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Corporations—Sale of Stock—Condition for the Transfer of Directorship Control.—Essex University Corp. v. Yates

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Corporations—Sale of Stock—Condition for the Transfer of Directorship Control.—*Essex University Corp. v. Yates*.¹—The defendant, Yates, was president of the board of directors of Republic Pictures Corporation, a New York corporation having 2,004,190 shares of common stock outstanding. On August 28, 1957 the defendant entered into a contract with Joseph Harris, the president of Essex Universal Corporation, whereby Essex agreed to buy and Yates to sell 566,223 shares, or 28.3 per cent of the Republic stock. The price was eight dollars a share, approximately two dollars above the then market price. A condition was attached to the contract whereby the seller would obtain the agreement of the majority of the directors of Republic to a process of seriatim resignation, each in turn being replaced by the Essex nominee. At the agreed date of performance the defendant (seller) refused to perform. Essex then brought an action for breach of contract in the New York Supreme Court, and it was removed to the United States District Court on the basis of diversity of citizenship. The District Court rendered summary judgment for the defendant on the ground that the condition for the transfer of directorship control was invalid as against public policy. On appeal to the United States Court of Appeals for the Second Circuit, HELD: The condition for transfer of directors was not, under New York law, per se invalid as against public policy.

The court was faced with the difficult question of determining, not what the law of New York should be, but what it is. The court recognized the fact that there is hardly enough New York authority for an informed prediction of what the New York Court of Appeals would decide on the facts here presented. In resolving this question the court refers initially to the early New York Court of Appeals decision of *Barnes v. Brown*² which held that the owner of a majority interest may properly, in connection with a sale of his shares agree with the buyer to procure the resignation of directors to facilitate or accelerate the transfer of control by the buyer. Judge Earl stated:

[The seller] had the right to sell out all his stock and interest in the corporation . . . and when he ceased to have any interest in the corporation, it was certainly legitimate and right that he should cease to control it. . . . It was simply the mode of transferring the control of the corporation to those who by the policy of the law ought to have it, and I am unable to see how any policy of the law was violated, or in what way, upon the evidence, any wrong was thereby done to anyone.

While in the *Barnes* case no term of the contract³ of sale required the seller to effectuate the immediate replacement of directors, as did the contract in the present case, the *Barnes* court stated, "I shall assume that it was the understanding and a part of the scheme that he should do so."⁴

¹ 305 F.2d 572 (2d Cir. 1962).

² 80 N.Y. 527 (1880).

³ Id. at 537.

⁴ Id. at 536.

As the agreement in *Barnes* was justified by the rationale that the transfer of the directorships was inevitable in a transfer of a majority of the stock and that the parties thus could facilitate the inevitable, the court's reliance on this case implies that today, in a large public issue corporation, a holding of 28.3 per cent of stock would be tantamount to majority control. Each of the three justices wrote a separate opinion. Judge Lombard, in his opinion, applied a "practical-certainty" test. He said that if, at the trial level, it could be found that a certain percentage of shares would in fact amount to control then the condition in the contract would be valid. Judge Clark however felt that twenty-eight per cent equals control and this should not be an issue at the trial level. Judge Friendly, while disagreeing with the rationale of Lombard and Clark, stated that, "although [*Barnes*] dealt with the sale of a majority interest, I am unable to find any real indication that the doctrine there announced has been thus limited . . . to indicate that New York would not apply the [*Barnes*] doctrine to a case where a stockholder conditioned a sale on his causing the resignation of a majority of the directors and the election of the purchaser's nominees."⁵

Although it may be true that the New York courts have not specifically overruled *Barnes v. Brown*, there are strong inferences that the 1880 doctrine is outmoded due to the evolution of corporate law and theory.

The early conventional approach of the *Barnes* court and of the decisions relying thereon⁶ was to regard controlling shares as an ordinary asset which corporate managers may buy and sell with the same freedom which the law permits with respect to other kinds of property.⁷ This approach is predicated upon the notion that the corporation—the collective body of shareholders—is a separate legal entity, an artificial personality, to whom an officer, a director or a controlling shareholder owes his sole duty. It followed as a necessary corollary that the controlling shareholder was not a fiduciary of and owed no duty to the outside shareholders as individuals when he sold his stock to strangers.⁸ Therefore, (under this conventional approach) the controlling shareholder could sell to any person, at any time and at any price.⁹

An examination of the recent New York cases will disclose a current trend in the law to prevent abuse of power on the sale of control. These cases show that the conventional approach of the *Barnes* court, which was used as authority by the present court in reaching its decision, has not only been generally discredited, but has been by implication discarded.

The Supreme Court of New York, in the case of *Ballantine v. Ferretti*,

⁵ 305 F.2d at 582.

⁶ *Roosevelt v. Hamblin*, 199 Mass. 127, 85 N.E. 98 (1908); *San Remo Copper Mining Co. v. Moneuse*, 149 App. Div. 26, 133 N.Y. Supp. 509 (1912).

⁷ *Jennings, Trading in Corporate Control*, 44 Calif. L. Rev. 1, 5 (1956); *Hill, The Sale of Controlling Shares*, 70 Harv. L. Rev. 986 (1957).

⁸ *Jennings*, supra note 7, at 6.

⁹ *Roosevelt v. Hamblin*, supra note 6; *Levy v. Feinberg*, 29 N.Y.S.2d 550 (Sup. Ct. 1941), rev'd sub nom., *Levy v. Armstrong Beverage Corp.*, 265 App. Div. 208, 38 N.Y.S.2d 517 (1942); *Stanton v. Schenck*, 140 Misc. 621, 251 N.Y. Supp. 221 (Sup. Ct. 1931). But see *Fremont v. Stone*, 42 Barb. 169 (N.Y. Sup. Ct. 1864), where the principle is qualified to the extent that the directorate may not be turned over to persons who there is reason to believe will loot the corporation.

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said in effect: Though a corporation may, under certain circumstances, pay or permit [a] third party to pay some consideration to some officers and directors to induce them to resign, sale of control by those standing in [a] fiduciary relation to the corporation may be wrongful even though [the] corporation does not complain.¹⁰ In the 1941 case of *Gerdes v. Reynolds*,¹¹ which Judge Lombard distinguished in that it "did no more than hold controlling shareholders who sold out to persons whose intentions they had reason to suspect to an accounting, after the fact,"¹² the court stated, in seeming contradiction to Judge Lombard's interpretation, that

Officers and directors always and necessarily stand in a fiduciary relation to the corporation and to its stockholders. . . . They undoubtedly may free themselves of that fiduciary relationship by ceasing to be officers and directors, but their right to resign, although sometimes stated with seeming absoluteness is qualified by their fiduciary obligation to others. . . . Neither can they accept pay in any form or guise, direct or devious, for their own resignation or for the election for others in their place. . . . [S]uch a contract cannot be made a vehicle for a violation of any fiduciary duty.¹³

In the *Gerdes* case, the liability of the four directors who sold their stock, resigned and placed the buyer's candidates in control of the directorship was asserted against them on two grounds. First, "that the sale of stock, accompanied by their resignations and the election of their successors nominated by the purchaser, was itself an *illegal* transaction because in violation of fiduciary duties owed to the corporation and the holders of its debentures and its preferred stock and its minority common stockholders."¹⁴ (Emphasis supplied.) The second reason for finding liability (*i.e.*, holding controlling shareholders who sold out to persons whose intentions they had reason to suspect to an accounting, after the fact) was the sole reason stated by Judge Lombard upon which he based his interpretation of the case. Even granting Judge Lombard's interpretation, there exists at the minimum a very strong inference that such a sale of directorship is illegal as a breach of fiduciary duty to the corporation and to the other stockholders.

The modern viewpoint, consistent with these recent New York cases, indicates that, when majority stockholders have in fact assumed the management of the corporation, they stand in a fiduciary relation to the minority.¹⁵ While they may resign, this right is qualified by their fiduciary obligation

¹⁰ 28 N.Y.S.2d 668, 680 (Sup. Ct. 1941).

¹¹ 28 N.Y.S.2d 622 (Sup. Ct. 1941).

¹² 305 F.2d at 577.

¹³ *Gerdes v. Reynolds*, supra note 11, at 651-52.

¹⁴ *Id.* at 649.

¹⁵ *Southern Pac. Co. v. Bogert*, 250 U.S. 483, 491 (1919); *Blaustein v. Pan Am. Petroleum & Transp. Co.*, 174 Misc. 601, 665, 690, 21 N.Y.S.2d 651, 711, 733 (1940); *Cleary v. Higley*, 154 Misc. 158, 168-69, 277 N.Y. Supp. 63, 76, aff'd, 246 App. Div. 698, 284 N.Y. Supp. 989 (1934); *Farmer's Loan & Trust Co. v. N.Y. & No. R.R. Co.*, 150 N.Y. 410, 430-31, 44 N.E. 1043, 1048-49 (1896); *Hornstein*, *Corporation Law & Practice* § 366 (1959); *Berle & Means*, *The Modern Corporation & Private Property* 243 (1932).

to others.¹⁶ Recent cases hold that a seller, who is a director and a dominant stockholder stands in a fiduciary relationship to the corporation and to the minority stockholders as beneficiaries thereof.¹⁷ The cases are imposing a strictly fiduciary capacity on the directors, in effect making their office a trust.¹⁸

In the fairly recent case of *Benson v. Braun* the New York Supreme Court stated that "It appears similarly probable that the sellers expected or assumed that their resignations would be requested. Such expectations or assumptions cannot be equated with the bartering of corporate offices which the law forbids."¹⁹

In recent commentary on the subject, the corporate asset theory, first advanced by Berle, has been emphasized.²⁰ The claim is "that any premium paid for a majority block of stock is paid by the purchaser because the shares carry 'control'; the purchaser is 'buying power and not stock' [Thus] 'the power going with the *control* is an asset which belongs only to the corporation. . . .'"²¹

While the 1880 case of *Barnes v. Brown* was a Court of Appeals decision and the three New York cases mentioned above²² were lower court decisions, it seems apparently clear that, while *Barnes* has not been overruled, the theory upon which its decision was based has passed from the prevailing concept of corporate law.²³ The directors are placed in office by the stock-

¹⁶ O'Neil v. City of Port Jervis, 253 N.Y. 423, 430, 171 N.E. 694, 696 (1930); Lattin, *The Law of Corporations* § 13 (1959); Jennings, *supra* note 7, at 9.

¹⁷ Pepper v. Litton, 308 U.S. 295 (1939); Southern Pac. Co. v. Bogert, 250 U.S. 483 (1919).

¹⁸ Perlman v. Feldman, 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955); Hill v. Nisbet, 100 Ind. 341, 353 (1885); Stratis v. Anderson, 254 Mass. 536, 150 N.E. 832 (1926).

¹⁹ 8 Misc. 2d 67, 71, 155 N.Y.S.2d 622, 627 (Sup. Ct. 1956).

²⁰ Berle & Means, *The Modern Corporation & Private Property* 244 (1932).

²¹ Jennings, *supra* note 7, at 9.

²² *Supra* notes 10, 11 & 19.

²³ The federal courts, in deciding a question of state law, are not necessarily bound by an early decision of the state's highest court where subsequent inferior state court decisions have consistently refused to be so bound. In *Bernhardt v. Polygraphic Co. of America*, 350 U.S. 198 (1955), faced in a diversity case with a question apparently settled by a 1910 decision of the state's highest court, the Court conformed to the early decision. However, in a concurring opinion, Mr. Justice Frankfurter suggested that a federal court might declare that the Vermont court if faced with the question at this time might reach a conclusion contrary to the 1910 decision. He argued quite forcefully that "the 1910 decision should not foreclose consideration by the federal district court of the question, and that the Court should attempt to decide what the Vermont court would do if faced with the question at this time." 350 U.S. at 211. Cf. *Mason v. American Emery Wheel Works*, 241 F.2d 906, 908 (1st Cir. 1957).

In the present case the court seemed unwilling to go beyond the 1880 decision of the New York Court of Appeals and the theory upon which it was based. Judge Friendly notes the solution to such a problem adopted in Florida, where the Supreme Court of Florida may answer questions of state law certified to it by the federal appellate courts. Fla. Rev. Stat. § 25.031 (1959); Rule 4.61 of the Supreme Court of Florida. In the absence of such an available procedure, the abstention of federal courts on questions of state law is limited to areas of sovereign prerogative, *Louisiana Power & Light Co. v. City of Thibodaux*, 360 U.S. 25 (1959), and uninterpreted state statutes, the constitutionality of which is doubtful, *Liter Minerals, Inc. v. United States*, 352 U.S. 220 (1957).

holders and a duty—a fiduciary relationship—flows down not only to the controlling shareholders but to all the stockholders. A sale of the directorships is a sale of a corporate asset and, considered as a breach of the fiduciary duty of these sellers, as directors, should not be countenanced by the law.

The trend of law today seems to be toward regarding management control as a corporate asset in which all shareholders have an equitable interest and in which they are entitled to share. On this basis the *Barnes* doctrine and the decision in the present case represent an outmoded view.²⁴

Judge Friendly's opinion in the present case is indicative of the modern approach to the director's increased fiduciary obligations:

. . . developments over the past decades seem to me to show that such a clause violates basic principles of corporate democracy. . . . A mass seriatim resignation directed by a selling stockholder, and the filling of vacancies by his henchmen at the dictation of a purchaser and without any consideration of the character of the latter's nominees, are beyond what the stockholders contemplated or should have been expected to contemplate. . . . A special meeting of stockholders to replace a board may always be called, and there could be no objection to making the closing of a purchase contingent on the results of such an election.²⁵

THOMAS J. MUNDY, JR.

Corporations—Stockholder's Rights—Inspection of the Corporate Stock Ledger.—*Trans World Airlines, Inc. v. State of Del. ex rel. Porterie*.¹—Petitioner, owner of record of one hundred shares of TWA stock, was refused permission by TWA to inspect its stock ledger. Its refusal was predicated on the contention that the petitioner was acting solely in behalf of Howard Hughes' interests which were being sued by TWA in another jurisdiction in connection with certain loans made to TWA. The airline further contended that the inspection was sought for the purpose of soliciting stockholder support for a resolution instigated by Hughes via the petitioner, recommending that it assist Hughes in prosecuting claims against certain lending institutions. Such action by TWA's management would result in an abandonment of its claims against Hughes, which TWA asserts would be inimical to the corporation. The Superior Court of Delaware granted a writ of mandamus permitting a qualified inspection of TWA's stock ledger. On

²⁴ Berle, "Control" In Corporate Law, 58 Colum. L. Rev. 1212, 1217 (1958): A third point of contact is the practically universal prohibition of contracts by directors to resign, [citing *Gerdes* case] The vice therefore of a director's contract to resign . . . at bottom rests not on the fact that such action is based on personal motives but on the simple fact that the control function is being abused. The thrust is quite simply, that directorships may not be bought and sold.

²⁵ 305 F.2d at 581.

¹ — Del. —, 183 A.2d 174 (1962).