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Corporations—Purchase by a Corporation of Its Own Capital Stock—Business Judgment Rule.—Propp v. Sadacca

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CASE NOTES

It is submitted that too often judicial metaphysics is the basis upon which the taxing power of a state is made to stand or fall, rather than the economic and fiscal realities of the situation. The decision at hand is a prime example of such an uneconomic result. By upholding the validity of the Washington levy, the instant court has subjected interstate commerce to the burden of paying the Washington business and occupation tax on the gross revenue of such organizations as WOSCA, *over and above* the tax paid by the various independent contractors doing the actual loading, unloading, and segregation. It must be remembered that WOSCA is a non-profit organization and, therefore, any imposition cannot be absorbed, but must be passed directly and fully to purchasing members by increasing the costs of the interstate shipments.

STUART R. ROSS

Corporations—Purchase by a Corporation of Its Own Capital Stock—Business Judgment Rule.—*Propp v. Sadacca*.¹—Textron, Inc., sought to gain control of American Screw Company, a company in which Noma Lites, Inc., held a substantial interest. Textron was unsuccessful because Noma, through the efforts of one Sadacca, the chairman of the board of directors of Noma, bought enough stock to insure its control. The chairman of Textron² then informed Sadacca that, though Textron could not gain control of American directly, it could acquire it indirectly by gaining control of Noma, and that it was prepared so to do. Sadacca then purchased on the open market on November 24 and 26, 1958, 199,000 shares of Noma common stock. These purchases of Noma stock were made with the purpose of preventing this acquisition of control by Textron, and without the knowledge or consent of the president or directors of Noma. Three days later, at a special meeting of the board of directors, Sadacca's purchase was ratified and financing arranged. This took place in the approximate time of three and one-half hours. Plaintiff, a shareholder of Noma, brought this action for an accounting. HELD: The business judgment rule is no defense where the purchase and ratification were made in a "precipitate and impulsive manner" without due and careful consideration of the problems involved.

A Delaware corporation may purchase shares of its own capital stock unless such purchase will impair the capital of the corporation.³ In the instant case the question of capital impairment apparently was not raised. No determination was made by the court whether this purchase did or did not, in fact, impair the capital. The main issue presented, then, was the extent to which the business judgment rule precluded judicial inquiry into corporate decisions. The court reasoned that although a corporation has a

¹ 175 A.2d 33 (Del. Ch. 1961).

² Chairman of Textron at that time was Mr. Royal Little, whom defendant claims was a "known liquidator."

³ Del. Code Ann. tit. 8, § 160 (1953); *In re International Radiator Co.*, 10 Del. Ch. 358, 92 Atl. 255 (1914).

right to purchase its own stock, that right is not absolute, even assuming no capital impairment, and a board of directors may not expect the wisdom of their decision to go completely unchallenged. As the court pointed out, the area is a "delicate" one and requires the "utmost in good faith and judgment."⁴

It seems clear that courts will not undertake, generally, to review decisions of a board of directors regarding business transactions. Review is undertaken, however, where fraud or misconduct by the directors is shown.⁵ Plaintiff in the instant case alleged misconduct in attacking Sadacca's relationship with the other directors by stating that the entire scheme was designed to perpetuate Sadacca's control of the corporation. Although the court specifically found that no fraud was shown,⁶ it made no definite decision as to the allegation of misconduct. Certain statements made by the court, however, compel the conclusion that the charge of misconduct was implicitly rejected.⁷

Another Delaware case, *Kors v. Carey*,⁸ was the leading precedent in this area. It involved a similar fact situation which was distinguished by the court primarily on the basis of the time involved between awareness of the threat to the corporation and the stock purchase. In that case, the company considered all possible alternatives, consulting with leading business advisors.⁹ Here, however, there was no such extensive consideration of the facts. Noma's only choice, after the purchase by Sadacca, was either ratification or rejection of his actions, and the court found that there was no real "business judgment" involved since the board did not consider rejection. It seems impossible to believe, however, that the directors could have avoided at least some thought of rejection and of the consequences which would follow therefrom.¹⁰ Accepting the fact that it was probably a cursory consideration for the majority of the directors, it would still seem unjustified to decide that there was an absence of consideration. Apparently then, the basis for judicial intervention in the instant case was the fact that sufficient time was not spent in considering the problems involved. Were there some proof of fraud or misconduct, it would seem unquestionable that the business judgment rule could not be invoked as a defense. On the other hand, if Noma's

⁴ "The purchase by a corporation of its own shares is the type of transaction in which creditors or stockholders may be prejudiced even though the purchase be made in good faith." 175 A.2d at 38.

⁵ *Blish v. Thompson Automatic Arms Corp.* 64 A.2d 581 (Del. Ch. 1948); *Casey v. Woodruff*, 49 N.Y.S.2d 625 (Sup. Ct. 1944). See also *Ballantine, Corporations* § 63(a) (1946).

⁶ 175 A.2d at 37-38.

⁷ *Id.* at 38.

⁸ 158 A.2d 136 (Del. Ch. 1960).

⁹ "While the actual decision to buy out United Whelan was arrived at quickly late in January 1958, the factors which went into the decision had been carefully weighed and evaluated. . . ." *Id.* at 141.

¹⁰ As the defendant pointed out, the consequences of rejection could have been catastrophic as far as Noma was concerned. Payment was due on the following Monday, and if it were not forthcoming, the brokers could have dumped the stock on the market, and then sued to recover any losses.

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board had spent more time in contemplation of their action, or considered in more detail rejection of Sadacca's purchase, the rule might have been effectively invoked. But if the time element is to be used as a criterion, it will open many problem areas as to what is sufficient contemplation to constitute the exercise of good business judgment. Should a corporation, presented with an external threat to its existence, consult the Harvard Business School, as was done in the *Kors*¹¹ case, before taking action? Or, should they be wary of making up their minds in a short time for fear of having their action termed "impulsive," and therefore be unable to contend that they exercised sound business judgment? The answer to both of these questions should, of course, be in the negative. Here is an area where prompt action indeed may be a necessity, and in many cases it may be apparent that the corporation must take prompt and effective action to protect itself from the external threat. The outsider also may be prepared to enter the market and purchase a controlling block of stock. Thus, unless the corporation acts quickly, it could discover that its deliberations have been in vain.

This case is now on appeal to the Supreme Court of Delaware. Hopefully the decision will be reversed, and the court will adopt the view expressed in *Banker's Security Corp. v. Kresge Dept. Stores, Inc.*,¹² wherein the court said:

When a Delaware corporation purchases its own stock, this is a matter entirely within the discretion of its board of directors and a court should not interfere with such a transaction unless there is misconduct or fraud on the part of the board of directors.¹³

As was pointed out earlier, by deciding this case on the basis of the lack of sufficient consideration given to the action, the court creates serious problems, especially when considering a criterion for what is adequate. The business judgment rule is founded upon the theory that the courts, who are generally much less familiar with the business world, should not substitute their judgment for that of the directors.¹⁴ This is what the court has done here; while it has not decided whether or not Sadacca's actions were well-advised, the court has determined that the directors did not give the matter sufficient reflection. To this extent the court has supplanted the judgment of the directors who are responsible for the management of the corporation. In the absence of a finding of misconduct or fraud, the reasoning supporting the decision seems to be a weak reed upon which to lean.

DAVID W. CURTIS

¹¹ *Supra* note 8.

¹² 54 F. Supp. 378 (D. Del. 1944).

¹³ *Id.* at 378.

¹⁴ *Kroese v. General Steel Casting*, 179 F.2d 760 (3d Cir. 1949); *Warren v. 536 Broad Street Corp.*, 4 N.J. Super. 584, 68 A.2d 175 (1949).