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Corporations—Protection of Incumbent Management by the Corporate Purchase of Its Own Stock—Business Judgment Rule.—Bennett v. Propp

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these agreements are, henceforth per se illegal.[40] The *Snap-On Tools Corp.* decision will, in such an eventuality, be meaningless as precedent and, in effect, overruled.

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Corporations—Protection of Incumbent Management by the Corporate Purchase of Its Own Stock—Business Judgment Rule.—*Bennett v. Propp.*[1]—Plaintiff-appellee brought a minority shareholders' derivative suit for an accounting, by the chairman and the board of directors of Noma Lites, Inc., and also for any damages proximately resulting from the allegedly improper expenditure of corporate funds in the purchase of the company's own capital stock. The chairman, without authority, had negotiated purchases of nearly two hundred thousand shares of Noma common stock in response to a letter, marked "personal and confidential," from Royal Little, the executive head of Textron, Inc. Therein was requested a list of Noma shareholders; it was further indicated that Little desired to obtain a controlling interest in Noma. Textron had previously been unsuccessful in its bid to garner a control interest in American Screw Company, a corporation in which Noma held 51 per cent of the outstanding stock, and it appeared that Little might now attempt to succeed by gaining control of Noma itself. Learning of the stock purchases only one business day before payment was due, Noma's board ratified the purchases although the financial instability of the corporation forced them to effect a loan, at one per cent interest per month, to meet the two million dollar purchase price. The Vice-Chancellor found the purchases to have been essentially motivated by the chairman's desire to further personal interests and preserve favored position; he refused to apply the business judgment rule to the board's resolution in view of the "precipitate and impulsive manner" in which they reached their decision.[2] On appeal to the Supreme Court of Delaware, it was HELD: the board was confronted with a *fait accompli*, which, if left unratified, might well result in serious financial embarrassment to the corporation. The urgency of the situation and the nature of the emergency justified the apparent haste with which the board meeting was conducted as well as the failure to consider possible alternate avenues of action. The court affirmed the finding of personal liability as to the chairman.[3]

The instant case is significant for the insight it may offer into the steps

[40] Justice Clark characterized the decision thusly:

> Today the Court does a futile act in remanding this case for trial. In my view appellant cannot plead nor prove an issue upon which a successful defense . . . can be predicated. Certainly the decision has no precedential value in substantive anti-trust law.

Supra note 1, at 282-83.

[1] — Del. —, 187 A.2d 405 (1962).

[2] Propp v. Sadacca, — Del. —, 175 A.2d 33 (Del. Ch. 1961).

[3] The court renumerated the accepted Delaware position that the board's resolution could not legalize the unlawful purchases of the chairman so as to exonerate him from liability. It only served to "take up the stock to save the corporation from financial difficulty." Supra note 1, at 411.

management may properly take to protect themselves from the so-called corporate "raider," although more specifically, the narrow holding concerns the validity of spending corporate funds for the purchase of its own outstanding stock. It is an oft commented-upon fact that serious abuses may result from the improper exercise of such a power,[4] the most relevant and obvious being that an incumbent management may utilize this authority to insulate itself, as it were, from potentially insurgent shareholders.[5] Each jurisdiction, manifesting a cognizance of these dangers, imposes its own equitable limitations on the exercise of this power,[6] implicitly recognizing, however, that the fact that a power may be abused is not in itself a compelling argument for the complete prohibition of its exercise.[7]

It is fundamental that directors of a corporation are in a fiduciary relationship to said corporation, and, as such, are bound to act with reasonable care and intelligence in the conduct of its affairs, although they are not responsible for mere errors of judgment.[8] It is noteworthy that in the case at bar there was no finding of fraud by the directors; the court made no definite finding as to the allegation of misconduct, although "statements made by the court . . . compel the conclusion that the charge of misconduct was implicitly rejected."[9] Thus, it is significant that in partly reversing the lower court, the board was absolved from liability *only* because of the potentially destructive effect on the corporation's credit and general financial position if they had refused to ratify.

To be sure, the corporate purchase of its own shares "is not ordinarily an essential corporate function," although, in Delaware, it is not per se invalid.[10] Little light is shed on this perplexing area by attacking a particular exercise of this power merely because it achieves a perpetuation of a group's positions and salaries.[11] Indeed, this is a necessary concomitant of any decision to purchase which is successful in its actual operation. A similar fact situation was presented in the case of *Kors v. Carey*,[12] where the stock purchases were sustained because the evidence "clearly showed" that the insurgents, if successful, would attempt to force a business policy upon the

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4 Ballantine, Law of Corporations § 257 (rev. ed. 1940); 1 Hornstein, Corporate Law & Practice § 491 (1959); 62 Colum. L. Rev. 1096 (1962); Comment, 70 Yale L.J. 308 (1960).

5 See Comment, 70 Yale L.J. 308 (1960).

6 Del. Code Ann. tit. 8, § 160 (1953) provides that a corporation organized under the relevant chapter of the Delaware laws "may purchase, hold, sell and transfer shares of its own capital stock; but no such corporation shall use its funds or property for the purchase of its own shares of capital stock when such use would cause any impairment of the capital of the corporation." See generally Model Bus. Corp. Act Ann. § 5, ¶ 2.02 (1960).

7 Noteworthy in this context is the British position that no company may purchase its own shares for any purpose. Trever v. Whitworth, 12 App. Cas. 409 (1887).

8 Albert E. Touchet, Inc. v. Touchet, 264 Mass. 499, 163 N.E. 184 (1928); Henn, Handbook of the Law of Corporations § 233 (1961).

9 3 B.C. Ind. & Com. L. Rev. 531, 532 (1962); Propp v. Sadacca, supra note 2, at 38.

10 Martin v. American Potash & Chem. Corp., 33 Del. Ch. 234, 92 A.2d 295 (1952); Brophy v. Cities Serv. Co., 31 Del. Ch. 258, 70 A.2d 5 (1949).

11 See 62 Colum. L. Rev. 1096, 1100 (1962).

12 — Del. —, 158 A.2d 136 (Del. Ch. 1960).

corporation which defendants, on "manifestly reasonable" grounds, determined would be detrimental to the best interests of their corporation. While there was no explicit finding in *Kors* that the corporation would have been damaged if the insurgents gained control, the court stated that plaintiff's proof failed to establish fraud or misconduct such as would compel a finding of breach of fiduciary duty.[13]

The lower court in the present case found that Textron posed no *immediate* threat to Noma; special emphasis was given to the fact that Little had not, as yet, obtained any stock in the corporation. It is unfortunate that this proved determinative for the court in distinguishing this case from the principles enunciated in *Kors*. There was at no time an evaluation of the character of Royal Little or the interests and intentions he represented. While the lower court was reversed on its distinguishing *Kors* because of the "extensive consideration" the board gave to the decision to purchase,[14] its dismissal of Little's letter as not constituting an immediate threat to Noma was accepted.

It is arguable that the board was faced with a situation which reasonably appeared to preface a serious attempt at stock purchase by Textron. The Chancellor's characterization of the letter as no more than a "thinly-veiled attempt to induce Sadacca and his fellow stockholder-directors to sell out to Little,"[15] is open to question. More important, however, are the disturbing implications suggested by this decision. The acknowledged advantages accruing to management when engaged in a proxy contest,[16] and the potential abuses of the power to purchase corporation stock with corporate funds by a group determined to preserve its position are surely relevant considerations in analyzing the inadequacies of modern corporate structure and practices. A purely objective decision by a board which is in danger of being ousted from power is not always to be expected.[17] Nevertheless, an equally "realistic" approach would suggest that while the purest of motives behind a challenge to management is that a change would result in a sounder and more profitable organization, it remains that control has added value that follows regardless of the virtue of the individual shareholder. The emoluments of office will similarly accrue to the insurgent shareholder or corporate raider if he is successful.

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13 Id. at 141 .

14 Supra note 1, at 409.

15 Ibid. The letter read essentially as follows:

> At the Textron directors' meeting Wednesday, November 26, I am going to ask the Board to consider making an offer to purchase 472,143 shares (more than 50%) of the stock of Noma. . . . Any such offer would be made on a basis where the first shares deposited would be taken up, not on a pro rata basis.
>
> I would like to have you let me know whether you would be willing to supply . . . a stockholders' list for the purpose of making such an offer.
>
> We believe that through such an offer we can gain control of both Noma Lites, Inc. and American Screw Company with a smaller total investment than we had planned to pay for American Screw Company alone.
>
> Since this matter is of a confidential nature, we naturally will not publicize it until after we have received your reply.

16 Aranow & Einhorn, Proxy Contests for Corporate Control (1957); Berle, "Control" in Corporate Law, 58 Colum. L. Rev. 1212 (1958).

17 62 Colum. L. Rev. 1100 (1962).

The difficulties inherent in applying a test of motive—personal gain rather than policy considerations—is well documented in the context of the expenditure of corporate funds in proxy contests.[18] It would seem that directors should be able "in the exercise of an honest business judgment" to adopt "a valid method of eliminating what appears to them a clear threat to the future of their business."[19] This does not give the directors an "uncontrollable" weapon against shareholder challenge, yet it achieves what are here suggested to be desirable ends. The corporation will not be forced to engage in costly and most often wasteful proxy fights in the name of furthering corporate democracy; it would not, under the facts of the case at bar, have to wait until the raider obtained a foothold in the company and improved his bargaining position for the ultimate "sell-out"; it could eliminate a dissentient faction for valid business purposes. At the same time, the court would not have foreclosed the possibility of an independent inquiry into the actions of the incumbent management if plaintiff could show fraud, bad faith or misconduct.

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Labor Law—Collective Bargaining Agreements—Procedural Arbitration.—*Livingston v. John Wiley & Sons, Inc.*[1]—District 65, Retail, Wholesale, and Department Store Union, AFL-CIO, on the basis of a collective bargaining agreement with Interscience Publishing, Inc., brought an action to compel arbitration on disputes arising over seniority rights, pension plans, job security and severance and vacation pay, against John Wiley & Sons, a successor corporation of a consolidation between Interscience and Wiley. It was undisputed that no notice of any grievance was filed within the four-week period required by the collective bargaining agreement, nor were any of the procedures established in the agreement followed.[2] The district court, assuming that the consolidation did not terminate the agreement, denied the motion to arbitrate on the grounds that the agreement should be so construed as "to exclude from arbitration matters involving the entire collective bargaining unit, as distinguished from the individuals comprising it;" and that even if not so limited, the Union failed to avail itself of the grievance procedure described in the agreement and thus abandoned any rights it might have had to arbitrate the dispute. The Court of Appeals

18 See Steinberg v. Adams, 90 F. Supp. 604, 608 (S.D.N.Y. 1950) (applying Delaware law); Hand v. Missouri-Kansas Pipe Line Co., 54 F. Supp. 649, 651 (D. Del. 1944).

19 McPhail v. L. S. Starrett Co., 257 F.2d 388 (1st Cir. 1958); Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 142 Atl. 654 (1928); In re International Radiator Co., 10 Del. Ch. 358, 92 Atl. 255 (1914).

1 313 F.2d 52 (2d Cir. 1963), cert. granted, 373 U.S. 908 (1963).

2 The collective bargaining agreement set forth "procedures, which shall be resorted to as the sole means of obtaining adjustment of the difference, grievance, or dispute" between Interscience and the Union. In another clause, the agreement stated that "notice of any grievance must be filed with the Employer and with the Union Shop Steward within four (4) weeks after its occurrence or latest existence. The failure by either party to file the grievance within this time limitation shall be construed and be deemed to be an abandonment of the grievance." Id. at 64.