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TRANSFERS OF CORPORATE CONTROL AND DUTIES OF CONTROLLING SHAREHOLDERS—COMMON LAW, TENDER OFFERS, INVESTMENT COMPANIES—AND A PROPOSAL FOR REFORM

THOMAS L. HAZEN†

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I. INTRODUCTION

A purchaser who acquires a controlling interest in a corporation often pays a premium above the prevailing market price for the stock. Legal scholars, the judiciary, and, more recently,

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Congress have examined the extent to which such premiums are unfair to the remaining shareholders and to the corporation. The initial question was whether to place some limitations on the receipt of a premium pursuant to a transfer of corporate control. The issue then became what those limitations should be. Neither the courts nor Congress has formulated a set of unifying principles that will provide the attorney and other corporate planners with the desired predictability of result. On the other hand, the development of different treatment for diverse situations may pay heed to equities that a unilateral approach would ignore.

While the courts are still struggling with the scope of the controlling shareholders' duties, they are also creating new methods of dealing with the control premium issue. One such refinement appears to be special treatment for close corporations. Another is the possibility of looking to the duties of the control purchaser as well as those of the seller. On the legislative front, recent developments under the federal securities laws have paved the way for federal scrutiny of control premiums.

This Article will examine the development of, and justifications for, obligations imposed on the sellers and purchasers of corporate control. It will begin with an analysis of state corporate law approaches to the problem and will proceed to describe the impact of several federal securities law provisions. Finally, it will propose a framework for solving control premium problems that tailors its protections to the size of the corporation involved.

II. CONTROL PREMIUMS AND THE DUTIES OF CONTROLLING SHAREHOLDERS UNDER STATE LAW

A. *Theories of Control Premiums—An Overview*

Much scholarly energy has been devoted to the sale of corporate control and the appropriate treatment of the resulting premium, with the common goal of providing the courts with unifying principles to aid in their analysis of control transfers.¹

¹ See, e.g., A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 207-52 (rev. ed. 1968); Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965); Bayne, *Corporate Control as a Strict Trustee*, 53 GEO. L.J. 543 (1965); Bayne, *The Sale-of-Control Premium: The Definition*, 53 MINN. L. REV. 485 (1969); Berle, *The Price of Power: Sale of Corporate Control*, 50 CORNELL L.Q. 628 (1965); Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259 (1966); Hill, *The Sale of Controlling Shares*, 70 HARV L. REV. 986 (1957); Jarvas,

The various theories that would prohibit the receipt of control premiums can be divided into three basic approaches. None of these theories has achieved more than partial and sporadic judicial acceptance. Nevertheless, they have provided the courts with insight and a basic framework for analyzing control transfer issues. Accordingly, a brief description of the leading theories is a prerequisite to understanding current state of the law.

In 1932, Professor Berle developed what is now called the "corporate asset" theory of control.² The basis of Berle's theory is that the premium above the per share market price that the seller realizes in return for a controlling block of stock is a corporate asset because it "arises out of the ability which the holder has to dominate property which in equity belongs to others."³ The corollary of this theory is that the entire premium "if it goes anywhere, must go into the corporate treasury."⁴ A major objection to Professor Berle's approach is that the price paid for a controlling block will necessarily be higher than the previously prevailing per share price because the control purchaser creates an increased demand that, combined with a constant supply, results in an upward pressure on the price. Another reason for rejecting Professor Berle's per se prohibition of control premiums is that the ability to exercise control as a vehicle for making the enterprise more valuable is a cognizable property right attaching to a controlling interest rather than representing a corporate asset. The courts have been persuaded by these and similar objections to a per se attack.⁵

The judicial springboard for further academic discussion of the control premium was the Second Circuit's landmark decision in *Perlman v. Feldmann*,⁶ which recognized the invalidity of at least a portion of the premium paid for control. In the wake of scholarly analysis of the *Perlman* decision, Professor Bayne developed a theory that, like Berle's, would label the entire premium

Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews, 32 U. CHI. L. REV. 430 (1965); Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956); Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725 (1956); O'Neal, *Sale of a Controlling Corporate Interest: Bases of Possible Seller Liability*, 38 U. PITT. L. REV. 9 (1976). See generally F. O'NEAL, *OPPRESSION OF MINORITY SHAREHOLDERS* § 4.05 (1975).

² A. BERLE & G. MEANS, *supra* note 1, at 207-52.

³ *Id.* 217; see Berle, *supra* note 1, at 629.

⁴ A. BERLE & G. MEANS, *supra* note 1, at 216-17.

⁵ See, e.g., *McDaniel v. Painter*, 418 F.2d 545, 547 (10th Cir. 1969); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622, 649 (Sup. Ct. 1941).

⁶ 219 F.2d 173 (2d Cir.), *cert denied*, 349 U.S. 952 (1955). *Perlman* is discussed more fully at text accompanying notes 60-62 *infra*.

invalid.⁷ Professor Bayne, while acknowledging the corporate asset approach, analyzes the issue in terms of the trusteeship of the control owner and a rigid code of corporate morality. He suggests the existence of a duty owed by the "controleur" of a corporation to the corporation and its shareholders. This duty can be described as resulting from a trustee⁸ or fiduciary⁹ relationship. A significant part of the controleur's duty is to choose a successor to control. Professor Bayne views the control premium as "an inducement paid to the controleur to breach his fiduciary duty in the specific area of the selection of his successor."¹⁰ The premium is treated as a bribe, presumably given to encourage the controleur to overlook some shortcoming of his successor. Acceptance of the control premium, when viewed in this light, is a breach of duty; therefore, the premium must be disgorged.

The third principal approach is more in the nature of a suggested remedy than a theory for invalidating premiums.¹¹ Professor Andrews proposes a tender offer to all shareholders on an equal basis whenever a purchase of a controlling interest is attempted.¹² The obvious advantage of such a treatment is that it avoids the necessity of determining the fair value of the shares in order to compute that portion of the premium paid for control.¹³ Compliance with Professor Andrews' proposal as a preventive measure will preclude an action against the seller of control, as least insofar as the premium is concerned, although it might not insulate the buyer¹⁴ or the seller¹⁵ from liability for subsequent harm.

Notwithstanding the varying scholarly approaches to invalidating a control premium, the courts agree that, absent special circumstances, a shareholder is not precluded from receiving a premium above the market price for selling a controlling block

⁷ See, e.g., Bayne, *Corporate Control as a Strict Trustee*, 53 GEO L.J. 543 (1965); Bayne, *A Philosophy of Corporate Control*, 112 U. PA L. REV. 22 (1963); Bayne, *The Sale-of-Control Premium: The Definition*, 53 MINN. L. REV. 485 (1969); Bayne, *The Sale-of-Control Quandary*, 51 CORNELL L.Q. 49 (1965).

⁸ Bayne, *Corporate Control as a Strict Trustee*, 53 GEO. L.J. 543, 549-50 (1965).

⁹ Bayne, *The Sale-of-Control Premium: The Definition*, 53 MINN. L. REV. 485, 496-97 (1969).

¹⁰ *Id.* 490.

¹¹ See Berle, *supra* note 1, at 639.

¹² Andrews, *supra* note 1, at 515.

¹³ The difficulty of computing the premium based on the enterprise value is evident from the decision on remand in *Perlman v. Feldmann*, 154 F. Supp. 436 (D. Conn. 1957).

¹⁴ See text accompanying notes 170-71 *infra*.

¹⁵ See text accompanying notes 41-53 *infra*.

of stock.¹⁶ At least a portion of the premium will be invalidated, however, when there is a sale of a corporate asset,¹⁷ a sale of corporate office,¹⁸ a taking of a corporate opportunity,¹⁹ or other breach of an independent fiduciary duty. Accordingly, control premium problems are, in one sense, part of the larger question of the extent of the fiduciary duties flowing from the controlling shareholders to the minority interests.²⁰

B. *Duties of Controlling Shareholders Outside
the Sale of Control Context*

Whether or not a controlling shareholder, absent independent wrongdoing or other special circumstances, owes a fiduciary duty to the minority shareholders may really be little more than a question of semantics. Without wrongdoing by the selling shareholder or other circumstances alerting the shareholder that special action is necessary, the fiduciary duty, if found to exist, would unlikely be breached. The existence of such a duty, however, may be significant because of the standard by which a fiduciary's actions with regard to the corporation are judged. The fiduciary has the burden of showing the "inherent fairness" of its transactions with the corporation "from the viewpoint of the corporation and those interested therein."²¹

The supposed basis of the duties attaching to the controlling shareholder *qua* shareholder is the Third Circuit's thirty-year-old decision in *Zahn v. Transamerica Corp.*²² The essence of the complaint was that the defendant Transamerica, as the controlling shareholder of Axton-Fisher Tobacco Company, breached its fiduciary duty to minority shareholders in executing its plan to

¹⁶ E.g., *Gerdas v. Reynolds*, 28 N.Y.S.2d 649 (Sup. Ct. 1941).

¹⁷ E.g., *Perlman v. Feldmann*, 219 F.2d 173, 176 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

¹⁸ E.g., *Caplan v. Lionel Corp.*, 20 App. Div. 2d 301, 246 N.Y.S.2d 913, *aff'd mem.*, 14 N.Y.2d 679, 198 N.E.2d 908, 249 N.Y.S.2d 877 (1964).

¹⁹ E.g., *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

²⁰ A control-related problem beyond the scope of this Article may arise in the context of a corporation's repurchases of its own shares, either as a defensive tactic against a shift in control or as part of a plan of going private. *Cf.* *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964) (corporation's repurchase of its own shares from a suspected looter upheld in the face of the minority's claim that the existing management was wasting assets to maintain its control position). *See also*, *Chicago Stadium Corp. v. Scallen*, 530 F.2d 204 (8th Cir. 1976) (corporation enjoined from issuing voting stock to its president at a deflated price as a preventive measure against a shift in control).

²¹ *Pepper v. Litton*, 308 U.S. 295, 306 (1939).

²² 162 F.2d 36 (3d Cir. 1947).

liquidate Axton-Fisher.²³ The defendants, with full knowledge of the increased value of Axton-Fisher's inventory of tobacco, proceeded towards a two-step liquidation that took advantage of the Class A shareholders' ignorance of the increased asset value. After causing the Axton-Fisher board to redeem the Class A shares at a price much lower than their liquidation value,²⁴ Transamerica proceeded to liquidate Axton-Fisher.

The Third Circuit reversed the trial court's dismissal of the complaint relying upon the "unmistakable" "fiduciary duty of those in control of the corporation."²⁵ The court found its principal support in two Supreme Court cases: *Southern Pacific Co. v. Bogert*²⁶ and *Pepper v. Litton*.²⁷ Although ample dicta in these decisions support this approach,²⁸ *Bogert* and *Pepper* involved independent wrongs that went far beyond the mere breach of a fiduciary duty of fairness flowing from the majority.

The *Bogert* controversy was nothing more than a conventional "cheap stock" problem. In the course of a corporate reorganization, Southern Pacific, the defendant and controlling shareholder, paid twenty-six dollars per share, while the plaintiffs were faced with a "prohibitive assessment" of more than seventy-one dollars per share.²⁹ The defendant claimed that the price disparity represented proper compensation for its efforts and for the risks it had taken in connection with its underwriting activities.³⁰ The Court ruled in the plaintiffs' favor, finding that even under the defendant's theory, the price disparity constituted excessive compensation under the circumstances.

²³ Transamerica owned virtually all of Axton-Fisher class B common stock that had full voting rights. The plaintiffs' class A shares, in addition to having cumulative dividend and conditional voting rights, were callable at \$60 per share plus accrued dividends and were convertible into class B shares on a one-for-one basis. The class A shares also contained a liquidation preference and were entitled to receive twice as much as class B out of the common fund. *Id.* at 38-39.

²⁴ For an analysis of the extent of the plaintiffs' injury and the proper measure of damages, see *Speed v. Transamerica Corp.*, 135 F. Supp. 176, 186-94 (D. Del. 1955), *modified on other grounds*, 235 F.2d 369 (3d Cir. 1956).

²⁵ 162 F.2d at 42.

²⁶ 250 U.S. 483 (1919).

²⁷ 308 U.S. 295 (1939).

²⁸ For example, in *Southern Pacific*, the Court stated: "The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors." 250 U.S. at 487-88. In *Pepper*, the Court stated: "A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust." 308 U.S. at 306 (citations omitted).

²⁹ 250 U.S. at 491.

³⁰ *Id.*

The *Pepper* case simply involved self-dealing in the form of excessive salary compensation paid to the controlling shareholder, as is evident from Justice Douglas' framing of the issue in his opinion for the Court: "The case presents the question of the power of the bankruptcy court to disallow either as a secured or as a general or unsecured claim a judgment obtained by the dominant and controlling stockholder of the bankrupt corporation on alleged salary claims."³¹ Both the *Bogert* and *Pepper* claims would have been valid even if the defendant had not been a controlling shareholder.³²

The factual setting of the Transamerica litigation is replete with such independent theories of recovery. The duty of the controlling shareholder could be viewed as arising from the possession of inside information that, in itself, has been classified by other courts as a corporate asset held in constructive trust for the benefit of the entire corporation.³³ This was the basis of a non-disclosure claim under Rule 10b-5 and under common law fraud and deceit in the companion case of *Speed v. Transamerica Corp.*³⁴ Relief could also have been sought on a contract theory predicated upon the terms of the Class A share agreement as set forth in the articles of incorporation.³⁵ The argument would be that in order to read the conversion and redemption clauses together with any degree of consistency, it is necessary to imply a clause or condition requiring that Class A shareholders be given an adequate opportunity to avoid redemption by the exercise of their conversion rights. Any other interpretation would arguably render the conversion rights hollow.

The *Zahn* decision can also be explained as depending upon the "puppet-puppeteer relationship exist[ing] between the directors of Axton-Fisher and Transamerica."³⁶ This marionette rela-

³¹ 308 U.S. at 296.

³² *But cf.* 250 U.S. at 487-88 (Justice Brandeis indicates in dictum that such independent conduct is not a prerequisite to the existence of a duty on the part of the majority shareholder).

³³ *Diamond v. Oreamuno*, 24 N.Y.2d 494, 498, 248 N.E.2d 910, 912, 301 N.Y.S.2d 78, 81 (1969); *see Schein v. Chasen*, 478 F.2d 817, 822-24 (2d Cir. 1973) (fiduciary duty of insider extended to outsider "tippees"), *vacated and remanded on other grounds sub nom. Lehman Bros. v. Schein*, 416 U.S. 386 (1974).

³⁴ 99 F. Supp. 808, 812 (D. Del. 1951).

³⁵ Insofar as the articles set forth the rights of the shareholders with respect to each other and to the corporation, the relationship between the shareholder and the corporate entity can be viewed as contractual. *See, e.g.,* H. BALLANTINE, CORPORATIONS § 198, at 465-66 (rev. ed. 1946).

³⁶ 162 F.2d at 46.

tionship might be a basis for imposing liability on Transamerica as a joint tortfeasor.³⁷ If it were established that Axton-Fisher's directors committed a tortious breach of their fiduciary duty by allowing the challenged transactions, Transamerica might be held jointly liable because it controlled the actions of Axton-Fisher's directors.

A narrow reading of the *Bogert*, *Pepper*, and *Zahn* cases—and thus a closely circumscribed notion of the duty owed by a majority shareholder—finds ample support in recent case law. The Michigan Supreme Court, for example, recently stated, “the fiduciary capacity which devolves upon a majority stockholder comes about *only* when such stockholder is in *actual* control and management of the corporation.”³⁸ The court's language highlights the key element of mismanagement and the traditional theories associated with it rather than relying upon ownership of the control stock alone as the basis of liability.

Although a fair amount of contrary dictum exists, the case law best supports the position that, without certain special circumstances, there is no general fiduciary duty owed by those holding a controlling interest in a corporation.³⁹ Because controlling shareholders—unlike directors and officers, who are the traditional corporate fiduciaries—have not assumed the responsibility of conducting corporate affairs, they should not have to assume the special burden of justifying their corporate dealings that fiduciary duty imposes.⁴⁰

C. Duties of the Seller of Control

Numerous cases have held a seller of control, in certain instances, liable for the harm to the corporation caused by the purchaser. Clearly, however, the liability is far from absolute.⁴¹

³⁷ See generally W. PROSSER, HANDBOOK OF THE LAW OF TORTS, §§ 69, 72 (4th ed. 1971). For a discussion of the joint and several liability of control persons under the federal securities laws, see text accompanying notes 101-06 *infra*.

³⁸ *Fenestra, Inc. v. Gulf Am. Land Corp.*, 377 Mich. 565, 600, 141 N.W.2d 36, 52 (1966) (emphasis supplied) (citing *Veaser v. Robinson Hotel Co.*, 275 Mich. 133, 266 N.W. 54 (1936)); see *Levy v. American Beverage Corp.*, 265 App. Div. 208, 38 N.Y.S.2d 517 (1942); *Blaustein v. Pan Am. Petroleum & Transp. Co.*, 263 App. Div. 97, 31 N.Y.S.2d 934 (1941). See generally 13 N. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 5828-5829 (rev. ed. 1970). “Actual control” may exist in the absence of majority ownership. Although the state law requires “actual control,” the federal securities laws speak in terms of the power to exercise such control. See note 102 *infra*.

³⁹ But see *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969), discussed at notes 74-80 *infra* & accompanying text.

⁴⁰ See text accompanying note 21 *supra*.

⁴¹ See, e.g., *Swinney v. Keebler Co.*, 480 F.2d 573, 577 (4th Cir. 1973); *Seagrave*

In *Insuranshares Corp. v. Northern Fiscal Corp.*,⁴² the court was faced with such a claim.⁴³ After a transfer of a controlling interest, the subsequent purchasers proceeded to loot the corporation. In holding the control seller liable, the district court reasoned that, at a minimum, the duty owed by the transferor of a controlling block of shares is triggered when "the circumstances surrounding the proposed transfer are such as to awaken suspicion and put a *prudent* man on his guard—unless a *reasonably adequate* investigation discloses such facts as would convince a *reasonable person* that no fraud is intended or likely to result."⁴⁴

This language, though stated as a minimum standard, indicates that the transferor of control is not bound to take any action unless suspicious circumstances exist. The Third Circuit, however, has relied, in dictum, on *Insuranshares* in placing a broad duty of inquiry on the seller of control,⁴⁵ thereby clearly exceeding the scope of both *Insuranshares*' holding and language. The Fourth Circuit, in *Swinney v. Keebler Co.*,⁴⁶ has followed the *Insuranshares* approach more faithfully. The court compared the

Corp. v. Mount, 212 F.2d 389, 395 (6th Cir. 1954); *DeBaun v. First W. Bank & Trust Co.*, 46 Cal. App. 3d 686, 696, 120 Cal. Rptr. 354, 359-60 (1975); *Allied Chem. & Dye Corp. v. Steel & Tube Co. of Am.*, 14 Del. Ch. 1, 12, 120 A. 486, 491 (1923); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622, 649-53 (Sup. Ct. 1941).

⁴² 35 F. Supp. 22 (E.D. Pa. 1940).

⁴³ There is little dispute about the main facts. On December 21, 1937, the management group transferred the control of the corporation to the Boston group, none of whom had ever had any interest of any kind in it. With the control, as that term is here used, went plenary power under the by-laws to sell, exchange or transfer all of the securities in the corporation's portfolio, as well as access to and physical possession of them. In this case, acquisition of control was the indispensable [*sic*] first step of a scheme, planned by Robb, Morris and Solomont with the connivance of Paine, Webber & Co., brokers, the purpose of which was to strip the corporation of its valuable assets, leaving its mere shell to the remaining stockholders. The project was carried out with thoroughness and dispatch, but its subsequent steps and its disastrous results to the corporation are not in dispute and need not be detailed here.

Id. at 24.

⁴⁴ *Id.* at 25 (emphasis supplied). Rather than emphasizing the existence of a special relationship between the parties, the tenor of the decision lies in its use of the negligence rubric by pointing to constructive notice as creating the defendant's duty to act in a certain manner and with a certain degree of care.

⁴⁵ *Estate of Hooper v. Virgin Islands*, 427 F.2d 45 (3d Cir. 1970):

Whoever sells the majority block of stock of a corporation has the duty to it and the shareholders to fully identify the purchaser in order to discover his background and the use to which the control stock is to be put in its management. *Insuranshares Corp. of Delaware v. Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa. 1940); *The Sale of Controlling Shares*, 70 Harv. L. Rev. 986 (1947).

Id. at 47.

⁴⁶ 480 F.2d 573 (4th Cir. 1973).

seven suspicious factors it found attendant to the sale in *Swinney*⁴⁷ with the six such factors it identified in *Insuranshares*⁴⁸ and concluded that the circumstances in *Swinney* were not so suspicious as to require the defendants to make further inquiry or to withdraw from the sale.

A California court, in *Debaun v. First Western Bank & Trust Co.*,⁴⁹ utilized an approach similar to that of the Fourth Circuit to hold the seller of a controlling interest liable for the looting activities of the purchaser. The court found that the seller had notice of the likelihood of looting by the purchaser because the seller had in its possession a Dun & Bradstreet report to the effect that "[the purchaser's] financial record was notable by the failure of entities controlled by him."⁵⁰ The sale constituted a breach of a duty to the minority shareholders only because of the seller's actual possession of this knowledge.

Thus, the weight of authority supports the existence of a principle of the free transferability of a controlling block of shares, with the *Insuranshares* restriction presenting a rather nar-

⁴⁷ These factors were: (1) no one from Atlantic had any experience in the candy business, (2) at the time the contract was executed no one from Atlantic had inspected the "Meadors operation," (3) by the time of the closing, only Atlantic's accountant had examined Meadors to "any appreciable extent and he was interested principally in the books and inventory," (4) Meadors had no market of its own and the "profit as shown could not have been accepted at face value by an outsider," (5) prior to the closing Atlantic had no negotiations with Meadors' key employees concerning the continuation of the business, (6) the sale was consummated with dispatch, and (7) Atlantic had inquired as to the availability of Meadors' funds for payment of the purchase price. Although the district court concluded that the first five factors were "not necessarily inconsistent with a legitimate sale of a business the size of Meadors," it held that when coupled with facts six and seven, they "were more than sufficient to arouse the suspicion of Keebler." 329 F. Supp. at 220.

Id. at 578.

⁴⁸ (1) [T]he defendants' probable knowledge that the purchase was to be financed by a pledge of the corporation's assets, (2) the corporation's president's clear predisposition to allow a sale to be financed by pledging those assets as security, (3) defendants' awareness of the purchasers' plan to have a large part of the corporation's assets converted into cash prior to the sale, (4) the inflated price or premium paid for control, especially given the nature of the business which was an investment trust with no physical assets but only the ready equivalent of cash in the form of marketable securities, (5) warnings from the sellers' attorneys as to their potential liabilities for dealing with little-known purchasers, and (6) the fact that the corporation had been looted five years before by a different group who had gained control by using the same method of financing.

Id. at 577.

⁴⁹ 46 Cal. App. 3d 686, 120 Cal. Rptr. 354 (1975).

⁵⁰ *Id.* at 697, 120 Cal. Rptr. at 360.

row exception to this general rule.⁵¹ Courts may, on occasion, state the exception in rather broad terms,⁵² but they do not seem to require special inquiry by the seller in the absence of suspicious circumstances. The duty owed by the seller of control to minority shareholders is, therefore, generally not an onerous one. Because the controlling shareholder's fiduciary duty is only triggered in certain circumstances, the plaintiff should formulate at least one of his counts in terms of the independent wrongful act.⁵³

D. *The Control Premium Cases*

The English case of *Gaskell v. Chambers*⁵⁴ is the forerunner of the modern day premium cases. In *Gaskell*, however, the premium represented direct compensation to the directors for "the loss of their offices."⁵⁵ On this ground, the court held that the plaintiffs had presented a prima facie case and issued an interlocutory order directing the defendants to give up that portion of the purchase price attributable to the sale of their seats on the board of directors.

The first American case to directly confront the issue of the propriety of a control premium was *Gerdes v. Reynolds*.⁵⁶ The defendants, who were officers and directors of the Reynolds Investing Company, sold a majority of the company's common stock at a premium of at least one hundred and sixty percent above the per share value of the stock. Prior to this transaction, the controlling shareholders only superficially investigated the buyer, a small stock brokerage firm. After the transfer of the shares and the simultaneous transfer of control of the board of

⁵¹ *E.g.*, *McDaniel v. Painter*, 418 F.2d 545, 547 (10th Cir. 1969) (applying Kansas law).

⁵² *E.g.*, *Estate of Hooper v. Virgin Islands*, 427 F.2d 45, 47 (3d Cir. 1970).

⁵³ *See, e.g.*, *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976). In that case, the plaintiff, a minority shareholder, director, president, and treasurer of the James H. Black Company, was denied, through a several-step corporate reorganization, his contractual right of first refusal for the controlling stock in the company. The plaintiff framed his state claim in terms of tortious interference with contract. Besides avoiding the uncertainties of the fiduciary duty concept, this claim allowed recovery of damages under the contract as well as the diminution in value of his minority interest. *Id.* at 989-90. For a discussion of the plaintiff's federal claims, see text accompanying notes 122-24 *infra*.

⁵⁴ 53 Eng. Rep. 937 (Ch. 1858); *cf.* *Snugden v. Crossland*, 65 Eng. Rep. 620 (Ch. 1856) (sale of trusteeship revoked), *discussed in* Bayne, *Corporate Control as a Strict Trustee*, 53 GEO. L.J. 543, 544-46 (1965).

⁵⁵ 53 Eng. Rep. at 937.

⁵⁶ 28 N.Y.S.2d 622 (Sup. Ct. 1941).

directors, the purchasers diverted the corporate assets to their own use. A trustee, appointed in a proceeding under the Bankruptcy Act, sought to hold the vendors accountable for the premium received for their stock.

The *Gerdes* court stated that neither the transfer of control in conjunction with the sale of stock nor the receipt of a premium was illegal in itself. Unless otherwise provided by statute, a controlling shareholder who does not assume management of the corporation does not stand in a fiduciary relation to the other shareholders, the court held, and therefore the defendants could not be held liable in their capacity as shareholders.⁵⁷ The defendants were, however, held to have breached their fiduciary duty as officers and directors. As in *Gaskell*, the premium, because it so far exceeded any reasonable economic value of the stock,⁵⁸ was found to have represented compensation to the directors and four officers for their resignations.⁵⁹

In 1955, fourteen years after *Gerdes*, the Second Circuit announced its landmark decision in *Perlman v. Feldmann*,⁶⁰ which involved the sale of a controlling block of Newport Steel stock to Willport at a premium of more than sixty-six percent above the market price and seventeen percent above the book value. The court viewed the premium as reflecting a bonus for Willport's newly acquired ability to control Newport's steel allocation—an especially valuable asset during the war-time shortage.⁶¹ Having identified the control of the steel allocation as a corporate asset, the court awarded judgment against the defendants for the portion of the premium that was properly attributable to the corporate asset.⁶²

⁵⁷ *Id.* at 650-51.

⁵⁸ *Id.* at 654-55.

⁵⁹ *Id.* at 660. Interestingly, the recovery in *Gerdes* went beyond repayment of the ill-gotten premium. The defendants were also held liable for \$903,000 that had been wrongfully appropriated from Reynolds Investment by the purchasers. *Gerdes v. Reynolds*, 30 N.Y.S.2d 755, 771-72 (Sup. Ct. 1941).

⁶⁰ 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

⁶¹ *Id.* at 174-75.

⁶² On remand, the district court found the enterprise value of the corporation, based upon its book value and earnings potential, to be \$14.67 per share. This, when subtracted from the \$20 received by Feldmann, resulted in a \$5.33 per share premium (a total of \$2,126,280). The complaining shareholders, who held approximately 63% of the stock, were granted a judgment of \$1,339,769 with interest. *Perlman v. Feldmann*, 154 F. Supp. 436 (D. Conn. 1957). The recovery in *Perlman* flowed to the minority shareholders individually; thus, the new purchaser was not benefited. The figures considered by the district court on remand indicate that Feldmann was permitted to retain his pro rata share of the premium. *Id.* at 446-47.

In *Essex Universal Corp. v. Yates*,⁶³ the Second Circuit had the opportunity to reflect upon the scope of its decision in *Perlman*. In *Yates*, the defendant refused to honor a contract in which he had agreed to sell to the plaintiff, Essex, more than twenty-eight percent of the outstanding shares of Republic Theaters at a premium, thereby giving Essex control. One clause in the contract of sale provided that the seller, Yates, who was also president and chairman of Republic's board, would resign his offices. Yates raised the invalidity of the resignation clause and the premium as a defense to Essex's subsequent action for breach of the contract.

The three circuit judges who heard the case concurred in the reversal of the district's court's grant of summary judgment for the defendant, but wrote separate opinions. Although Judge Clark did not reach the issue, Judges Lumbard⁶⁴ and Friendly,⁶⁵ relying largely on an old New York case,⁶⁶ agreed that directors' agreements to resign were not invalid if they accompanied a valid transfer of control. Judge Lumbard stated that *Perlman* was not applicable in the absence of a showing of harm to the corporation.⁶⁷

The litigational setting of the *Yates* case raises some questions concerning the relevance of the court's decision to the more traditional control transfer situation. In *Yates*, the seller of control—the usual defendant in such actions brought by the minority—was trying to avoid his contractual obligations. To the extent that Yates would have been able to prove the contract's invalidity, he would have been relying upon his own wrongdoing to exonerate him for his breach. That Yates failed to convince the court to rescind the contract does not necessarily mean that a subsequent suit against him by the minority Republic shareholders also would have failed.

⁶³ 305 F.2d 572 (2d Cir. 1962).

⁶⁴ *Id.* at 576. See also *Caplan v. Lionel Corp.*, 20 App. Div. 2d 301, 246 N.Y.S.2d 913, *aff'd*, 14 N.Y.2d, 679, 198 N.E.2d 908, 249 N.Y.S.2d 877 (1964) (election of directors following resignation of previous directors pursuant to sale of three percent of the corporation's stock at a premium was invalidated).

Today, § 14(f) of the Securities Exchange Act of 1934 (Exchange Act) requires full disclosure of agreements concerning directorships made in connection with a tender offer. 15 U.S.C. § 78n(f) (1970). See generally Ratner, *Section 14(f): A New Approach to Transfers of Corporate Control*, 54 CORNELL L. REV. 65 (1968).

⁶⁵ 305 F.2d at 582.

⁶⁶ *Barnes v. Brown*, 80 N.Y. 527 (1880).

⁶⁷ 305 F.2d at 576.

A second case viewed as rejecting *Perlman* is *Honigman v. Green Giant Co.*⁶⁸ The Eighth Circuit refused to disturb an internal recapitalization under which the defendants, as owners of all the voting stock, received a premium as compared to the exchange rate for the complaining nonvoting shareholders.⁶⁹ Notwithstanding approval of the plan by over ninety percent of the nonvoting shares, the plaintiff attacked the unfairness of the reorganization on the grounds that the defendants' compensation for relinquishing their voting control constituted payment for a corporate asset.⁷⁰ The court first held that the plaintiff failed to demonstrate Minnesota's adoption of the Berle approach;⁷¹ second, it relied upon the subsequent ratification by the holders of nonvoting stock.⁷²

The *Honigman* case is inapposite for two reasons. Not only were the plaintiffs members of the class of shareholders that ratified the exchange, but they were also in the class that acquired control. Professor Berle, while acknowledging the Eighth Circuit's disapproval of his corporate asset theory, observed:

The *Green Giant* decision held only that under the law of Minnesota, through due corporate procedure for recapitalization, *stockholders* may vote to compensate the holders of voting control for giving it up. It does not, and does not purport to settle the question whether the holders of control can sell their control without liability to account to the corporation or their fellow stockholders.⁷³

While the *Green Giant* case, like the *Yates* decision, is distinguishable from *Perlman* on both its facts and reasoning, it cannot be ignored, at least as a refusal to expand the *Perlman* doctrine.

The next major step in the doctrinal development of the

⁶⁸ 309 F.2d 667 (8th Cir. 1962), *cert. denied*, 372 U.S. 941 (1963).

⁶⁹ Prior to the recapitalization *Green Giant* had two classes of stock. The defendants owned all 44 shares of the class A voting stock, while the plaintiff class represented holders of the class B nonvoting stock. Under the terms of the recapitalization, the class A stockholders received the new common stock on a 1,000-for-one basis, while the class B holders participated on a one-for-one basis. The result was to dilute the defendants' voting control from 100% to 9.3%. *Id.* at 668-69.

⁷⁰ "The plaintiff relies heavily on the much discussed view of Professor A.A. Berle that control is a corporate asset. It is claimed therefore that the dilution of the B shareholders' equity cannot be justified by the A shareholders' surrender of their exclusive control." *Id.* at 670.

⁷¹ *Id.*

⁷² *Id.* at 671.

⁷³ Berle, *supra* note 1, at 637 (emphasis in original).

Pertman rationale was the California Supreme Court's decision in *Jones v. H.F. Ahmanson & Co.*⁷⁴ The individual defendants combined owned eighty-five percent of the stock in United Savings and Loan Association of California, which was closely held and and rarely marketed beyond the original shareholders. The defendants, who wanted to take advantage of the bullish market for savings and loan stock, decided to undertake a public offering. Because the existing shares had a book value of \$1,131 each, however, they felt it was necessary to split them into interests that would be more marketable. To effectuate this plan, the individual defendants formed United Financial as a holding company for their shares in the Savings and Loan Association and then made a public offering of United Financial.⁷⁵ The minority shareholders filed suit claiming that the formation of the holding company and the subsequent public offerings constituted a breach of the majority's fiduciary duty to the minority shareholders because the minority shareholders could not share in the benefits resulting from the creation of a public market. Chief Justice Traynor, writing for the court, used broad language in holding that the plaintiff had stated a valid cause of action: "[T]he *comprehensive rule of good faith and inherent fairness* to the minority in any transaction where control of the corporation is material properly governs controlling shareholders in this state."⁷⁶ Accordingly, the court held that the plaintiff minority shareholders of the Savings and Loan Association were entitled to damages on the basis of what they would have gained had they been invited to participate on an equal basis in the formation and subsequent public offering of United Financial.

⁷⁴ 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

⁷⁵ In forming the holding company, the defendants transferred their Association shares to United Financial at the rate of 250 United Financial shares for each Association share. The first public offering involved 60,000 units, each being a package of two United Financial shares and one \$100 convertible debenture. Of the \$7.2 million to be received, \$6.2 million was to be distributed to the individual defendants as a return of capital. Within eight months there was a second public offering that consisted of 50,000 shares in addition to a secondary offering of 600,000 shares by the individual defendants. The court found that "[t]he derived blocks of United Financial shares commanded an aggregate price of \$3,700 per block exclusive of the \$927.50 return of capital." *Id.* at 104, 460 P.2d at 468, 81 Cal. Rptr. at 596. At the same time, the defendants caused United Financial to offer to purchase up to 350 of the plaintiffs' Association shares at \$1,100. Subsequently, the plaintiffs were offered 51 United Financial shares, valued at \$2,400, for each Association share, at a time when the value of the derived blocks had risen to \$8,800. *Id.* at 103-05, 460 P.2d at 467-69, 81 Cal. Rptr. at 595-97.

⁷⁶ *Id.* at 112, 460 P.2d at 474, 81 Cal. Rptr. at 602 (emphasis supplied) (footnote omitted).

The *Ahmanson* decision was heralded as breaking new ground in even its most narrow reading by "chang[ing] the generally accepted theory of stockholders' fiduciary responsibility."⁷⁷ A careful reading of the case, however, casts some doubt on this expansive view. Despite Chief Justice Traynor's use of broad statements concerning the majority's fiduciary duties to the minority,⁷⁸ the case can be viewed as merely involving the taking of a corporate opportunity. Although no identifiable corporate asset similar to the control of steel in *Perlman*, was involved and there was no subsequent looting as in the *Gerdes* and *Insurance* cases, the defendant majority stockholders did appropriate a corporate asset, though a more amorphous one. The Association, by virtue of the defendant's acts, lost its ability to go public and take advantage of the bull market. Certainly, any viable closely held concern has the potential for going public, and the success of the defendants' activities proved that the Association had the ability as well. It may be argued that the plaintiffs could have pooled their fifteen percent and formed their own holding company to take advantage of the market, but this position is not realistic in light of what was left of the plaintiffs' interest after the defendants' activities.⁷⁹ In essence the minority was frozen out by a de facto recapitalization.⁸⁰ Notwithstanding this narrow, more traditional analysis, Justice Traynor's broader language may have future ramifications.

Relatively few decisions have considered the treatment of control premiums since *Ahmanson*. Unfortunately, these cases do not provide the heretofore missing sense of consistency, and the field remains wide open.

In *Thompson v. Hambrick*,⁸¹ the Texas Court of Civil Appeals confronted the premium question. The defendants sold their controlling interest in the American Bank and Trust Company of Irving, Texas at a thirty-seven and one-half percent premium

⁷⁷ 83 HARV. L. REV. 1904, 1906 (1970).

⁷⁸ See 1 Cal. 3d at 108-12, 460 P.2d at 471-74, 81 Cal. Rptr. at 599-602.

⁷⁹ A fractional interest in a holding company that is in only a minority position with respect to its sole asset is not likely to be very marketable.

⁸⁰ For the more traditional application of the de facto doctrine in the context of corporate fusions, see *Farris v. Glen Alden Corp.*, 393 Pa. 427, 143 A.2d 25 (1958), in which the Supreme Court of Pennsylvania pierced a purported sale of assets, finding that, in substance, there had been a merger entitling the plaintiffs to exercise their appraisal rights. See generally, e.g., W. CARY, CASES & MATERIALS ON CORPORATIONS 1641-74 (4th unabr. ed. 1969) & cases cited therein.

⁸¹ 508 S.W.2d 949 (Tex. Civ. App. 1974).

above the per share value.⁸² Although the complaint also sought enforcement of the plaintiffs' alleged right of first refusal,⁸³ the key question for the court was the extent to which the Texas courts would accept the general thrust of the *Perlman* and *Ahmanson* decisions. In asserting that the premium had been the fruit of the control sellers' breach of fiduciary duty, the plaintiffs drew that court's attention to a Texas decision, which it readily distinguished, as well as to *Perlman* and *Ahmanson*.⁸⁴ The Texas court found *Perlman* inapplicable on the familiar ground that it "involved more than the acquisition of mere control; it also involved the frustration of a corporate business opportunity to the detriment of the minority stockholders."⁸⁵ The court then noted that, even though *Ahmanson* "does appear to expand" the judicial treatment of control premiums,⁸⁶ the promotion of the marketing scheme in *Ahmanson* was more than a mere sale of control in the *Perlman* sense and concluded that the case at hand did not call for an exception to the general rule that controlling shareholders "are at liberty to sell their shares at any time and for any acceptable price."⁸⁷

In 1975, the Supreme Judicial Court of Massachusetts utilized the *Ahmanson* "equal opportunity" approach in *Donahue v. Rodd Electrotype Co.*,⁸⁸ in which the corporate defendant purchased a portion of the holdings in a close corporation of the controlling shareholders without offering to purchase the minority's holdings. The court reasoned that, because of the closeness of the corporation, it would be a breach of fiduciary duty not to offer to purchase the minority's shares on an equal basis and at the same price.⁸⁹

The Massachusetts decision in *Donahue* thus adds a new

⁸² Buchanan and Hambrick sold their controlling interest at \$55 per share after Buchanan had acquired some of the plaintiffs' shares at \$40. *Id.* at 951.

⁸³ Each shareholder had entered into an agreement with Hambrick and Buchanan as "trustees" that provided for the right of first refusal. The court reversed the lower court's grant of summary judgment to the plaintiffs' claim that this agreement was applicable to the facts at hand. *Id.* at 952.

⁸⁴ *Id.* The court distinguished *Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963), because there the defendants' breach of duty in selling their shares had been predicated upon their being officers and directors. 508 S.W.2d at 953.

⁸⁵ 508 S.W.2d at 952.

⁸⁶ *Id.* at 953.

⁸⁷ *Id.* at 954 (citing *Seagrave v. Mount*, 212 F.2d 389, 395 (6th Cir. 1954)).

⁸⁸ — Mass. —, 328 N.E.2d 505 (1975). See generally 61 CORNELL L. REV. 986 (1976); 89 HARV. L. REV. 423 (1975); 21 VILL. L. REV. 309 (1975).

⁸⁹ — Mass. —, 328 N.E.2d at 518-19.

wrinkle. Rather than pointing to the sale of a corporate asset or any other independent breach of fiduciary duty, the court analogized the relationship among owners of a close corporation to the relationship among participants in partnerships.⁹⁰ The court thus contrasted the "strict" partnership standard of "utmost good faith and loyalty" that it applied to the close corporation, with the "less stringent standard of fiduciary duty" that applies to larger corporate structures.⁹¹

The impact of the *Donahue* decision has not yet been determined. Although the court viewed the corporation's repurchase of the shares of a former controlling shareholder as prohibited self-dealing in corporate assets,⁹² the broad language of the decision could be the basis for the adoption of a per se approach to the receipt of a control premium in the close corporation. The concurring opinion, perhaps aware of this as well as other possible extensions of the decision beyond its specific facts, cautioned that "[t]he analogy to partnerships may not be a complete one."⁹³ On the other hand, at least one subsequent case outside the control transfer context seems to have extended rather than restricted the partnership analogy.⁹⁴

The state of the law with respect to receipt of premiums by sellers of control remains confused. The most common theory is that, unless special circumstances exist, the majority shareholder owes no fiduciary duty to the other shareholders and may therefore keep the premium. Special circumstances may include situations in which the seller is also an officer or director, in which the seller has actual knowledge of information indicating that the purchaser would harm the corporation or the minority shareholders once it assumes control, or in which acceptance of a

⁹⁰ *Id.* at ____, 328 N.E.2d at 515.

⁹¹ *Id.* at ____, 328 N.E.2d at 515. The approach taken by the court in *Donahue* is a logical extension of the landmark decision in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928), in which Chief Judge Cardozo explained: "Joint adventures, like copartners, owe to one another . . . the duty of the finest loyalty. . . . [They are] held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." *Id.* at 463-64, 164 N.E. at 546.

⁹² *Id.* at ____, 328 N.E.2d at 518-19.

⁹³ *Id.* at ____, 328 N.E.2d at 521 (Wilkins, J. concurring).

⁹⁴ In *Cain v. Cain*, 75 Mass. App. Adv. Sh. 1121, 334 N.E.2d 650 (1975), the court used *Donahue*'s partnership analogy as the basis for enjoining the defendant from competing with a close corporation while he remained an officer, director, or shareholder. The *Cain* holding is a significant departure from precedent to the extent that it would impose a duty not to compete upon the controlling shareholder *qua* shareholder. Clearly, if this is the beginning of a trend, premiums for a controlling interest in a close corporation may well become per se invalid.

premium constitutes appropriation of a corporate asset or sale of a corporate office. What other situations may be included is, as yet, unclear. *Ahmanson*, the most significant exception to the special circumstances theory, states that the majority shareholder always stands in a fiduciary relationship to the other shareholders and therefore its corporate dealings must be subjected to an "inherent fairness" test. *Donahue* imposes an even stricter test, but limits its application to the close corporation context.

Under the special circumstances theory, control premiums will always be valid if special circumstances do not exist and will probably always be invalid if they do. The *Ahmanson* test provides the least amount of predictability because it is often more difficult to determine the fairness of an arrangement than to determine whether one of a number of readily identifiable special circumstances exists. The *Donahue* approach also avoids the *Ahmanson* uncertainty because it imposes a per se prohibition in the contexts in which it is applied.

There are no concrete formulations of the parameters of the control premium proscriptions. The result of these diverse approaches is a lack of predictability on a case-by-case basis. The obvious advantage of such an approach is to allow the courts to achieve an equitable result in each case. Another advantage is that the corporate planner will have to scrutinize each transaction on its merits with an eye toward giving the minority a fair deal. Whether the trade-offs are worth the lack of predictability is a debatable issue, but the more recent decisions under both state and federal law have not succeeded in drawing clearer guidelines. Before suggesting which approach or which combination of these approaches is the best solution to the control premium issue, this Article will examine the approaches taken by several securities law provisions.

III. TRANSACTIONS OF CONTROLLING SHAREHOLDERS UNDER FEDERAL LAW

The federal legislative scheme⁹⁵ takes three basic approaches to the regulation of the activities of controlling

⁹⁵ See generally, e.g., Schwartz, *The Sale of Control and the 1934 Act: New Directions for Federal Corporate Law*, 15 N.Y.L.F. 674 (1969), wherein Professor Schwartz analyzed many of the problems discussed here at the time when it first appeared that appropriate weapons could be found in the federal arsenal. Although the earlier cases opened the paths for the "new directions," developments since 1969 have created several detours.

shareholders, through disclosure requirements, provisions rendering a controlling person jointly liable for the corporation's securities violations,⁹⁶ and various substantive provisions that regulate such shareholder transactions.

A. *The Reporting Requirements and the Joint Liability of Controlling Persons*

When a corporation's securities are subject to the registration requirements of the Exchange Act⁹⁷ its management and controlling shareholders become subject to various reporting requirements and must file reports with the Securities Exchange Commission (SEC). In addition to the various provisions that apply directly to the controlling shareholders themselves, the corporation must file reports that identify its control persons.⁹⁸ Section 13(d)(1) of the Exchange Act requires the filing of a report by any person who acquires beneficial ownership of more than five percent of the outstanding shares of a class of equity securities subject to the Act's registration requirements.⁹⁹ This section is aimed at alerting the public as well as the corporation to creeping acquisitions by way of open-market purchases. Section 16(a) of the Act requires reports of all transactions in the corporation's registered equity securities by officers, directors, and owners of more than a ten percent beneficial interest. The section was adopted as a means of keeping track of insider trading, especially trading that may violate section 16(b)'s prohibition on the taking of short swing profits by corporate insiders.¹⁰⁰

In addition to the reporting requirements, the conduct of

⁹⁶ 15 U.S.C. §§ 77o, 78t(a) (1970).

⁹⁷ *Id.* § 78l(g) (1970).

⁹⁸ *E.g.*, Form S-1, Item 19, 2 FED. SEC. L. REP. (CCH) ¶ 8210 (registration statement for securities under the Securities Act of 1933 (Securities Act); identification of "principal holders of securities"); Form 8-K, Item 1, 3 FED. SEC. L. REP. (CCH) ¶ 31,003 (current report under the Exchange Act; identification of "changes in control of registrant"); Form 10-K, Item 4, 3 FED. SEC. L. REP. (CCH) ¶ 31,103, Item 11, 3 FED. SEC. L. REP. (CCH) ¶ 31,104 (annual report under the Exchange Act; identification of "parents and subsidiaries," and of "principal security holders and security holdings of management"). For a more complete listing of corporate reporting requirements relating to controlling shareholders, see 2 FED. SEC. L. REP. (CCH) ¶ 8210, at 7141.

⁹⁹ 15 U.S.C. § 78m(d)(1) (1970). Schedule 13D, 17 C.F.R. 240.13d-101 (1976), requires, *inter alia*, disclosure of the purchaser's identity and intentions with respect to the shares purchased. Section 14(d), a companion provision, requires that any person who is making or is about to make a tender offer that would result in acquisition of more than five percent file all related communications with the Commission. 15 U.S.C. § 78n(d) (1970).

¹⁰⁰ 15 U.S.C. § 78p(a), (b) (1970). See generally Hazen, *The New Pragmatism Under Section 16(b) of the Securities Exchange Act*, 54 N.C. L. REV. 1 (1975).

controlling shareholders may be influenced significantly by the joint liability provisions of the securities laws. Section 15 of the Securities Act and section 20(a) of the Exchange Act provide in essence that unless the controlling person can demonstrate the absence of actual or constructive knowledge of the prohibited activity, anyone who directly or indirectly "controls" a violator of the securities laws is jointly and severally liable.¹⁰¹ The concept of control, which is not limited to share ownership, is the possession of the power to direct management and policies.¹⁰² Accordingly, the federal statutory scheme, like the common law, does not view a majority ownership interest as a prerequisite to the finding of a control relationship.¹⁰³

The joint liability provisions are far-reaching and do not stop at imposing liability on shareholders exercising the type of control present in *Zahn*.¹⁰⁴ There is a dispute, however, whether the federal provisions preempt or supplement preexisting common law doctrines. For example, the Sixth Circuit recently held that traditional agency principles including the doctrine of *respondeat superior* may be used to hold an employer liable under the Securities Act and Exchange Act even if the exculpatory lan-

¹⁰¹ Section 15 provides in full:

Every other person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77o (1970). Section 20(a) of the Exchange Act is substantially similar except for exculpatory language that provides for no liability when such "controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." *Id.* § 78t(a) (1970).

¹⁰² The SEC has adopted the following definition in Rules 405(f) and 12b-2(f):

(f) *Control*. The term "control" (including the terms "controlling", "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

17 C.F.R. §§ 230.405(f), 240.12b-2(f) (1976) (substantially identical). Compare the circular definition contained in § 2(a)(9) of the Investment Company Act. 15 U.S.C. § 80a-2(a)(9) (1970).

¹⁰³ *E.g.*, *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 694 (5th Cir. 1971); *Klapmeier v. Telecheck Int'l, Inc.*, 315 F. Supp. 1360, 1361 (D. Minn. 1970), *rev'd on other grounds*, 482 F.2d 247 (8th Cir. 1973); *see note 38 supra*.

¹⁰⁴ *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947), *discussed at text* accompanying notes 22-37 *supra*.

guage of section 15 is satisfied.¹⁰⁵ The court there reached this result in the face of Ninth Circuit authority to the contrary.¹⁰⁶ Regardless of the eventual resolution of this conflict between the circuits, these provisions place added responsibility on controlling persons.

B. *The Questionable Role of Rule 10b-5*

The Exchange Act's general antifraud provision¹⁰⁷ and correlative rule 10b-5,¹⁰⁸ unlike the reporting requirements discussed above, are applicable to all "securities" regardless of registration. These provisions have been judicially molded to cover several types of wrongdoing by corporations and their officers, directors, and agents.¹⁰⁹ The expansion of the rule beyond the traditional fraud situation and its extension to corporate mismanagement cases have opened the door to 10b-5's applicability to the sale-of-control situation. In 1952, the Second Circuit constructed the first roadblock in 10b-5's expansive path when it announced its restrictions on standing to sue in *Birnbaum v. Newport Steel Corp.*¹¹⁰ *Birnbaum* was the 10b-5 counterpart to *Perlman v. Feldmann*,¹¹¹ arising out of the same facts and challenging the same control premium. The court dismissed the 10b-5 claim because the plaintiff was neither a purchaser nor a seller of the securities in question. Although the *Birnbaum* standing restrictions appeared to have eroded substantially,¹¹² its

¹⁰⁵ *Holloway v. Howerdd*, 536 F.2d 690, 694-96 (6th Cir. 1976); *accord*, SEC v. Management Dynamics, Inc., 515 F.2d 801, 812-13 (2d Cir. 1975); *Fey v. Walston & Co.*, 493 F.2d 1036, 1051-52 (7th Cir. 1974); *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1130 (4th Cir. 1970); *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359, 362 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970).

¹⁰⁶ 536 F.2d at 695 (citing *Kamen & Co. v. Aschkar & Co.*, 382 F.2d 689, 697 (9th Cir. 1967), *cert. denied per stipulation*, 393 U.S. 801 (1968)).

¹⁰⁷ 15 U.S.C. § 78j(b) (1970).

¹⁰⁸ 17 C.F.R. § 240.10b-5 (1976).

¹⁰⁹ The historical origins and development of 10b-5 have been described fully elsewhere and need not be repeated. *See generally*, e.g., 1 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 (1975); 3 L. LOSS, SECURITIES REGULATION 1445-518 (2d ed. 1961).

¹¹⁰ 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

¹¹¹ 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955), *discussed at* text accompanying notes 60-62 *supra*.

¹¹² E.g., *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), *cert denied*, 416 U.S. 960 (1974). *See generally*, Boone & McGowan, *Standing to Sue Under SEC Rule 10b-5*, 49 TEX. L. REV. 617 (1971); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968); Note, *Rule 10b-5: The Rejection of the Birnbaum Doctrine By Eason v. General Motors Acceptance Corp. and the Need for a New Limitation on Damages*, 1974 DUKE L.J. 610 (1974).

holding was recently adopted by the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*.¹¹³

Thus, 10b-5 has not become as powerful a weapon for protecting minority rights in control transactions as was once predicted.¹¹⁴ The rule can nevertheless play an important role. Should the minority or corporation itself be cast in the position of selling its securities, a 10b-5 action would clearly lie. More importantly, while the *Birnbaum-Blue Chip* restriction is limited to private suits, 10b-5 not only involves potential criminal penalties but also is subject to enforcement by the Commission.¹¹⁵ Accordingly, to the extent that the substantive scope of the rule applies to the sale of a controlling interest for an excessive premium, 10b-5 could be utilized as the basis of an SEC action seeking injunctive relief or an accounting of profits to the corporation. Additionally, there remains the alternative of an enforcement action brought by the SEC and the concomitant availability of ancillary relief under 10b-5 as a means of requiring disgorgement of the control premium.¹¹⁶

*Christophides v. Porco*¹¹⁷ presented the issue of the substantive applicability of 10b-5 in a sale of control situation. Plaintiffs, minority shareholders in Brown Company, challenged the sale of a controlling block of twenty-three percent of the Brown stock by Fasco to Gulf & Western at a premium. The complaint also pointed to Gulf & Western's plan to acquire Brown's assets in return for Gulf & Western debentures after gaining control of Brown. The plaintiffs claimed that this was more than the conventional freeze-out situation because of the additional factor of the premium paid by Fasco. The court, relying upon common law authority, concluded that control premiums were not per se invalid under 10b-5 because "[i]t is only where fraud, deceit or manipulation enter that a violation of state law or Rule 10b-5 occurs."¹¹⁸ The court went on to say that even if the Brown directors "had violated their fiduciary management duties by approving the plan of acquisition" no federal claim would lie absent deception.¹¹⁹ The court did indicate, however, that the

¹¹³ 421 U.S. 723 (1975).

¹¹⁴ Schwartz, *supra* note 95, at 700.

¹¹⁵ See, e.g., SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307-08 (2d Cir. 1971).

¹¹⁶ See generally, e.g., Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976).

¹¹⁷ 289 F. Supp. 403 (S.D.N.Y. 1968).

¹¹⁸ *Id.* at 405.

¹¹⁹ *Id.*

Birnbaum standing limitations might not apply as a bar to an action for injunctive relief.¹²⁰

More recent decisions call the validity of the *Porco* holding into question, at least insofar as it relied upon 10b-5's unavailability in corporate mismanagement cases.¹²¹ *Bailey v. Meister Brau, Inc.*,¹²² demonstrates the significance of 10b-5 when a control premium plays a part in a fraudulent scheme. In that case, the minority shareholder, suing derivatively, successfully challenged the Black corporation's sale of its assets in exchange for Meister Brau stock, which had a market value significantly below that of Black's assets. As part of the deal, Meister Brau purchased Black stock from Black's controlling shareholders at a significant premium. The *Birnbaum* requirement was satisfied because the nondisclosure concerned the purchase of the Meister Brau stock by the Black corporation, which was the nominal plaintiff.¹²³ The court held that the majority shareholder was liable under 10b-5 for the loss incurred upon the sale of its assets because it failed to disclose its conflict of interest to Black's other shareholders.¹²⁴ Thus, the receipt of the premium created the conflict of interest that 10b-5 requires to be disclosed. The court did not discuss, however, how such nondisclosure to minority shareholders could proximately cause any damages to the corporation.

In 1970, the Fifth Circuit, in two derivative actions, faced the question of 10b-5's applicability to transfers of control allegedly detrimental to the minority.¹²⁵ In both instances the court refused to sustain the defendants' motions to dismiss, relying on the puppet-puppeteer relationship that enabled the controlling shareholders to manipulate the board of directors in negotiating a transfer of control through a merger agreement.¹²⁶

¹²⁰ *Id.* at 406 (citing *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 546 (2d Cir. 1967)).

¹²¹ *See, e.g.*, *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974). *But see*, *Santa Fe Indus., Inc. v. Green*, 97 S. Ct. 1292 (1977). The relevant cases are more fully discussed in Lipton, *Sale of Corporate Control: Going Private*, 31 BUS. LAW. 1689 (1976); Schwartz, *supra* note 95.

¹²² 535 F.2d 982 (7th Cir. 1976).

¹²³ *Id.* at 992.

¹²⁴ *Id.* at 993.

¹²⁵ *Shell v. Hensley*, 430 F.2d 819 (5th Cir. 1970); *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970).

¹²⁶ *Shell v. Hensley*, 430 F.2d 819, 827 (5th Cir. 1970), *quoted in* *Herpich v. Wallace*, 430 F.2d 792, 809-10 (5th Cir. 1970). *See also* *Harman v. Willbern*, 374 F. Supp. 1149 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975), which according to one

The damage alleged flowed primarily from the subsequent looting activities by the purchaser of control and did not arise out of the sale or premium directly.¹²⁷ Although the *Birnbaum-Blue Chip* requirement was held satisfied by the corporation's proposed merger,¹²⁸ it is questionable whether this type of harm is closely enough connected to the sale or purchase of securities to meet the requirement as the courts will eventually construe it.

At least when receipt of a control premium is an integral part in schemes to defraud the corporation whose control was sold, private 10b-5 damage actions still may be viable. Given the Supreme Court's recent eagerness to limit the scope of 10b-5 actions¹²⁹ and the tenuous relationship between the sale and the alleged damages, however, the future of such 10b-5 actions cannot be considered bright. The dark outlook for private damage actions under 10b-5 in most control premium situations should not necessarily be taken as an indication of its overall impotence. In addition to its use as an enforcement, compliance, and remedial device in the hands of the Commission and as a basis for privately instigated injunctive relief, the rule has paved the way for the Exchange Act's tender offer antifraud provisions.¹³⁰

C. *The Williams Act—Federal Regulation of Tender Offers*

One result of the corporate fusion movement of the 1960's was the use of cash tender offers directly to the target company's shareholders as an alternative to the more conventional statutory merger route that required compliance with the Exchange Act's proxy rules.¹³¹ The vociferousness with which such battles were waged both publicly and privately led to the 1968 Congressional enactment of the Williams Act amendments to the Exchange

commentator, "suggested that a rule 10b-5 claim is appropriate where the sale and control and subsequent looting of the corporation might be viewed as part of one scheme." Lipton, *supra* note 121, at 1693.

¹²⁷ *Shell v. Hensley*, 430 F.2d 819, 822-23 (5th Cir. 1970); *Herpich v. Wallace*, 430 F.2d 792, 809-10 (5th Cir. 1970).

¹²⁸ *Shell v. Hensley*, 430 F.2d 819, 827 (5th Cir. 1970); *Herpich v. Wallace*, 430 F.2d 792, 810 (5th Cir. 1970).

¹²⁹ See *Santa Fe Indus., Inc. v. Green*, 97 S. Ct. 1292 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

¹³⁰ See 15 U.S.C. § 78n(e) (1970), which is patterned on the language of the rule.

¹³¹ 17 C.F.R. §§ 240.14a-1 to .14a-103 (1976). Section 14(a), 15 U.S.C. § 78n(a) (1970), and Rule 14a-9, 17 C.F.R. § 240.14a-9 (1976), require full disclosure for all proxy solicitation materials of companies that are subject to the reporting requirements of § 12 of the Act, 15 U.S.C. § 78l (1970).

Act.¹³² Because the scope of these amendments extends beyond the conventional cash tender offer, they may affect control premiums in certain situations.

In *Jones v. H.F. Ahmanson & Co.*,¹³³ Justice Traynor ordered what was tantamount to a forced tender offer to the minority to accomplish a pro rata distribution of the invalid control premium. Professor Andrews' proposal that all control premiums be distributed on a pro rata basis to all shareholders would have the same effect.¹³⁴ The 1968 amendments include both reporting and disclosure requirements that the Supreme Court has indicated may be the basis of an implied private right of action by a shareholder of the target company.¹³⁵ The Act may be of significance in the traditional sale-of-control situations by the direct application of its provisions. The relief available under the Act might also be used by analogy to focus upon the fiduciary duties and potential liabilities of the purchaser, thereby creating additional remedies for the minority.

More specifically, section 14(d) provides minimum requirements for "a tender offer for, or a request or invitation for tenders of," any equity security registered under section 12 of the Exchange Act.¹³⁶ Similarly, section 14(e), which is not limited to registered securities, expressly applies 10b-5 standards to all parties to a "tender offer or request or invitation for tenders."¹³⁷

¹³² Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d)-(e), n(d)-(f) (1970)). The Williams Act Amendments cover various reporting and disclosure provisions that go far beyond the scope of this Article. See generally E. ARANOW & H. EINHORN, *TENDER OFFERS FOR CORPORATE CONTROL* (1973); Bromberg, *The Securities Law of Tender Offers*, 15 N.Y.L.F. 462 (1969); Hamilton, *Some Reflections on Cash Tender Offer Legislation*, 15 N.Y.L.F. 269 (1969).

¹³³ 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969), discussed at text accompanying notes 74-80 *supra*.

¹³⁴ Andrews, *supra* note 1.

¹³⁵ In *Piper v. Chris-Craft Industries, Inc.*, 97 S. Ct. 926 (1977) the Court held that the Williams Act did not create a private damage remedy in the hands of a tender offeror. However, the Court strongly indicated that such relief would be available to a shareholder of the target company. See *id.* at 941-44. In the control premium situation it would be the target company shareholder who would be asserting his minority rights.

In the course of its opinion the Court repeatedly stressed the fact that the Act was directed at the protection of investors (i.e. tender offerees) rather than at tender offerors. *Id.* at 941-50. In fact, the dissent noted that "[n]o one seriously questions the premise that Congress implicitly created a private right of action when it enacted § 14(e) in 1968." *Id.* at 956 (Stevens, J., dissenting) (footnote omitted). The Court expressly stated that it was not facing that issue in its denial of the *Piper* plaintiff's claim. *Id.* at n.28. In addition to a damage pending the Court has acknowledged the potential of private injunctive relief. *Rondeau v. Mosinee Paper Co.*, 422 U.S. 49 (1975).

¹³⁶ 15 U.S.C. § 78n (d) (1970); see *id.* § 78l(g)(1) (1970) (scope of the Act's registration requirements).

¹³⁷ *Id.* § 78n(e) (1970). For a discussion of the cases dealing with the private right of

For example, in *Ahmanson*¹³⁸ nineteen individual defendants, acting in concert, transferred their aggregated eighty-five percent control block in the United Savings and Loan Association to their conduit United Financial for subsequent distribution to the public. If United Financial's purchases were to fall within the scope of the Act's coverage, the Association's minority shareholders would have two potential federal remedies. If the securities in question were subject to the Exchange Act's registration and reporting requirements, the minority would have the protection of section 14(d),¹³⁹ which requires full disclosure to *all* shareholders in addition to the filing with the SEC of all related communications with the tender offerees.¹⁴⁰ This gives the minority notice of the impending public offering and a chance to tender their shares to the newly formed holding company on the same basis as the majority. Section 14(d)(6) provides that all tenderers must be given the opportunity to share equally on a pro rata basis.¹⁴¹

Even if the securities in question were not registered and therefore not subject to section 14(d)'s requirements, section 14(e) would still apply. In addition to requiring full and honest disclosure, section 14(e), like its model, rule 10b-5, prohibits "fraudulent" and "deceptive" acts.¹⁴² The plaintiff in a section 14(e) action would not necessarily be subject to 10b-5's purchaser-seller requirement. If the plaintiff can establish that the receipt of an excessive control premium is a breach of duty under the common law, the same act could constitute a "fraudulent" or "deceptive" practice prohibited by section 14(e).

The availability of these alternatives depends on the scope of the Williams amendments' coverage. The threshold question is what is a "tender offer" within the context of the Williams Act. Unfortunately, the Act is silent concerning this crucial issue. Congress considered and rejected¹⁴³ the possibility of providing

action and scope of relief under § 14(e), see generally Note, Chris-Craft: *The Uncertain Evolution of Section 14(e)*, 76 COLUM. L. REV. 634 (1976).

¹³⁸ 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

¹³⁹ 15 U.S.C. § 78n(d) (1970).

¹⁴⁰ *Id.* § 78n(d)(1) (1970). For the corresponding SEC rules contained in Regulation 14D and Schedule 14D that spell out the minimum disclosure requirements, see 17 C.F.R. §§ 240.14d-1 to .14d-101 (1976).

¹⁴¹ 15 U.S.C. § 78n(d)(6) (1970).

¹⁴² *Id.* § 78n(e) (1970).

¹⁴³ *Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids. Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 131 (1967) (statement of Arthur Fleischer, Jr.).

objective definitions, such as those in the proposed Federal Securities Code,¹⁴⁴ thus indicating a Congressional intent to keep the definition flexible and to leave the issue to the SEC and ultimately to the courts. The SEC has likewise declined to set objective standards,¹⁴⁵ and instead has endorsed a flexible, fairly broad concept of what a tender offer is:

The Commission's position should in no way be construed to mean that the term applies only to so-called conventional tender offers whereby an offer is published by a person requesting that all or a portion of a class of a company's securities be deposited during a fixed period of time so that such person may purchase such securities at a specified price (whether cash and/or securities) and subject to specified conditions. But rather, the term is to be interpreted flexibly and applies to special bids; purchases resulting from widespread solicitations by means of mailings, telephone calls and personal visits; and any transaction where the conduct of the person seeking control causes pressures to be put on shareholders similar to those attendant to a conventional tender offer.¹⁴⁶

In 1968, the SEC issued a release stating that a special bid—the placing on the exchange of a bid for a specified large number of shares at a fixed price—would be considered to con-

¹⁴⁴ The American Law Institute's proposed Federal Securities Code, which would substantially follow the provisions of the Williams Act in most respects, provides the following definition: "'Tender request' means an offer to buy a security, or a solicitation of an offer to sell a security, that is directed to more than thirty-five persons" ALI FED. SEC. CODE 299.9(a) (Tent. Draft No. 1, 1972). In drafting the section Professor Loss acknowledged the "public connotation" of "tender offer" under the current legislation but also was aware of the open-ended nature of the Act in its present form; his solution was to select an arbitrary cutoff point. *Id.* Comment 1.

Some state statutes on tender offers also provide objective standards. *E.g.*, DEL. CODE tit. 8, § 203(c)(2) (1976); KY. REV. STAT. § 292.560 (Supp. 1976). *See generally* 1977 SUGGESTED STATE LEGISLATION 29 (1976); Wilner & Landy, *The Tender Trap: State Takeover Statutes and Their Constitutionality*, 45 FORDHAM L. REV. 1 (1976); Report, *State Takeover Statutes and the Williams Act*, 32 BUS. LAW. 187 (1976).

¹⁴⁵ [T]he Commission's position at this time is that a definition of the term "tender offer" is neither appropriate nor necessary. This position is premised on the dynamic nature of these transactions and the need of the Commission to remain flexible in determining what types of transactions, either present or yet to be devised, are or should be encompassed by the term. Therefore, the Commission specifically declines to propose a definition of the term "tender offer."

SEC Release No. 33-5731, 41 Fed. Reg. 33,004, 33,005 (1976), in [Current] FED. SEC. L. REP. (CCH) ¶ 80,659, at 86,696.

¹⁴⁶ *Id.* (footnotes omitted) (emphasis supplied).

stitute a tender offer.¹⁴⁷ In 1971, the Commission issued a no action response under section 14(d) when the holder of a substantial ownership interest in the target company planned to purchase additional shares on the open market with an eye toward gaining fifty percent control.¹⁴⁸ In contrast, less than one month later, the Commission, in a Staff Reply, commented:

[Y]ou note that the term "tender offer" is not defined in section 14(d) of the Act or the rules thereunder. It is not limited to the classical "tender offer" where the person desiring to acquire shares makes a public invitation or a written offer to the shareholders to tender their shares. Nor is there a requirement that the shares be rendered through a depository. *The change in control may be effected by direct purchase from shareholders without a public or written invitation for tenders having been made.*¹⁴⁹

The earliest case examining the definition of tender offer involved the issue of section 14(e)'s applicability to a two-step corporate reorganization.¹⁵⁰ In holding that the reorganization was not a tender offer, the court noted that although there is no statutory definition, "[t]he legislative history . . . makes clear that the type of activity intended to be regulated . . . is the acquisition of control of a corporation by outsiders through the purchase of its shares."¹⁵¹ The court thus stressed the absence of both an offer by outsiders and a transfer of control, because the share ownership, subject to the dissenters' exercise of their appraisal rights, was the same as it had been prior to the reorganization.¹⁵²

¹⁴⁷ SEC Release No. 34-8392, 33 Fed. Reg. 14,109 (1968). See generally E. ARANOW & H. EINHORN, *supra* note 132, at 70-71.

¹⁴⁸ American Gen. Ins. Co., [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,588 (SEC Staff Reply).

¹⁴⁹ Cattlemen's Inv. Co., [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,775, at 81,627 (SEC Staff Reply) (emphasis supplied). This controversy reached the courts in *Cattlemen's Inv. Co. v. Fears*, 343 F. Supp. 1248 (W.D. Okla. 1972), discussed at text accompanying notes 160-61 *infra*.

¹⁵⁰ *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890 (N.D. Me. 1971).

¹⁵¹ *Id.* at 907.

¹⁵² *Id.* at 909. This narrow reading was confirmed by the Fifth Circuit in *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974): The lesson we read in *Dyer* is not that there may not be a friendly tender offer. Rather, it is that a corporation does not become a tender offeror simply by proposing a paper exchange of securities. There must be contemplated some change of control. If actual control does not shift, it is difficult to see why the shareholder needs the protection of Section 14(e). He has what he had before, in reality if not in form.

Id. at 599.

Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Co.,¹⁵³ was the first case deciding the issue of tender offer definition in the context of open-market purchases. The court held that the purchases were not subject to section 14(d)'s disclosure requirements, because they had fallen short of the statute's five percent threshold.¹⁵⁴ Two months later, a New Jersey District Court, in *Water & Wall Associates, Inc. v. American Consumer Industries, Inc.*,¹⁵⁵ refused to grant a preliminary injunction preventing Water & Wall from soliciting proxies, making a conventional tender offer, or exercising any incidents of ownership over 53,253 shares of stock recently purchased by Water & Wall on the open market.¹⁵⁶ It was argued that Water & Wall was subject to section 14(e) because it planned a series of open-market purchases of more than five percent of the shares in the target company with an eye toward control. The court concluded that the purchases did not come within the purview of section 14(e), relying on the following "definition" in the Williams Act's legislative history:

The offer normally consists of a bid by an individual or group to buy shares of a company—usually at a price higher than the current market price. Those accepting the offer are said to tender their stock for purchase. The person making the offer obligates himself to purchase all or a specified portion of the tendered shares¹⁵⁷

The failure of the court to consider the SEC statement concerning the inclusion of certain open-market purchases in the definition of tender offer¹⁵⁸ and the court's finding of independent grounds on which to base the denial of the injunction¹⁵⁹ weaken *Water & Wall's* precedential value.

An Oklahoma district court, in *Cattlemen's Investment Co. v. Fears*,¹⁶⁰ held that a series of privately negotiated transactions

¹⁵³ 356 F. Supp. 1066 (S.D.N.Y.), *aff'd*, 476 F.2d 687 (2d Cir. 1973).

¹⁵⁴ *Id.* at 1074.

¹⁵⁵ [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,943 (D.N.J. 1973).

¹⁵⁶ In addition to the claim under § 14(e), relief was sought under §§ 10(b), 13(d), 14(a), 15 U.S.C. §§ 78j(b), m(d), n(a) (1970).

¹⁵⁷ S. REP. NO. 550, 90th Cong., 1st Sess. 2 (1967); H.R. REP. NO. 1711, 90th Cong., 2d Sess. 2 (1968), *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS 2811.

¹⁵⁸ SEC Release No. 34-8392, 33 Fed. Reg. 14,109 (1968).

¹⁵⁹ [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,943, at 93,759-60.

¹⁶⁰ 343 F. Supp. 1248 (W.D. Okla. 1972).

constituted a tender offer. The court first stressed that remedial legislation should be given a liberal interpretation and then relied upon the importance of an "unhurried investment decision" and of "assur[ing] fair treatment."¹⁶¹

The most recent decision, and the only appellate decision, on this definitional problem is *Smallwood v. Pearl Brewing Co.*,¹⁶² which raised "a variety of difficult questions" under the Exchange Act in the context of a corporate merger that had been supported by the target company's management.¹⁶³ The section 14(e) claim was predicated upon a communication from the would-be surviving corporation to the shareholder of the target company, including a draft of the proposed exchange prospectus and an explanation of how the sell-out provision of the proposed merger would be handled.¹⁶⁴ In considering whether this communication was subject to scrutiny under section 14(e), the court not only rejected the defense that a tender offer must involve a "hostile bid *opposed* by incumbent management,"¹⁶⁵ but also indicated that the need for Williams Act protection is "even greater" when dealing with a "friendly" takeover attempt.¹⁶⁶ The court also emphasized the need for Williams Act regulation because the shareholders of the target company were being asked to make a "significant investment decision for which information and reflection are essential."¹⁶⁷ In the typical control premium case, the minority would not make any investment decisions, because only the control block is sold. Although the *Smallwood* court relied on this factor, it did not indicate that its absence would preclude application of the Williams Act.

From the foregoing legislative history, SEC statements, and judicial decisions, it is possible to glean some general guidelines for determining whether a given transaction is within the statutory concept of "tender offer." Clearly, the definition goes beyond conventional tender offers and, in certain circumstances will apply to both privately negotiated transactions and open-market purchases. The legislative history and decisions by the courts and the SEC also indicate that a key factor is a shift in

¹⁶¹ *Id.* at 1251.

¹⁶² 489 F.2d 579 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974).

¹⁶³ *Id.* at 584, 585-89.

¹⁶⁴ *Id.* at 586-87.

¹⁶⁵ *Id.* at 597 (emphasis in original) (quoting Brief for Appellees at 10).

¹⁶⁶ *Id.* at 598.

¹⁶⁷ *Id.* at 599.

control by the acquisition or by a series of acquisitions of a block of shares by an outsider. Finally, there is the necessity for full and honest disclosure when the shareholders of the target company are asked to make an investment decision. All of the factors listed above, except for the last,¹⁶⁸ could be present in any sale of control situation.

Although there is no express minimum number of tender offerees, it is unlikely that the sanctions of sections 14(d) and 14(e) apply to an isolated transfer of a controlling block of stock. Accordingly, any remedies found in the Act itself would not apply to all control premium situations. The analogy exists, however, and may give guidance to courts willing to adopt a more imaginative approach under state law.

Two aspects of the Williams Act warrant special attention by state courts employing this analogy. The first is the requirement mentioned above that tender offerors make their offers pro rata to all shareholders. The second is the applicability of the Act's proscriptions to the tender offeror as well as to the management of the target company.¹⁶⁹ Purchaser liability may be inconsistent with state law theories that require the seller to disgorge a control premium. To the extent that relief is premised on the seller's appropriation of a corporate asset such as Newport's steel allocation in *Perlman v. Feldmann*,¹⁷⁰ once the minority has been made whole by the seller of control, the courts may be obliged to say that because the purchaser paid for the asset it is now his. This would give the purchaser a license to use it in such a way that would otherwise constitute a breach of fiduciary duty to the minority or to the corporation itself.

There are, however, alternative theories for imposing state liability on the purchaser. Rather than rely upon some type of threshold relationship to the corporation, the courts could rely upon traditional tort principles. When there is a negotiated sale of control at an excessive premium, the purchaser could be held liable on an equal basis as a joint tortfeasor. Another similar method would allocate such joint liability on a conspiracy theory because it clearly takes both the purchaser and seller acting in

¹⁶⁸ Of course, if a pro rata offering is required, all shareholders have an investment decision requiring full disclosure.

¹⁶⁹ Section 14(e) covers all communications issued "in connection with any tender offer or request or invitation for tenders." 15 U.S.C. § 78n(e) (1970).

¹⁷⁰ 219 F.2d 173 (2d Cir.), *cert denied*, 349 U.S. 952 (1955).

concert in order to effectuate a transfer of control at an excessive premium.¹⁷¹

Although more than eight years have elapsed since the passage of the Williams Act, the judicial refinements are still in their incipency. It is thus not unlikely that some of the questions raised herein will be answered in such a way as to give the minority shareholders a more viable weapon against excessive control premiums.

IV. THE INVESTMENT COMPANY ACT—ANOTHER APPROACH TO THE CONTROL PREMIUM

The Investment Company Act of 1940¹⁷² places express limitations upon the receipt of a premium based on the transfer of controlling interests in an investment adviser to a mutual fund or investment company. Like the Williams Act, it may have significance beyond the scope of the statute because it is a congressional statement concerning the proper safeguards against evils that may accompany the transfer of control for a premium. With respect to an assignment of the advisory contract, unlike the more traditional sale-of-control case, the injured shareholders do not complain about the transfer of a controlling block of stock in their own corporation. Instead, their complaint is based on a more straightforward sale-of-a-corporate-asset theory, viewing future earnings under the investment advisory contract as a proper matter for the fund to decide. This might be analogized to the ability to control the allocation of steel in *Perlman*.¹⁷³

The Act also provides that any "direct or indirect" transfer of a controlling block of shares in the investment adviser or affiliate constitutes an assignment of the advisory contract.¹⁷⁴ And the investment advisory contract automatically terminates when there is an assignment of the contract.¹⁷⁵ Accordingly, when control in the adviser is sold at a premium and the investment company reinstates the advisory contract, there is an express approval of the transfer of control for a premium. This investment advisory contract premium is analogous to the sale of

¹⁷¹ For an example of the conspiracy analogy as the basis for attacking both the seller and purchaser of control, see *Mayflower Hotel Stockholders Protective Comm. v. Mayflower Hotel Corp.*, 193 F.2d 666, 668-71 (D.C. Cir. 1951).

¹⁷² 15 U.S.C. §§ 80a-1 to 80a-52 (1970 & Supp. V 1975).

¹⁷³ See text accompanying notes 60-62 *supra*.

¹⁷⁴ 15 U.S.C. § 80a-2(a)(4) (1970).

¹⁷⁵ *Id.* § 80a-15(a)(4) (1970).

a corporate office insofar as the former adviser is receiving a premium for choosing its successor, a decision that, at least in form, lies in the hands of the investment company's directors and shareholders. Absent the Act's provisions, this premium might be prohibited by the common law of most states.

The Act's current provisions on control premiums were added in 1975 in response to the uncertainty generated by decisions under the prior law. These amendments, though only a minor segment of the Securities Acts Amendments of 1975,¹⁷⁶ are significant because they are the only direct congressional statement on control premiums, though not in the conventional control premium context.

Two judicial decisions provided the backdrop to the 1975 Amendments. In the first, *SEC v. Insurance Securities, Inc.*,¹⁷⁷ the Ninth Circuit refused an injunction sought by the SEC against the sale of a controlling interest in the defendant investment adviser at a price more than twenty-five times the net asset value. The court looked to the Investment Company Act's silence on the issue and reasoned that Congress had determined that section 15(a)(4)'s requirement that the investment company renew the advisory contract provides adequate protection against the potential abuses resulting from this type of transaction.¹⁷⁸ The court concluded that the SEC had not shown the "gross misconduct" or "gross abuse" then required by the Act¹⁷⁹ for suits instituted by the Commission.¹⁸⁰ Subsequently, in the 1970 Securities Acts Amendments, Congress deleted the "gross misconduct" and "gross abuse" language and allowed the SEC to bring suit when there is "a breach of fiduciary duty involving personal misconduct in respect of any registered investment company."¹⁸¹

In the second decision, *Rosenfeld v. Black*,¹⁸² the share-

¹⁷⁶ Act of June 4, 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975).

¹⁷⁷ 254 F.2d 642 (9th Cir. 1958).

¹⁷⁸ *Id.* at 651. The court also stated that a significant portion of the sale price was based on anticipation of future fees from the investment company pursuant to the advisory contract and that such profits are not an asset of the investment company. Thus, receipt of a premium could not constitute a breach of the fiduciary duty not to profit from the sale of a corporate asset. *Id.* at 650-51.

¹⁷⁹ Investment Company Act of 1940, ch. 686, tit. I, § 36, 54 Stat. 841 (current version at 15 U.S.C. § 80a-35(a) (1970)).

¹⁸⁰ 254 F.2d at 651.

¹⁸¹ 15 U.S.C. § 80a-35(a) (1970) (amending Investment Company Act of 1940, ch. 686, tit. I, § 36, 54 Stat. 841).

¹⁸² 445 F.2d 1337 (2d Cir. 1971), *cert. dismissed sub nom. Lazard Freres & Co. v. Rosenfeld*, 409 U.S. 802 (1972).

holders of the Lazard Fund sued the fund's former investment adviser to recover a premium received in consideration for assignment of the advisory contract. The Second Circuit reversed the District Court's grant of summary judgment for the defendants. The court's opinion does not make clear the precise basis of this decision,¹⁸³ but it does contain broad statements concerning the investment adviser's fiduciary duty and corresponding obligation not to profit personally from a sale of its office.¹⁸⁴

Shortly after the *Rosenfeld* decision, SEC Chairman William J. Casey indicated that a broad reading of the Second Circuit's opinion might impose an undue hardship on the investment company industry and that perhaps some corrective legislation was needed.¹⁸⁵ The Investment Company Institute (ICI), an industry trade association, responded quickly by submitting to the Senate a proposed amendment to section 15 of the Act that would expressly sanction the receipt of a premium by the outgoing investment adviser unless the result would be to impose an "unfair burden" upon the underlying investment company.¹⁸⁶

The SEC decided that the "unfair burden" standard, by itself, did not adequately resolve the existing uncertainty and decided to submit its own draft legislation.¹⁸⁷ The ensuing proposal, submitted to both the House and Senate,¹⁸⁸ sanctioned the receipt of any consideration for the assignment of the advisory contract subject to certain conditions. The proposed legislation required an independent board of directors for five years and

¹⁸³ The opinion could be read as supporting recovery for a direct violation of the Investment Company Act, *id.* at 1344-48, for violation of common law principles of fiduciary obligations as defined by the Investment Company Act, *id.* at 1342, for violation of the proxy rules of the 1934 Exchange Act, *id.* at 1349, or for any combination of the above.

¹⁸⁴ For example:

If Lazard did not wish to continue as advisor and chose to recommend a successor and assist in the latter's installation, it was obliged to forego personal gain from the change of office, no matter how deeply or rightly it was convinced it had made the best possible choice. It is wholly immaterial that the prospect of receiving future management fees if it had continued as an adviser would have been an asset of Lazard rather than of the Fund . . .

Id. at 1343 (footnote omitted).

¹⁸⁵ N.Y. Times, Sept. 12, 1971, § 3, at 3, col. 1. See generally, Markham, *The Sale of Advisory Contracts—Rosenfeld v. Black*, 19 N.Y.L.F. 61, 75-81 (1973) (discussion of the background of the congressional action and an examination of the *Rosenfeld* issue).

¹⁸⁶ The proposal is quoted by the Second Circuit in *Newman v. Stein*, 464 F.2d 689, 695-96 (2d Cir. 1972).

¹⁸⁷ Letter from SEC Chairman William J. Casey to Senator Harrison J. Williams, Jr. (Mar. 10, 1972), reprinted in [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,671 [hereinafter cited as Letter].

¹⁸⁸ H.R. 15304, 92d Cong., 2d Sess. (1972); S. 3681, 92d Cong., 2d Sess. (1972).

incorporated the "unfair burden" proviso, although without the precise definition that the Chairman had promised in his March 1972 letter to the Senate.¹⁸⁹

Senator Williams greeted the SEC proposal with enthusiasm and with embellishments.¹⁹⁰ Under the Williams legislation, in order to retain the advisory contract transfer premium it would have to be shown that no "unfair burden" resulted and that three-fourths of the investment company's board were independent of the predecessor or successor investment adviser. The SEC considered this solution satisfactory insofar as the bill "resolved" the "uncertainty created by the possible implications of the *Rosenfeld* decision."¹⁹¹

The Senate passed the proposed amendment to section 15 in 1973, and the bill was introduced in the House.¹⁹² The bill was reintroduced and was eventually passed by both the Senate and the House as a part of the Securities Acts Amendments of 1975.¹⁹³ Thus, the Act permits receipt of such a premium only if two conditions are met. First, seventy-five percent of the fund's board must be composed of independent directors for a period of three years after the contract's assignment.¹⁹⁴ More specifically, three-quarters of the directors must not be "interested persons" of the old or new advisory company.¹⁹⁵ This provision was designed to safeguard the fund's shareholders against self-dealing by either the old or new investment adviser.¹⁹⁶ The provision may fall short of its mark because it is limited to directors and does not preclude "interested persons" from functioning as officers of the fund. Also, although protection at the board level

¹⁸⁹ Letter, *supra* note 187.

¹⁹⁰ S. 4071, 92d Cong., 2d Sess. (1972) (reintroduced as S. 470, 93d Cong., 1st Sess. (1973)). See *Hearings on S. 470 and S. 488 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 93d Cong., 1st Sess. (1973) [hereinafter cited as *1973 Senate Hearings*]. For a critical comparison of this and the SEC's earlier version, see Markham, *supra* note 185, at 77-80.

¹⁹¹ *1973 Senate Hearings*, *supra* note 190, at 230.

¹⁹² H.R. 10570, 92d Cong., 2d Sess. (1974).

¹⁹³ Act of June 4, 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975). The Investment Act amendment is codified at 15 U.S.C. § 80a-15(f)(1) (Supp. V 1975).

¹⁹⁴ 15 U.S.C. § 80(a)-15(f)(A) (Supp. V 1975).

¹⁹⁵ "Interested person" is defined in § 2(a)(19) of the Act, 15 U.S.C. § 80a-2(a)(19) (1970), and includes employees, officers, and agents of the investment company; but such status is not attained merely by owning stock or holding a director's seat. An interested person of an investment adviser, on the other hand, expressly includes any controlling person of the adviser or any person who knowingly has a beneficial interest in a security issued by the adviser. 15 U.S.C. § 80a-2(a)(19)(B)(iii) (1970).

¹⁹⁶ E.g., SENATE COMM. ON BANKING AND URBAN AFFAIRS, REPORT ON THE SECURITIES ACTS AMENDMENTS OF 1975, S. REP. NO. 94-75, 94th Cong., 1st Sess. 74 (1975).

is seemingly substantial because the board is charged with the management of the investment company, it is a very thin shield given the SEC's finding that general industry practice allows the adviser to perform the roles traditionally carried out by a company's board of directors.¹⁹⁷

The second condition to the validity of a control premium is that "there is not imposed an *unfair burden* on such company as a result of such transaction or any express or implied terms, conditions, or understandings applicable thereto."¹⁹⁸ Once again we are faced with the magic words without an explicit definition. The only proper conclusion is that Congress has decided to leave the decision to the courts, for the closest the Act comes to providing some meaning for "unfair burden" is in an example provided by section 15(f)(2)(B):

For the purpose of paragraph (1)(B) of this subsection, an unfair burden on a registered investment company includes any arrangement, during the two-year period after the date on which any such transaction occurs, whereby the investment adviser or corporate trustee or predecessor or successor investment advisers or corporate trustee or any interested person of any such adviser or any such corporate trustee receives or is entitled to receive any compensation directly or indirectly (i) from any person in connection with the purchase or sale of securities or other property to, from, or on behalf of such company, other than bona fide ordinary compensation as principal underwriter for such company, or (ii) from such company or its security holders for other than bona fide investment advisory or other services.¹⁹⁹

The subsection's language fails to give even a clear indication of the parameters of "bona fide ordinary compensation."

¹⁹⁷ REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. (1966).

¹⁹⁸ 15 U.S.C. § 80a-15(f)(1)(B) (Supp. V 1975) (emphasis supplied).

¹⁹⁹ *Id.* § 80a-15(f)(2)(B) (Supp. V 1975). In one of its legislative memoranda, the Commission gave one example of the type of non-bona-fide compensation at which the subsection is directed: "Such a burden could arise, for example, where the transaction involves an arrangement entitling an interested person of an investment adviser to receive brokerage commissions for executing the investment company's portfolio transactions." *Hearings on H.R. 10570 and H.R. 13986 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 93d Cong., 2d Sess. 39 (1974). Once again, would not such an arrangement clearly be violative of the adviser's fiduciary obligations even without this provision?

An adviser cannot loot the underlying fund without violating subsection (2)(B); but such action would almost certainly violate the high fiduciary standards embodied in the rest of the 1940 legislation. Clearly, Congress did not intend that this example exhaust the class of transactions that impose an "unfair burden" because the subsection provides only that this class "includes" the arrangements for non-bona-fide compensation. Thus, the question what other transactions impose an "unfair burden" remains.

The key question is whether the "unfair burden" safeguard can be employed to put a check on excessive premiums without any direct evidence of the foregoing type of arrangements between the outgoing and incoming advisers. A court could still utilize the analysis employed in *Perlman* and its progeny to determine whether there is an "unfair burden"—by establishing what would be the fair value of expected future "bona fide" adviser remuneration and then viewing any excess as an "unfair burden" under subsection (f)(1)(B). An alternative is to consider such an excess in the transfer price as raising a presumption in favor of the existence of the type of arrangement expressly forbidden under the terms of subsection (f)(2)(B), thereby placing the burden on the seller and purchaser of control to prove the fairness of the transaction. In effect, this would impose a fiduciary duty on those involved in the transfer of control in the advisory corporation.²⁰⁰ The possibility remains, however, that courts, through overreliance on section 15(f)(2)(B), may insulate control premiums from any effective attack. The trend of the future is therefore unpredictable.

V. CONCLUSION—AN ECLECTIC PROPOSAL

The courts' refusal to adopt the Berle-Bayne approach that control premiums are per se invalid has left an analytical morass of hybrid theories that may be utilized to recapture a control premium. Each theory may seem justified by the facts of a particular case, but when considered collectively, they fall far short of forming a coherent body of law. The absence of a consistent framework has resulted in a series of obstacles for the unwary corporate planner as well as some tools for the wily corporate litigator. More than forty years have passed since Berle's initial

²⁰⁰ See text accompanying note 21 *supra*.

articulation of his corporate asset theory²⁰¹ and more than thirty years since the first modern day control premium cases.²⁰² The time has come for the courts and/or Congress and state legislatures to establish order in the law relating to control premiums.

The judicial inconsistency may be attributable to the courts' failure to agree upon a general treatment of control premiums. The courts have yet to decide whether the Berle-Bayne analysis really warrants acceptance. Although there has been a universal rejection of the *per se* approach,²⁰³ both the judicial and legislative treatment have shown great concern with the abuses that frequently accompany control transfer situations. The courts and legislatures have apparently accepted some of the theoretical underpinnings of the theories of Professors Berle and Bayne, although rejecting their ultimate solutions.

The increasing willingness of courts to invalidate control premiums²⁰⁴ reflects a growing affinity to the Berle-Bayne analysis. Yet rather than face the problem directly, the courts have found premiums invalid by stretching and distorting the more traditional theories of insider liability such as the wasting of a distinct corporate asset or the taking of a corporate opportunity. The refusal of the courts to adhere to the *per se* approach can be traced to their continued sensitivity to the poignant arguments that some control premiums represent legitimate economic rewards and not the oppression of minority shareholders.²⁰⁵

Predictability for the corporate practitioner can be accomplished by following the advice of Professor Andrews²⁰⁶ and fashioning all control transfer transactions in the mode of a tender offer to all on a *pro rata* basis. This fails to take account of the economic arguments in favor of the premium, even though it does guarantee that the controlling shareholder will realize a larger *per capita* share of the control premium than would the

²⁰¹ A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

²⁰² *E.g.*, *Insuranshares Corp. v. Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa. 1940); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (Sup. Ct. 1941); *see text accompanying notes 42-44 & 56-59 supra*.

²⁰³ *See text accompanying notes 2-5 supra*.

²⁰⁴ *E.g.*, *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); *Donahue v. Rodd Electrotypes Co.*, 75 Mass. Adv. Sh. 1295, 328 N.E.2d 505 (1975); *see text accompanying notes 74-93 supra*.

²⁰⁵ *See Andrews, supra note 1*, at 526.

²⁰⁶ *Id.*

other tendering shareholders. Any other solution by a corporate planner today would present a risk that the control transaction might be attacked on the basis of any of the potential weapons previously discussed.

The courts could preserve a large degree of the needed flexibility while increasing predictability of result by isolating particular situations suitable for a *per se* approach and instituting safeguards in other cases that would permit the retention of a premium without prejudicing the rights of the minority shareholders or the corporate entity. When the potential for abuse is great, the *per se* approach should be adopted.

Sales of control in the very closely held concern such as the incorporated family business or farm is one such context. When there are only a few shareholders, often no practically ascertainable market value can fairly be placed on the shares. Accordingly, it would be impractical for the courts to try to determine what portion of a premium is reasonable. The increasing realization that the family corporate venture warrants partnership-like treatment in several respects²⁰⁷ provides additional support for the adoption of the *per se* recapture rule for control premiums in this context. In a partnership, the controlling general partner cannot in practice transfer his or her interest without obtaining the consent of all remaining partners.²⁰⁸ Prohibiting the sale of a controlling block in a very closely held corporation for more than its *per share* value, unless, of course, the same offer is made to all shareholders, protects the minority while preserving the reasonably free transferability of corporate equity interests.

Even in the absence of such a judicially enforced rule, corporate counsel representing the minority interests can achieve similar protection through the use of restrictions on share transfers, such as calling for a right of first refusal.²⁰⁹ Similarly, such

²⁰⁷ See text accompanying notes 88-94 *supra*. For an explanation of the availability of partnership tax treatment to closely held corporations under subchapter S, see 1 Z. CAVITCH, BUSINESS ORGANIZATIONS § 3.01 [22] (1976).

²⁰⁸ Although the Uniform Partnership Act provides that a conveyance of a partner's interest does not of itself dissolve a general partnership, UNIFORM PARTNERSHIP ACT § 27(a), the remaining partners may agree to dissolve the partnership without breach of contract, *id.* § 31(1)(c). Thus, a general partner selling a controlling interest in the partnership needs the consent of the remaining partners to prevent dissolution. The retirement, death, or insanity of a general partner dissolves a limited partnership, unless the business is continued by the remaining general partners either under a right to do so stated in the certificate, or with the consent of all members. UNIFORM LIMITED PARTNERSHIP ACT § 20.

²⁰⁹ Other types of transfer restraints include buy-out arrangements and redemption

restrictions should also be drafted to reflect the minority's right to share in the control premium in the event that they elect not to exercise their rights to maintain family or existing ownership. Adoption of the *per se* approach would encourage such arrangements to avoid the need for litigation over whether a given sale price represents a control premium.

At the other end of the spectrum, a similarly objective approach is also warranted. The potential unfairness is equally serious in sales of control of large publicly held corporations. The Williams Act clearly evidences concern for open-market acquisitions of control, and similar considerations would appear to call for regulation of all control premium situations involving companies large enough to be subject to the Exchange Act's reporting requirements.²¹⁰ Although all such control transactions are arguably subject to scrutiny under 10b-5,²¹¹ the availability of private 10b-5 damage actions in this area is limited, and decisions under the rule have not supplied the desired level of predictability. Expansion of the Williams Act to cover every control-related transaction would achieve a desirable balance. The antifraud provisions of section 14(e)²¹² provide the same type of flexibility—and hence unpredictability—as would rule 10b-5, while the other reporting and disclosure provisions of the Williams Act would provide at least a minimum level of protection for other investors.

The intentional open-endedness of the statutory definition of "tender offer" would permit adoption of the proposed expansion through judicial interpretation of the statute's reach. It would be preferable, however, for the SEC or Congress to define "tender offer" as extending to all control premium situations involving a reporting company. Without necessarily resolving the ultimate question whether the premium should be disgorged, this would guarantee adequate safeguards through the disclosure rules as well as through the procedures for making the "tender offer"—or, as proposed here, the "control transaction." The existence of a readily identifiable market for the shares of a reporting company, unlike the very closely held concern discussed above, would render the isolation of a "reasonable pre-

provisions in the share certificates. *See generally, e.g.,* 2 F. O'NEAL, *supra* note 1, at §§ 7.01-17.

²¹⁰ 15 U.S.C. § 78l(g)(1) (1970).

²¹¹ *See* text accompanying notes 107-30 *supra*.

²¹² 15 U.S.C. § 78n(e) (1970).

mium" more practical, thus obviating the need for a *per se* approach.

The foregoing suggestions cover two extremes—the very large corporation and the very small. The remaining question is how to treat a corporation that has more than a handful of shareholders but that is not of such substantial size nor so widely held as to be a reporting company under the 1934 Act. One possibility would be to leave this vast middle ground to the numerous common law doctrines as they now exist. This could be supported on the theory that any more predictability would result in an undue reduction of flexibility. An equally effective balance could be maintained by using the approach taken in the recent amendments to the Investment Company Act.²¹³ The result would be accomplished by incorporating the Act's subjective safeguards as embodied in the "unfair burden" standard and by looking to the more objective requirement of an independent board of directors for a stated period of years following the control premium transaction.

This independent board of directors would not deny the control purchaser representation on the board. It would, however, provide an additional check against self-dealing. Because the control purchaser would still be in a position to introduce new corporate policies, the valid purposes that might lead such a purchaser to pay a premium would be preserved. On the other side of the balance, the disinterested board of directors could prevent many of the types of mismanagement that have confronted the courts in the control premium cases.²¹⁴

An independent board could be defined as one in which three-quarters or, alternatively, two-thirds of its members owe no allegiance to either the control seller or the control purchaser. Although all directors are bound to make their decisions solely for the corporation's benefit, the exigencies of the situation clearly call for closer scrutiny. The membership of such an independent board could be selected according to standards that parallel those of the Investment Company Act. Whereas the Act's protections are embodied in its concept of "interested persons," the analogous standard here would require that the independent directors have neither familial, pecuniary, nor other

²¹³ See text accompanying notes 194-200 *supra*.

²¹⁴ See, e.g., *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (Sup. Ct. 1941), discussed at text accompanying notes 56-59 *supra*.

business affiliation with either the control purchaser or the control seller. Although this restriction may seem harsh, it would not apply to the whole board and would be of limited duration—perhaps the Investment Company Act's three year period. Additionally, the need for such an independent board would be obviated were the minority invited to participate in the control transaction on a pro rata basis.

As in the investment company context,²¹⁵ this method of protection can be viewed as relatively hollow to the extent that it is concerned with the form of the transaction rather than the substance. In the investment company context, however, the functions of the board have been largely preempted by the investment adviser,²¹⁶ the very entity from which protection is needed. In the conventional corporate context, looting or the appropriation of a corporate opportunity would ordinarily be accomplished by the corporation's officers or directors. Although directors have little control over officers' actions on a day-to-day basis, an independent board of directors should be able to prevent the grosser forms of abuse present in many of the cases.²¹⁷ Also, the independent board is only one safeguard; control transactions are not insulated from attack merely by complying with that requirement.

Placing checks on the actions of the control purchaser makes it less likely that the premium will reflect anything other than what the courts would call reasonable under traditional analysis. In addition, this proposal could be supplemented by a requirement that the premium or a substantial portion thereof, when not offered pro rata to the minority, be held by the control seller in constructive trust for the minority shareholders for the same three-year period. The seller might be required to establish some type of escrow arrangement for the premium or the assets in which the seller chose to invest. Although this varies substantially from Professor Bayne's *strict* trust theory, it is a limited vehicle for providing much of the protection he advocates. The minority could seek an accounting from the constructive trust if any of the abuses associated with control premiums occur during the three-year period.

This proposed remedial scheme would provide the final

²¹⁵ See text accompanying note 197 *supra*.

²¹⁶ *Id.*

²¹⁷ See, e.g., *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976).

protection of applying an "unfair burden" concept similar to that now contained in the Investment Company Act.²¹⁸ The premium would be subject to recapture when there is an inherent unfairness in the transaction. This, in effect, adopts the *Zahn-Ahmanson* position that the controlling shareholder is under a fiduciary duty to the corporation and the other shareholders, at least when the shareholder is selling control.²¹⁹ The "inherent unfairness" standard is the key to providing the necessary flexibility in dealing with control premium situations. Courts could then attack the substance of the transaction in the extreme cases in which compliance with the form outlined above would not be sufficient and in which the transaction turns sour after expiration of the three-year period.

These protections would fill the gap between the per se rule in the case of the very closely held corporation and the expanded Williams Act type of coverage that would apply to the public issue company. Adoption of this aspect of the proposal could best be implemented by means of state legislation. In the absence of such legislation, corporate practitioners could achieve the same protections by patterning control transfers according to these suggested guidelines.

Twenty years ago Professor Jennings lamented the "meandering" path of the law governing control-related transaction.²²⁰ Although today's path may be longer and wider, it is no less tortuous. This uncertainty in the law has resulted in the emergence of a variety of approaches to the control premium problem. State law treatment of the issue has dealt mainly with the extent to which the controlling shareholders owe a fiduciary duty. The most significant recent state law development is special treatment for closely held corporations. Federal securities law also plays an important role in dealing with the control issue. Although the possibility of relief through a private 10b-5 damage action is not great, the Williams Act's disclosure and pro rata offering requirements may provide new remedies for the minority, either directly or by analogy. The Investment Company Act's response to the control premium problem in the context of

²¹⁸ See text accompanying notes 187-200 *supra*.

²¹⁹ See text accompanying notes 74-80 *supra*. Although *Ahmanson* probably does not state the majority rule on the duties of controlling shareholders, it is part of the trend towards closer scrutiny of control transactions. See text accompanying notes 39 & 204 *supra*.

²²⁰ Jennings, *supra* note 1, at 38.

transfers of an investment advisory contract—especially the Act’s “unfair burden” standard, the requirement of an independent board, and the imposition of liability on the purchaser of control—should be useful in fashioning safeguards and remedies in the conventional control premium situation.

The proposal stated above is an attempt to combine these approaches while maintaining two important balances. First, the minority shareholder’s need for protection from oppression by the majority must be balanced against the majority’s right to the full economic value of their holdings. Second, providing a reasonable amount of predictability in the law on control premiums must be balanced against leaving the courts sufficient flexibility to heed the equities of the individual case. It is time for the courts and legislatures, whether through this proposal or another, to provide the necessary balance to the law governing control transactions.