Cornell Law Review

Volume 54
Issue 1 *November 1968*

Article 4

Section 14 (f) a New Approach to Transfers of Corporate Control

David L. Ratner

Follow this and additional works at: http://scholarship.law.cornell.edu/clr

Part of the Law Commons

Recommended Citation

David L. Ratner, *Section 14 (f) a New Approach to Transfers of Corporate Control*, 54 Cornell L. Rev. 65 (1968)
Available at: http://scholarship.law.cornell.edu/clr/vol54/iss1/4

This Article is brought to you for free and open access by the Journals at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Review by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.

SECTION 14(f): A NEW APPROACH TO TRANSFERS OF CORPORATE CONTROL

David L. Ratner†

For some years now, courts and commentators have been wrestling, inconclusively, with problems arising out of transfers of "controlling" blocks of shares of publicly held corporations. In the typical situation, the holder of such a block—sometimes a majority but often the largest single minority interest in the corporation—sells his shares privately at a price higher than the current market price and, as part of the arrangement, agrees to procure the resignation of all or a majority of the existing directors and their replacement by designees of the buyer.

There are two questions. First, can the seller keep the premium over market price which he receives for his shares, or should he pay all or part of it over to the corporation or the other shareholders? Second, is it appropriate to replace all or a majority of the directors without a vote of the shareholders?

Some of these transfers of control have been attacked in the courts.[1] Judge Friendly noted that they often result in serious injury

---

† Professor of Law, Cornell Law School. A.B. 1952, LL.B. 1955, Harvard University. Executive Assistant to the Chairman, Securities and Exchange Commission, 1966-68.

1 The most picked-over case on the premium issue is Perlman v. Feldman, 219 F.2d 173 (2d Cir.), *cert. denied,* 349 U.S. 952 (1955). For early pickings, see Berle, *"Control" in Corporate Law,* 58 COLUM. L. REV. 1212 (1958); Hill, *The Sale of Controlling Shares,* 70 HARV. L. REV. 986 (1957); Jennings, *Trading in Corporate Control,* 44 CALIF. L. REV. 1 (1956). Later ruminations include Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares,* 78 HARV. L. REV. 505 (1965); Berle, *The Price of Power: Sale of Corporate Control,* 50 CORNELL L.Q. 628 (1965); Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews,* 32 U. CHI. L. REV. 420 (1965).

The substitution-of-directors issue was most thoroughly worked over by the Second Circuit in Essex Universal Corp. v. Yates, 305 F.2d 572 (2d Cir. 1962). The ramifications were further explored in New York cases involving the activities of Victor Muscat and his associates with respect to Lionel Corporation and Republic Corporation. Matter of Lionel Corp., 151 N.Y.L.J. No. 24, at 14, col. 3 (Sup. Ct., Feb. 4, 1964), *aff'd sub nom.* Caplan v. Lionel Corp., 20 App. Div. 2d 301, 246 N.Y.S.2d 913 (1st Dep't), *aff'd mem.,* 14 N.Y.2d 679, 198 N.E.2d 908, 249 N.Y.S.2d 877 (1964); Gabriel Indus., Inc. v. Defiance Indus., Inc., 151 N.Y.L.J. No. 119, at 13, col. 8 (Sup. Ct., June 17, 1964), *aff'd mem.,* 23 App. Div. 2d 630, 257 N.Y.S.2d 565 (1st Dep't 1964); Matter of Carter, 151 N.Y.L.J. No. 103, at 17, col. 1 (Sup. Ct., May 26, 1964), *aff'd sub nom.* Carter v. Muscat, 21 App. Div. 2d 543, 251 N.Y.S.2d 378 (1st Dep't 1964). These cases are fully described and imaginatively analyzed in Bayne, *The Sale-of-Control Quandary,* 51 CORNELL L.Q. 49 (1965).

to public shareholders.[2] Legal attacks, however, have generally been unsuccessful, and the courts and commentators have been unable to develop adequate standards to deal with either problem.[3]

The proxy rules[4] adopted by the Securities and Exchange Commission under section 14 of the Securities Exchange Act of 1934[5] have, over the past thirty-four years, been instrumental in producing a high level of disclosure about matters submitted to shareholders for their consideration. The impact of these rules was greatly broadened by the Securities Acts Amendments of 1964,[6] which not only extended the rules to certain unlisted as well as listed companies but also made them applicable to all shareholder meetings, including those for which the corporation did not solicit proxies.

Under the proxy rules, shareholders must be furnished with information about nominees for election as directors prior to the election meeting, whether or not proxies are solicited[7] and whether or not the nominees have previously been elected by the shareholders.[8] Special rules prescribe the information to be furnished when there is a contest for seats on the board.[9] However, when a "controlling" block of shares is sold, and the agreement provides that the seller will procure the resignations of all or a majority of the existing directors and their replacement by designees of the buyer, not only do the other shareholders have no chance to vote on the new directors, but up to now there has been no requirement that they be told about the transfer of control until it has actually taken place, and no information about the new directors had to be supplied to them until the next annual meeting. This is so despite the fact that many of these transactions involve complex financial arrangements between the buyer and seller or with third parties which are precisely the types of arrangements about which shareholders should be fully informed.

The reason that the proxy rules have been inapplicable in these situations is the provision found in most state laws which permits the directors to fill vacancies on the board in the period between annual meetings. The provision has generally been interpreted as permitting the entire board to resign seriatim at the direction of the

---

2 Essex Universal Corp. v. Yates, 305 F.2d 572, 581 (2d Cir. 1962) (concurring opinion).

3 *See* articles cited in note 1 *supra*.

4 17 C.F.R. §§ 240.14a-1 et seq. (1968).

5 15 U.S.C. § 78n (1964).

6 78 Stat. 565 (1964).

7 17 C.F.R. § 240.14c-2 (1968).

8 17 C.F.R. § 240.14a-101 Item 6 (1968).

9 17 C.F.R. § 240.14a-11 (1968).

old "controlling" shareholder and to select designees of the new "controlling" shareholder to fill their places. This line of interpretation is probably an unwarranted extension of the original intent of these provisions, but there is no reasonable prospect at the present time that it will be reversed or that state laws will be amended to rectify the situation. Illinois is the only state that clearly requires a shareholder vote in these circumstances;[10] the Delaware law, which was previously unclear, was amended in 1961 so that it now clearly permits the directors to select their replacements.[11] The American Bar Foundation's Model Business Corporation Act, patterned largely on the Illinois Act, departs from its model in this respect by providing that "[a]ny vacancy occurring in the board of directors may be filled by the affirmative vote of a majority of the remaining directors though less than a quorum . . . ."[12] The explanation is that this "enables a corporation to have a full board without the expense and delay incident to holding a special meeting of shareholders."[13]

The federal proxy rules serve as an adjunct to state corporation laws by assuring that shareholders have adequate information when asked to give their proxies to vote on actions for which state law requires their consent. The impact of the rules, however, goes considerably further. The Securities Acts Amendments of 1964 made the proxy rules applicable to all meetings of shareholders, even when no proxies were solicited,[14] and the Supreme Court held in 1964 that shareholders had a right under federal law to enjoin a transaction approved by the

10 ILL. REV. STAT. ch. 32, § 157.36 (1965). An earlier provision requiring directors to fill vacancies in the board of directors was held to violate ILL. CONST. art. XI, § 3. People v. Cohn, 339 Ill. 121, 171 N.E. 159 (1930). For a summary of state provisions, see ABA MODEL BUS. CORP. ACT ANN. § 36, ¶2.01-2.03 (1960).

11 Delaware law permits directors to fill vacancies on the board, except that if the remaining directors constitute less than a majority of the whole board, the Court of Chancery, upon application of the holders of 10% of the shares, can order a meeting of shareholders to elect new directors to replace those selected by the board. DEL. CODE ANN. tit. 8, § 223 (Supp. 1968). Before 1961, it was unclear whether the provision for an election by shareholders could be evaded by having the directors resign seriatim instead of as a group. In 1961, the statute was amended to add a provision that when one or more directors resign from the board, effective at a future date, a majority of the directors then in office, *including those who have so resigned*, have power to fill the vacancies. 53 Del. Laws ch. 168, § 3 (1961), DEL. CODE ANN. tit. 8, § 223 (Supp. 1968) (emphasis added). This amendment in effect nullified any possibility that a shareholder vote could be required when a majority of the directors resigns in connection with a transfer of a controlling block of shares.

12 ABA MODEL BUS. CORP. ACT ANN. § 36 (1960).

13 *Id.* at ¶ 4.

14 15 U.S.C. § 78n(c) (1964).

vote of proxies solicited in violation of the proxy rules.[15] It does not seem appropriate, therefore, that the operation of these rules, which serve an important informative and prophylactic function even when considered apart from the proxy solicitations to which they were originally tied, should be limited by anomalous provisions of state law.

In March and April of 1967, the Subcommittee on Securities of the Senate Committee on Banking and Currency held three days of hearings on a bill introduced by Senator Williams of New Jersey to regulate take-over bids (either through public tender offers or private or open market purchases) and corporate repurchases of their own securities.[16] This bill was generally noteworthy as one of the first systematic attempts to deal with public offers to purchase—as distinguished from public offers to sell—securities. But, as originally proposed, it was not directed at transfers of large blocks of shares by the person or group currently controlling the corporation.[17]

In its statement to the subcommittee in support of the bill, the Securities and Exchange Commission suggested a number of changes. One of these was the addition of a new subsection (f) to section 14 of the 1934 Act, providing that if, in connection with any transfer of more than ten per cent of the outstanding shares of a corporation, there is any arrangement or understanding by which a majority of the directors are to be changed without a vote of shareholders, the corporation must file with the SEC and send to its shareholders, before any of the new directors are installed, information substantially equivalent to that which would have to be filed and sent if those persons were nominees for election as directors at a meeting of shareholders.[18]

---

15 J. I. Case Co. v. Borak, 377 U.S. 426 (1964).

16 *Hearings on S. 510 Before the Subcommittee on Securities of the Senate Committee on Banking and Currency*, 90th Cong., 1st Sess. (1967) [hereinafter cited as *Hearings*].

17 It did contain a provision requiring any person, or group of persons, who acquires more than 10% of the shares of a publicly-held company to send to the issuer and to the SEC, within seven days after the acquisition, a statement setting forth certain information about the person making the acquisition, the source of his funds, any plans he may have for major changes in the company's business or corporate structure, the number of shares he owns, and any contracts, arrangements or understandings with any other person regarding the securities of the company. *Hearings*, *supra* note 16, at 4-5. This provision was retained in the bill as finally enacted, except that the deadline for filing the statement was extended to ten days after the acquisition. S. REP. No. 550, 90th Cong., 1st Sess. 12-13 (1967). It does not, however, require prior notification to anyone of the transfer of a controlling block of shares, or a change in the board of directors, and does not require any information to be sent to *shareholders* even after the event.

18 *Hearings*, *supra* note 16, at 25-26, 37, 39-40.

In a subsequent proceeding before the Commission involving failure to file required reports covering transactions with persons who took over a majority of the seats on the board after purchase of a controlling stock interest, the Commission stated:

The proposal drew no comment from the other witnesses who testified on the bill, other than a "no objection" from the New York Stock Exchange.[19] It was incorporated without change in the bill reported out by the Banking and Currency Committee on August 29, 1967,[20] and signed into law by the President on July 29, 1968.[21]

This new section 14(f) does have some built-in limitations. It extends only to corporations already subject to the proxy rules, thus excluding in general corporations having fewer than 500 shareholders or less than one million dollars in assets. And it does not reach the situations where a transfer of effective control is achieved by a change of less than a majority of the board[22] or by a sale of less than ten per cent of the outstanding shares.[23] Within these limitations, however, it will elicit effective and timely disclosure of the important facts about the transaction.

A disclosure requirement is obviously not the equivalent of a requirement that the new directors be elected by a vote of the shareholders. Nevertheless in many situations the disclosure may be more

> Where, as here, a majority of directors resigns within 11 days of a transfer of controlling blocks of stock, it is most important to the public stockholders that they obtain at the least prompt information with respect to the charges that have taken place. Indeed, to be fully effective, detailed information as to such changes should be given to stockholders before they are actually consummated, so that stockholders will be aware that a material alteration in the managerial structure of their company is about to take place and they will be alerted to the possible impact of the changes on their investment interests and be in a better position to take steps to protect those interests. Such disclosure would among other things make more difficult the concealment of transactions for the benefit of a controlling person of the type that occurred in the present case.

Matter of Crescent Corporation, SEC. EX. ACT. OF 1934 REL. No. 8200, at 12 (Dec. 4, 1967).

19 *Hearings*, *supra* note 16, at 93.

20 S. REP. No. 550, 90th Cong., 1st Sess. (1967).

21 82 Stat. 454 (*United States Code Cong. & Adm. News* at 2767, Aug. 25, 1968).

22 At the annual meeting of Old Town Corp. in July 1967, a group headed by Roy M. Cohn, which had bought from the family of the former head of the company 19% of the shares and options to buy and proxies to vote an additional 26%, elected 6 representatives to the 14-member board. Wall St. J., Dec. 1, 1967, at 13, col. 3.

23 Section 14(f) is limited by its terms to changes in the board pursuant to transactions which are subject to § 13(d) or 14(d) of the Act. These sections, which are the basic provisions of 82 Stat. 454 (*United States Code Cong. & Adm. News* at 2767, Aug. 25, 1968), generally apply only to transactions involving more than 10% of a class of shares. However, where less than 10% of the shares are transferred, the courts may set aside the substitution of directors on the ground that "the management of a corporation . . . cannot be bought apart from actual stock control." Caplan v. Lionel Corp., 20 App. Div. 2d 301, 303, 246 N.Y.S.2d 913, 915 (1st Dep't), *aff'd mem.*, 14 N.Y.2d 679, 198 N.E.2d 908, 249 N.Y.S.2d 877 (1964) (setting aside replacement of directors in connection with a sale of 3% of the outstanding shares). *But cf.* Matter of Carter, 151 N.Y.L.J. No. 103, at 17, col. 1 (Sup. Ct., May 26, 1964), *aff'd sub nom.* Carter v. Muscat, 21 App. Div. 2d 543, 251 N.Y.S.2d 378 (1st Dep't 1964) (permitting replacement of directors following sale of 9.7% of oustanding shares).

significant than the voting right. For example, if the controlling shareholder has a majority of the voting shares, the vote is a mere formality; only the disclosure is significant. And even if he does not have a majority, but the remaining shareholders are widely scattered and have no effective voting power, the principal significance of state law voting requirements at present may still be their effect in triggering the operation of federal disclosure requirements under the proxy rules.

Nor does a disclosure requirement operate as a direct control on the price a controlling shareholder may charge for his shares or the persons to whom he can sell them. But if the terms of the disclosed transaction are offensive enough, any shareholder has the right to seek an injunction or other appropriate relief. It is important, however, that the information be sent to shareholders before the new directors are installed, so that shareholders will have greater leverage in attempting to prevent an unfair transaction.[24] A court will be more sympathetic to a shareholder seeking to enjoin a proposed transfer of control than one seeking to set aside a consummated transfer.

Finally, no disclosure provision can provide an answer to the basic substantive question: Under what conditions and on what terms may the shareholder or shareholders who control a publicly held corporation turn over that control to another? That question, however, cannot be dealt with until we decide whether there is anything wrong if someone who owns a majority—or thirty per cent or perhaps even fifteen per cent—of the voting stock of a publicly owned corporation exercises complete control over that corporation's policies through his power to select the board of directors. The implications of that inquiry deserve more extended treatment.

---

[24] The temporary rules and regulations adopted by the SEC require that the information called for by section 14(f) be filed with the Commission and sent to shareholders not less than 10 days before the new directors take office. SEC. EX. ACT OF 1934 REL. No. 8370, at 4 (July 30, 1968).