurant known as The Lobster House in Charlestown. The buyers agreed to purchase all of the shares of Tremont from George for \$80,000, subject to certain adjustments and George's agreement to pay all outstanding obligations of Tremont. The purchase price was to be paid by cash payments of \$25,000 together with the buyers' note for \$55,000, secured by a pledge of the stock and a mortgage upon substantially all the personal property of Tremont.

In a separate document executed contemporaneously with the first agreement, George granted to the buyers the right to use the name "The Lobster House" in the operation of the Tremont Street restaurant; agreed to sell to the buyers lobsters for their restaurant at the same price charged to Atlantic for its lobsters; and agreed to mention "The Lobster House" at Tremont Street in all advertising for "The Lobster House" in Charlestown operated by Atlantic. In consider-

⁶ In *State National Loan & Trust Co. v. Fuller*, 26 Tex. Civ. App. 318, 63 S.W. 552 (1901), a stockholder who remained silent at a stockholders' meeting when certain proposals were discussed was held to be estopped from later protesting the validity of the proposals.

⁷ *Johnson v. King-Richardson Co.*, 36 F.2d 675 (1st Cir. 1930); *West Side Irrigation Co. v. United States*, 246 Fed. 212 (9th Cir. 1917).

§6.3. 1 336 Mass. 738, 148 N.E.2d 167 (1958).

2 336 Mass. at 742, 148 N.E.2d at 170.

ation of the grants contained in this agreement the buyers agreed to pay George a percentage of the gross receipts of the Tremont Street restaurant and to purchase all their lobsters from George.

The buyers' note for \$55,000 and the corporate mortgage securing it were delivered to George together with a certified copy of a vote of the directors of Tremont which recited that the mortgage was given ". . . to secure a promissory note given in consideration of a grant by . . . George to the Corporation of the right to use the name 'The Lobster House' in the conduct of the business of the Corporation."³ George indorsed the buyers' note to Atlantic, which borrowed \$41,000 from the defendant bank and pledged the note and assigned the Tremont mortgage as security for the loan. Payments totaling approximately \$25,000 made by Tremont were credited to the buyers' note and to the \$41,000 loan. About two years later Tremont was adjudicated a bankrupt, and the trustee in bankruptcy brought this action against the bank to recover the \$25,000 in payments received from Tremont.

In finding for the defendant the lower court ruled that "something in the nature of an equitable estoppel"⁴ barred the trustee's claim. The Supreme Judicial Court, however, in overruling the plaintiff's exceptions, held that the mortgage was a valid corporate obligation on two principal grounds: (1) the unanimous consent of the stockholders barred any contention that the mortgage was merely for the accommodation of the stockholders;⁵ and (2) the giving of the mortgage was beneficial to the corporation in that the latter obtained the benefits set forth in George's second agreement such as the right to use the name "The Lobster House," the assurance of a supply of lobsters, and the like.⁶

That the unanimous consent of the stockholders will validate what may otherwise be a questionable corporate transaction is a well-established principle,⁷ and the Court was on firm ground in so ruling. This consent, of course, will not bar contemporaneous creditors from challenging the transaction,⁸ but in the present case the trustee in bankruptcy, appointed more than two years after the payments were made, undoubtedly represented subsequent creditors. In addition, the Court's suggestion that the defendant bank was entitled to rely upon the certificate of the directors' vote, reciting what appeared to be adequate consideration for the mortgage, is supported by an earlier leading Mas-

³ 336 Mass. at 741, 148 N.E.2d at 169.

⁴ 336 Mass. at 739, 148 N.E.2d at 168.

⁵ 336 Mass. at 742, 148 N.E.2d at 170.

⁶ 336 Mass. at 744-745, 148 N.E.2d at 171.

⁷ *Gilbert Manufacturing Co. v. Goldfine*, 317 Mass. 681, 59 N.E.2d 461 (1945); *Medlinsky v. Premium Cut Beef Co.*, 317 Mass. 25, 57 N.E.2d 31 (1944). But see *Boston Box Co. v. Shapiro*, 249 Mass. 373, 380, 144 N.E. 233, 235 (1924).

⁸ "Where the rights of creditors are not impaired, corporate funds may be used to pay the personal indebtedness of its officers or such funds may be transferred to them as gifts, if this is done with the assent of all the officers and stockholders." *Gilbert Manufacturing Co. v. Goldfine*, 317 Mass. 681, 688, 59 N.E.2d 461, 465 (1945).

sachusetts case.⁹ On these grounds, therefore, the ultimate result in the *Widett* case probably cannot be questioned.

The tortuous reasoning, however, which the Court employed in ruling in *Widett* that the mortgage was given for the benefit of the corporation is much more difficult to accept.¹⁰ Stripped of its frills, the mortgage on Tremont's property was executed to secure the note of the individuals given in payment for the capital stock of the company. This was a bold use of corporate funds to satisfy the debts of the stockholders, a practice which the Court might well have condemned instead of striving to find that the corporation benefited from the transaction. From a realistic standpoint the alleged benefits received by the corporation from George under the second agreement appear to be insubstantial and designed to conceal the fact that the corporate mortgage was given primarily to secure the personal obligations of the stockholders. Furthermore, George was to receive separate consideration from the buyers under the second agreement, i.e., a percentage of the gross receipts of Tremont, a factor which tends to negate the finding that the mortgage was given for the purposes of the corporation.¹¹

§6.4. Validity of employees' stock option plan. The so-called restricted stock option plan has become a popular method of granting deferred compensation to corporate employees since the adoption of the Revenue Act of 1942 which accorded these plans favorable income tax treatment.¹ In the typical plan key employees designated by management are given an option to purchase shares of the corporation, normally aggregating a very small fraction of the outstanding stock, at a price usually equal to at least 95 percent of the current market price of the stock.² The option is to be exercised within a period not exceeding ten years³ from the date of the grant. The plan contemplates that the market price of the stock will increase and, of course, that the employees have an incentive to help bring about that result by diligent efforts on behalf of the company. If the price does go up, the em-

⁹ *Commonwealth v. Reading Savings Bank*, 137 Mass. 431 (1884).

¹⁰ See 336 Mass. 738, 742, 743, 148 N.E.2d 167, 171 (1958).

¹¹ 336 Mass. at 745, 148 N.E.2d at 171. Another questionable ground relied upon by the Court to support the mortgage as a valid corporate act was based on the commitment of George in connection with the sale of the stock that all the obligations of Tremont would be paid. Although the mortgage made no reference to this commitment, the Court reasoned that the mortgage was validly given, in part at least, to secure the payment of the corporation's own debts. In so ruling the Court rejected the plaintiff's much sounder contention that the mortgage in this aspect actually secured the debt of another, namely, George's obligation to the buyers that the corporation would be free of debt.

§6.4. ¹ The statutory requirements of a restricted stock option are found in Section 421 of the Internal Revenue Code of 1954, which reenacted the substantially similar provisions of Section 130A of the Internal Revenue Code of 1939.

² The option price may be as low as 85 percent of the fair market value of the stock at the time the option is granted, Int. Rev. Code of 1954, §421(d), but certain additional tax advantages accrue if the option price is 95 percent or greater. *Id.* §421(b).

³ *Id.* §421(d)(1)(D).

ployees exercise their options, and the appreciation in value is not taxed to them until they sell the shares and then only at capital gains rates.⁴

In *McPhail v. L. S. Starrett Co.*,⁵ the plaintiff owned 20,400 shares of the no par common stock of the defendant corporation out of a total of 150,000 shares outstanding, and was the largest single stockholder. The officers and directors collectively owned less than 4000 shares.⁶ The shares were listed on the New York Stock Exchange. McPhail had attempted unsuccessfully to persuade the management that he should be elected to the board of directors. In 1955 the directors, subject to the approval of the stockholders, adopted a stock option plan to supplement or supersede an earlier plan. The new plan had the following features: (1) 20,000 shares were to be available to employees with six months' service (a maximum of 500 shares could be allocated to any individual); (2) the employees and the number of shares covered by their options were to be determined by a committee of directors ineligible to participate in the plan; (3) the options had to be exercised within thirty days; (4) an employee exercising the option could pay for the stock in instalments (including the application of dividends received on the stock) over a period of up to ten years without paying any interest on unpaid balances; (5) upon paying the first instalment the employee became the owner of the shares and was entitled to full voting rights and dividend rights, although his stock was pledged to secure the balance of the purchase price. Furthermore, the right to pay for the stock in instalments ceased upon termination of employment.

The plan was approved at a stockholders' meeting by a more than two-to-one majority. McPhail thereupon sought to enjoin the operation of the plan, asserting that it was illegal in several respects, principally that it was unconscionable to permit the use of dividends to pay for the stock and that the carrying out of the plan constituted an unlawful manipulation of voting power by management to perpetuate its control.⁷ The District Court found for the defendant, and its judgment was affirmed on appeal to the Court of Appeals.⁸

McPhail's first objection was an attack upon the payment of full dividends on stock being purchased on an instalment plan. In theory at least, the distribution of a full dividend to a participant in the stock option plan who had paid in only 10 percent of the purchase price was unfair to other stockholders who had paid 100 percent cash for their shares. The District Court rejected this argument by referring to "the well-settled proposition that dividends on outstanding stock must be paid equally on all stock of the same class,"⁹ although it cited no cases

⁴ Id. §§421(a), (b).

⁵ 157 F. Supp. 560 (D. Mass. 1957), *aff'd*, 257 F.2d 388 (1st Cir. 1958). The author's firm represented the plaintiff in this action.

⁶ 257 F.2d at 390.

⁷ 157 F. Supp. 560, 562 (D. Mass. 1957).

⁸ 257 F.2d 388 (1st Cir. 1958).

⁹ 157 F. Supp. 560, 562 (D. Mass. 1957).

for this rule. The Court of Appeals, in affirming on this point, referred to a series of Massachusetts statutes that permit stock to be paid for by instalments,¹⁰ allow payroll deductions for the purchase of stock pursuant to employee stock purchase plans,¹¹ and provide that in the absence of special provisions in the agreement of association every share of stock without par value is equal to every other share.¹² It seems doubtful that this group of unrelated statutes should compel a decision that full dividends had to be paid on the shares issued under the circumstances of this case. Yet the Court of Appeals held that to rule otherwise would be tantamount to a judicial amendment of the statutes in question.¹³ The court conceded, however, that circumstances might arise in which equitable relief to minority stockholders would be warranted despite literal compliance with statutory provisions.¹⁴

Perhaps the most interesting issue in the *McPhail* case involved the claim that the plan constituted an unlawful manipulation of voting power for the benefit of management and to the detriment of McPhail as the largest minority stockholder. The fiduciary obligations of directors in connection with the issuance of shares is well-established,¹⁵ although the Court of Appeals suggested that the approval of the plan by the stockholders might have made that rule inapplicable in the present case.¹⁶ The court relied in part upon the finding of the lower court that the avowed purpose of the plan was to increase employee incentive,¹⁷ but the fact that the option arrangement covered 20,000 shares, an amount almost identical with, and hence sufficient to neutralize McPhail's holdings, led the Court of Appeals to consider the question of the directors' motives in promulgating the plan.¹⁸

Here the court turned to the findings of a special master in an unsuccessful state court suit brought in 1953 by McPhail to obtain access to the company's list of stockholders. The master had found that McPhail was a manipulator who wished to be elected a director so as to reduce dividends, and thereby depress the value of the stock in order that he might buy additional shares more cheaply. How a single director could have accomplished this against the opposition of the other members of the board is not clear, but in any event the court seems to be treading on dangerous ground here in relying upon the master's findings. In so doing the court tacitly approved the use of a stock option plan, ostensibly designed for employee incentive purposes, but

¹⁰ G.L., c. 156, §15.

¹¹ *Id.*, c. 154, §8.

¹² *Id.*, c. 156, §14.

¹³ 257 F.2d 388, 392 (1st Cir. 1958).

¹⁴ 257 F.2d at 392.

¹⁵ *Andersen v. Anderson Mfg. Co.*, 325 Mass. 343, 90 N.E.2d 541 (1950); *Ballantine, Corporations* §209 (rev. ed. 1946).

¹⁶ 257 F.2d 388, 394 (1st Cir. 1958).

¹⁷ "While the avowed purpose of the Plan was to increase employee incentive, the result unquestionably is to neutralize, at least partially, McPhail's holdings. I am not prepared, however, to find that the Plan was designed solely, or even principally, to achieve this result." 157 F. Supp. 560, 563 (D. Mass. 1957).

¹⁸ 257 F.2d 388, 395 (1st Cir. 1958).

very probably, as the court assumes, intended to neutralize the position of a minority stockholder objectionable to management. An earlier decision of this same court,¹⁹ moreover, indicates that in similar types of suits the motives of the plaintiff-stockholder, no matter how selfish, are irrelevant.²⁰ Since the plan also contemplated the purchase by the company of shares on the open market in order to provide stock for the options,²¹ management was in effect using corporate funds to finance an arrangement the court assumed was designed to thwart McPhail and, incidentally, to insure a continuation of management's control.²²

§6.5. Distribution of assets of dissolved corporation: Directors' liability for liquidating dividends. The life of a Massachusetts corporation normally continues for a period of three years after its charter expires or its corporate existence is otherwise terminated.¹ This statutory extension is primarily a period of grace to permit the corporation to wind up its affairs gradually. Since the statute, although in somewhat awkward language, expressly permits the corporation ". . . to dispose of and convey its property and to divide its capital stock

¹⁹ In *Johnson v. King-Richardson Co.*, 36 F.2d 675 (1st Cir. 1930), the court, in a derivative stockholders' suit charging the directors with permitting the majority stockholder to obtain personal profits at the expense of the corporation, held that even if the purpose of the plaintiff in bringing the suit was to drive the corporation out of business, that fact would not bar the action. Although the *Johnson* decision, unlike the *McPhail* case, was a derivative suit brought for the benefit of the corporation, the acts complained of by *McPhail* wronged the corporation as well as him and might have been the subject of a minority stockholder's suit.

²⁰ The corporation in the *Johnson* case was organized in New Jersey, although its principal place of business was in Massachusetts. Although the opinion in that case relied primarily upon New Jersey decisions, since it was decided prior to *Erie Railroad Co. v. Tompkins*, 304 U.S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188 (1938), the court was not compelled to follow New Jersey law. In any event Massachusetts and the bulk of authorities in other jurisdictions are in accord with the *Johnson* ruling. *Spiegel v. Beacon Participations, Inc.*, 297 Mass. 398, 408, 8 N.E.2d 895, 903 (1937); *Fletcher*, *Cyclopedia of the Law of Private Corporations* §5877 (rev. ed. 1943).

²¹ 257 F.2d 388, 395 (1st Cir. 1958).

²² *McPhail* also attacked the plan on the ground that it contemplated the granting of valuable options without consideration, and he cited a group of Delaware cases in which stock options granted to employees without any commitment on the part of the optionees to remain in the employ of the corporations had been held invalid for lack of consideration. *Frankel v. Donovan*, 120 A.2d 311, 34 A.L.R.2d 852 (Del. Ch. 1956); *Kerbs v. California Eastern Airways*, 33 Del. Ch. 69, 90 A.2d 652 (1952), *reargument denied*, 33 Del. Ch. 174, 91 A.2d 62 (1952); *Rosenthal v. Burry Biscuit Corp.*, 30 Del. Ch. 299, 60 A.2d 106 (1948). The court distinguished the Delaware cases and pointed out that the *Starrett* options had to be exercised within 30 days by the execution of a purchase agreement. Thus, even if the option lacked consideration, once the purchase agreement was signed by which the employee committed himself to buy the stock, this defect was remedied. As to the contention that the liberal instalment provisions made the options things of value to the company which might have been sold for a price, the court held that the company could expect to receive increased loyalty and effort from the participating employees, who would also remain with the company in order to take advantage of the interest-free instalment privilege of the plan. This privilege terminated upon the cessation of employment. 257 F.2d 388, 393-394 (1st Cir. 1948).

§6.5. 1 G.L., c. 155, §51.

. . . ,”² presumably the directors have the right to make partial, and eventually final, distributions of assets among the stockholders. These distributions have been held to be dividends within the meaning of Section 37 of G.L., c. 156,³ so that directors authorizing these payments have been subject to potential liability under that statute if the corporation was insolvent or bankrupt at the time, or was rendered so by the distribution. The directors’ liability is limited to the amount of the dividend but includes responsibility for all debts or contracts, whether or not they existed at the time of the distribution.⁴

To what extent this liability has in fact been enforced against directors of a corporation engaged in distributing its assets in liquidation is not clear, but the risk of such liability apparently persuaded the General Court to act. The new statute, Chapter 204 of the Acts of 1958,⁵ provides a reasonable remedy. During the three-year grace period the corporation may file a petition in the Supreme Judicial Court or Superior Court for leave to distribute the whole or part of its assets to stockholders. After notice by registered mail to the Commissioner of Corporations and all known creditors, and by publication, the Court may, after hearing, and a finding that the rights of creditors, including the Commonwealth, are reasonably protected, enter a decree permitting the proposed distribution. Directors authorizing dividends or other distributions in accordance with the decree are absolved from the personal liability imposed by G.L., c. 156, §37.

² *Ibid.*

³ *Moseley v. Briggs Realty Co.*, 320 Mass. 278, 69 N.E.2d 7 (1946); *Calkins v. Wire Hardware Co.*, 267 Mass. 52, 165 N.E. 889 (1929).

⁴ *Calkins v. Wire Hardware Co.*, 267 Mass. 52, 165 N.E. 889 (1929).

⁵ This act added new Section 51A to G.L., c. 155.