REFLECTIONS ON THE PRACTICAL ASPECTS OF "THE SALE OF CORPORATE CONTROL"

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The famous decision of *Perlman v. Feldmann*[1] aroused a continuing debate over the numerous questions prompted by the court's treating the sale of control of a corporation as a transfer of a corporate asset or opportunity.[2] This article deals with the practical aspects of representing clients involved in sales of corporate control. Two areas of representation are considered in the analysis: litigation representation and representation of parties involved in or affected by transactions transferring corporate control. Because the article centers on the practical aspects of the sale of corporate control, theoretical aspects of the subject are not covered.[3] After a discussion of the principles underlying the corporate control rationale, three representative cases are considered, with emphasis on the practical problems confronting the lawyers participating in the transaction transferring control and in the ensuing litigation. The remainder of the article is devoted to a consideration of a number of practical problems which may be involved in a sale of corporate control situation. One major observation which is posited at various places in the article is that from a practical point of view it is impossible for a controlling share-

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1. 219 F.2d 173 (2d Cir.), *rev'g* 129 F. Supp. 162 (D. Conn. 1952), *cert. denied*, 349 U.S. 952 (1955).

2. *See* 219 F.2d at 175, 178.

3. Professor David C. Bayne of the University of Iowa Law School has written a series of articles which analyze all aspects of the problem, with particular emphasis on the theoretical rationalization of transfer of corporate control situations. For his analyses, see *A Philosophy of Corporate Control*, 112 U. PA. L. REV. 22 (1963); *The Sale of Corporate Control*, 33 FORDHAM L. REV. 583 (1965); *The Sale of Control Quandary*, 51 CORNELL L.Q. 49 (1965); *The Definition of Corporate Control*, 9 U. ST. LOUIS L.J. 445 (1965); *Corporate Control as a Strict Trustee*, 53 GEO. L.J. 543 (1965); *A Legitimate Transfer of Control: The Weyenberg Shoe—Florsheim Case Study*, 18 STAN. L. REV. 438 (1966); *The Sale-of-Control Premium: The Definition*, 53 MINN. L. REV. 485 (1969); *The Sale-of-Control Premium: The Intrinsic Illegitimacy*, 47 TEXAS L. REV. 215 (1969); *The Sale-of-Control Premium: The Disposition*, 57 CALIF. L. REV. 615 (1969).

Another article which should be cited more for its bibliography than for the conclusions reached is Connolly, Perlman v. Feldmann *and the Sale of Control—A Brief Reconsideration*, 26 BUS. LAW. 1259 (1971). Mr. Connolly seems far too optimistic in concluding that *Perlman v. Feldmann* and the cases which have followed it have not radically changed what was once thought to be the law. In addition, a recent case, Boggess v. Hogan, 328 F. Supp. 1048, 1051 n.6 (N.D. Ill. 1971), contains an extensive bibliography.

holder either to exercise his control or to transfer it if he acts solely in his capacity as a shareholder. Instead, the exercise of control and the transfer thereof necessarily involve a controlling shareholder's acting in non-shareholder, managerial capacities which entail duties to the corporation and other shareholders—an aspect of control situations which the courts have tended to overlook or to which they have paid inadequate attention.

FUNDAMENTAL ASPECTS OF CORPORATE CONTROL

What is Control?

One might assume that control can be aptly defined as one of the benefits which inhere in the ownership of a particular block of stock, that it is in the nature of an individual property right, and therefore, that it can be dcalt with and disposed of as such. The various factual situations presented by the case authorities and commentators soon make it clear that such a simple definition is not valid.

The ownership of a majority of the issued and outstanding voting stock of a corporation by a single shareholder is actually a rare factor in the cases.[4] Most of the cases involve combinations of shareholders, sometimes related by blood or marriage,[5] owning together a majority of the voting stock. There are also situations involving practical control without legal control where the non-controlling stock is sufficiently widely held that less than the ownership of a majority of the issued and outstanding stock provides practical control.[6] However, control is not limitcd to those individuals who own voting stock in a corporation. Management, *without* any stock ownership, can be capable of controlling and transferring control to other management.[7] Also, ownership of the control of one corporation may from a practical point of view constitute the power to control the management of another corporation.[8] This situation is not limited to chains of parent

4. Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969), presents one of these infrequent situations. There, H.F. Ahmanson & Co., one of the defendants, owned 4,171 shares out of a total issued and outstanding stock of 6,568 shares.

5. *See* Brown v. Halbert, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (Dist. Ct. App. 1969), where a husband and wife each owned 26.2% of the 1,000 issued and outstanding shares.

6. *See, e.g.*, Essex Universal Corp. v. Yates, 305 F.2d 572 (2d Cir. 1962) (defendant owning 28.3% of the outstanding stock of Republic Pictures Corp.); Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955) (total stock held by the Feldmann family aggregating 33% of the outstanding stock of the corporation involved).

7. *See, e.g.*, McClure v. Law, 161 N.Y. 78, 55 N.E. 388 (1899) (control of a mutual life insurance company was so transferred).

8. *See* Perlman v. Feldmann, 129 F. Supp. 162 (D. Conn. 1952), *rev'd*, 219 F.2d 173 (2d Cir. 1955).

and subsidiary corporations but may result solely from contractual arrangements whereby one corporation performs management functions for one or more other corporations.[9]

In a different context, the Securities and Exchange Commission has endeavored to define 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.[10]

This rule 405 definition, which is significant in Commission practice with respect to the contents of registration statements and prospectuses, limitations upon the transferability of securities, and the classification of persons as underwriters under the Securities Act of 1933,[11] probably comes as close as possible to expressing the essential features of the control concept. Because the definition clearly recognizes the fact that the ownership of voting securities is not necessary for control, it embraces all of the fact situations referred to above. This recognition is important, because it indicates that control, if exercised, is exercised not solely through rights vested in the shareholders as such.[12]

How is Control Exercised?

Corporation law vests the management of corporations in a board of directors. The board delegates the management functions to its officers who in turn have the power to further delegate duties and responsibilities. The legal rights of a shareholder, such as the right to vote, the right of access to information, the right to dividends and other distributions, and the right to sell and transfer the shares owned, are exactly the same whether the shareholder owns one share

9. *Compare* SEC v. Insurance Sec., Inc., 254 F.2d 642 (9th Cir. 1958) *with* Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971), *petition for cert. dismissed*, ___ U.S. ___ (1972). These cases involved the sale of control where control inhered in a management contract to manage a mutual fund.

10. 17 C.F.R. § 230.405(f) (1972). Such a broad definition could make a controlling person out of the president's wife, his mistress, or both.

11. 15 U.S.C. § 77 (1970).

12. The failure to define control in the 1933 Act was intentional, and the rule 405 definition followed Congressional intent that the term be given the broadest possible application. *See* H.R. REP. No. 1383, 73d Cong., 2d Sess. 26 (1934): "It was thought undesirable to attempt to define the term. It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exercised."

or a controlling interest. From the point of view of these rights, control does not inhere in any particular block of shares; it is derived not from the ownership of the shares but from the exercise of the voting rights of those shares at an annual or special shareholders' meeting. Viewed practically, however, the exercise of day-to-day control involves an individual's acting in a non-shareholder, managerial capacity or controlling the conduct of persons performing non-shareholder functions—that is, persons who are directors, officers, managers, or employees of the corporation. If a corporation acts or willfully refrains from acting, it does so through the agency of human beings who owe obligations to the corporation and its shareholders which are not derived from the ownership of stock.

How is Control Transferred?

The sale of control involves the transfer of the control of a going business—a complex of assets, liabilities, contractual relations, and internal and external economic conditions. Because control of a going concern is to be transferred, usually the sellers and buyers both insist on a form of transaction which (1) insures that they will not be required to deliver the agreed-upon consideration until they are confident of receiving the consideration to be furnished by the other party and (2) provides that the exchange of consideration will not have to take place if, by virtue of changes in the going business, the transaction no longer complies with the original expectations of the parties. Therefore, the typical contract of sale is quite detailed, containing provisions reciting the premises of the agreement, basic terms of the purchase and sale transaction, representations and warranties concerning the state of the business, and conditions precedent which are intended to assure that any material adverse change will constitute an excuse for withdrawing from the transaction and which are designed to prevent the seller from intentionally changing the condition of the corporate business.[13] Only when such an agreement has been signed can the parties make the preparations needed to close the transaction, such as arranging financing, complying with local legal requirements, verifying titles, and, occasionally, securing a certified audit of the corporation's finances. Thus, the contract of sale will necessarily provide that the closing take place at a specified future

13. Paradoxically, the contract in *Perlman v. Feldmann* was atypically simple. See note 25 *infra* and accompanying text.

date after all of the above-mentioned arrangements have been accomplished.

The agreement may or may not set forth the mechanics for the transfer of corporate control. Frequently, the contract of sale contains a provision that the seller will procure the resignations of the members of the board of directors currently in office and will accomplish the election of directors nominated by the buyer. Regardless of the terms of the agreement, a change in the board of directors and management personnel almost invariably occurs and is accomplished shortly before, at, or immediately after the closing. This change of command constitutes the transfer of control that must be a part of a transaction to make it a sale-of-control transaction.

How is Control Valued?

Valuation of control is a subject replete with problems, dilemmas, misconceptions, and contradictions.[14] The issue is an important one because, historically, judicial determination of the value of the stock sold has played an important role in the development of the law governing sales of control. The objective of a court in its valuation of control is to determine if the "premium for control" in a particular sale situation is a justifiable premium and therefore no wrongdoing is involved. Analysis normally begins with the proposition that stock is property freely salable by its owner, and that if stock carries with it a unique quality—the power to control—it is worth more than stock without this quality. Whether or not a justifiable premium was paid in a particular situation is ascertained by a court's determining the value of the stock sold and comparing that computed value with the price obtained. If the computed value of the controlling block of shares is less than the price received for the control stock, the illegality of the sale is established. However, if all the seller received was the fair value of what he sold, then it is assumed that he was guilty of no wrongdoing.

There are three basic methods used by experts to determine value: (1) capitalization of income; (2) replacement cost; and (3) comparable sales. Since income per share is the same for all stock of the same class, the capitalization of income method could not justify a premium. Replacement cost necessarily involves stock carrying with it the

14. See Perlman v. Feldmann, 129 F. Supp. 162, 176 (D. Conn. 1952), *rev'd*, 219 F.2d 173 (2d Cir. 1955), where the trial court extensively discussed and evaluated the evidence in determining whether an unlawful premium had been paid for control.

power to control; therefore, this method tends to merge with the comparable sales approach. If one looks to other sales to determine value, must not one also analyze each such sale to determine whether the premium there involved was "justifiable," and if it was not, discard such sale as not "comparable" for the purpose of establishing a "justifiable" premium? In deciding that another sale was comparable, the expert and the court will necessarily decide that what was done there was legal, and to the extent that the same question is present in the case before it, the court will have smuggled the conclusion into the premise.

It is extremely difficult to approach the problem of evaluating control from the point of view of appraisal techniques, particularly if the block of stock involved is not a majority block held by a single shareholder. For example, take the situation of a corporation with ten shareholders, each of whom owns ten percent of its stock. Any six of these shareholders together hold a controlling interest in the corporation. Under the theory that a controlling interest may be valued at a premium over a minority interest, the six who work together at any moment have stock that is worth more per share than the stock held by those shareholders with whom they will not work or who will not work with them. The stock of the shareholder who falls out with the control group loses value, and the stock of one who joins with the control group gains value. What is valued, then, is not a property right but rather the cooperative association of the parties involved, since this association is the sole factor that contributes the excess value. It may be noted that "conspiracy" would as aptly describe the situation as "cooperative association."[15]

Moreover, as noted above,[16] practical control may not require the concerted action of individuals holding a majority of the voting shares of the corporation—where the company is widely held, considerably less than 50 percent of the voting power is sufficient for control. Such minority control is possible primarily because most of the shareholders of widely held companies go along with the management position as set forth in the annual proxy statements.

It is the power to solicit proxies for the annual meeting through the control of the proxy solicitation machinery that perpetuates control.[17] The corporation's proxy solicitation machinery is a corporate

15. See discussion notes 45-54 *infra* and accompanying text.

16. See note 6 *supra* and accompanying text.

17. For language supporting this proposition in a frame of reference where access to the

asset operated at the corporation's expense by persons who are employed by the corporation. If the owners of the controlling block of shares confine their activities solely to those things that can be done in their capacity as shareholders, they will not be assured of perpetuating their control and they will not be able to transfer it to the purchaser of that block of stock. Because the management must act in its corporate capacity to transfer control to the buyer of the shares, one writer has referred to the premium not as the excess value attributable to the power to control, but rather as "the premium bribe."[18]

SALE OF CORPORATE CONTROL: CASE ANALYSES

Attention is given to three significant cases involving sale of control situations. *Perlman v. Feldmann*[19] is analyzed first, because it was the case that prompted an intensive study of the sale-of-control area and created a number of questions which are still unsettled today. Two recent cases, *Jones v. H.F. Ahmanson & Co.*[20] and *Brown v. Halbert*,[21] which have established the law of California on the subject of sale of control and have been influential in affecting the law of other jurisdictions, are also treated.[22] Factual analysis of these three cases leads to the conclusion that in cases where a controlling shareholder is held liable for the sale of control at a premium, his condemned activities are usually not merely those of a shareholder but include actions in positions where he has a responsibility to the corporation and other shareholders.

Perlman v. Feldmann

Perlman v. Feldmann[23] was a derivative action brought by minority shareholders of Newport Steel Corporation for an accounting

stockholders' meeting was not tied to equitable ownership of the corporation, see Rosenfeld v. Black, 445 F.2d 1337, 1343-49 (2d Cir. 1971).

18. *See* Bayne, *Sale-of-Control Premium: The Definition*, *supra* note 3, at 490.

19. 219 F.2d 173 (2d Cir. 1955).

20. 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

21. 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (Dist. Ct. App. 1969).

22. The present writer bas subjective reasons for cboosing these two cases for discussion, both because the writer practices in California and because there has becn made available to the writer a considerable amount of factual information concerning the two cases which does not appear in the published opinions.

23. 219 F.2d 173 (2d Cir. 1955). The most effective way to gain a true understanding of *Perlman* is to study the voluminous findings of fact, the conclusions of law, and the opinion of the trial court in conjunction with the appellate opinion and in conjunction with the related case of Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952).

and restitution of allegedly illegal gains accruing to the defendants as a result of their sale of 37 percent of Newport common stock, which constituted the controlling interest in the corporation. The Korean War had made steel an item in short supply. The purchasers of the controlling stock were a group of steel users, negotiating through a newly formed corporation, who desired a sure supply of steel and who, more particularly, desired to control the selection of Newport's customers. The plaintiffs contended that a part of the consideration paid for the stock included compensation for the sale of a corporate asset—the ability to control the allocation of the corporate product in a time of short supply. The trial court held for the defendants.[24] The Court of Appeals for the Second Circuit reversed and permitted the plaintiffs to recover in their own right, rather than on behalf of the corporation, because the purchasers in the illegal transfer as the new owners of the corporation should not be permitted to share in any of the judgment. Several factors concerning the principal participants and their agreement which were either hastily mentioned or ignored in the opinion of the court of appeals indicate that the defendants' breach in their managerial capacities of duties owed to the corporation and its shareholders would have furnished a logical ground for the decision.

C. Russell Feldmann was the principal defendant and was treated as the controlling or dominant shareholder. In fact, however, he held no shares of stock in his own name, and his control was derived from his ownership of controlling interests in two other corporations which held Newport stock and from Newport stock held by other members of his family. Feldmann was the president of Newport, was presumably its chief executive officer (at a salary of $75,000 per year), and also was chairman of the board of directors. During the negotiations and prior to the execution of the written agreement, Feldmann gave the prospective buyers complete access to all corporate business information which they desired. Additionally, he allowed a firm of certified public accountants employed by the buyers to examine the financial records of the corporation.

The contract for the condemned sale was in the form of an option in the handwriting of William A. Alfs, who was counsel for both Newport and Feldmann:

24. 129 F. Supp. 162 (D. Conn. 1952), *rev'd*, 219 F.2d 173 (2d Cir. 1955).

August 24, 1950

William Mericka:

For and in consideration of $100, receipt of which is acknowledged, I agree to sell to you 200,000 shares of Newport Steel Corporation for $4,000,000—at any time on or before August 31, 1950.

If you exercise this option on or before Sept. 1, 1950, on the terms above set forth, I will give you at that time an option to buy an additional number of shares of Newport Steel Corporation, not less than 175,000 shares nor more than 200,000 shares at $20. per share, until 12:00 noon E.S.T. Nov. 1, 1950.

If you exercise the option to buy the shares (minimum 175,000, maximum 200,000) on or before Nov. 1, 1950, I will deliver to you, at the time you exercise the option, the resignation of all of the members of the Board of Directors of Newport Steel Corpn.

(Signed) C. Russell Feldmann[25]

The participants in the transaction informally agreed that if only the first option were exercised, the buyers would be entitled to only one seat on the board of directors. Both options were exercised on August 31, 1950, and Feldmann delivered 398,927 shares of Newport stock, receiving the stated purchase price. On that date, Feldmann's controlled corporations and members of his family owned only 343,375 shares. Where the balance of the stock was obtained and why Feldmann gave an option to purchase a number of shares substantially in excess of those that he owned or controlled is not explained. There are references in the district court's opinion, however, to insider trading by his friends and members of his family at prices of $11 to $12 per share to the extent of 3,000 shares in the over-the-counter market and an indication that the stock so purchased was delivered at the closing for $20 a share.[26]

Because Feldmann owned no stock personally and because he stood in a fiduciary role as Newport's president and director, a conflict of interest stands out in bold relief. Moreover, Feldmann owed a conflicting fiduciary duty not only to Newport but also to the two corporations subject to his control which held Newport stock. Further fiduciary problems are evident in the fact that all Newport directors were shareholders, all joined in the sale, and all resigned at the closing. And as noted previously, Feldmann's personal counsel was general counsel to the corporation and was also a shareholder who benefited from the sale.

25. *Id.* at 172.

26. *Id.* at 176. For the modern view of insider trading, see SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971).

What would have been the reaction of Feldmann, as Newport's president, if his son-in-law, Joseph V. McKee, Jr., who was a shareholder and also a director, had without Feldmann's consent opened the corporation's records, files, and properties to examination by the proposed purchasers and had granted an option to purchase a controlling interest just as did Feldmann? Is it not apparent that Feldmann would have considered this an act of great disloyalty to him, to Newport, and to the other shareholders? Similarly, when Feldmann and all of the other directors joined together to sell their personal stock, made complete information available to the buyers, and ultimately resigned their positions as directors, they abdicated their positions of responsibility. No one remained to guard the interests of the corporation and the non-participating shareholders who, in fact, owned more than 60 percent of the outstanding stock of Newport Steel.

Instead of emphasizing the misuse of powers acquired by the control group through accepting fiduciary positions in the management of the corporation, the Second Circuit seemed to condemn the defendants' self-interested conduct primarily because of Newport's advantageous position in the wartime steel market. In remanding to the district court for a determination of "the value of defendants' stock without the appurtenant control over the corporation's output of steel,"[27] the court implied that it would have been permissible for the defendants to act as they did if they had not received a premium price for their stock. If, in keeping with traditional corporation law concepts, the court had focused on the defendants' misconduct in their fiduciary roles, a more coherent decision reaching the essence of the illegality would have resulted.

Jones v. H.F. Ahmanson & Co.

Jones v. H.F. Ahmanson & Co.,[28] decided by the California Supreme Court in 1969, is a landmark decision in California corporation law. It has been referred to as establishing that majority shareholders, as such, owe a fiduciary obligation to minority shareholders.[29] Again, however, the question arises: Were the controlling shareholders acting solely as shareholders or in positions which entailed responsibilities to the corporation and its other shareholders? *Jones* arose when an owner of 25 shares of United Savings and Loan

27. 219 F.2d at 178.
28. 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).
29. *See, e.g.*, Connolly, *supra* note 3, at 1266.

Association stock brought a class action against a Delaware holding company owning 87 percent of United's stock and against the present or former holders of United stock who had transferred a controlling block of shares to the holding company. The plaintiffs in the class action sought damages for breach of fiduciary responsibility. The holding company had been formed to attract investor interest in United Savings and Loan. The control group had transferred their controlling interest in United to the holding company in exchange for its stock. A series of public offerings of the stock of the holding company had been registered with the SEC and underwritten by a nation-wide group of underwriters, and the holding company stock had been subsequently listed on the New York Stock Exchange. The result was that the holders of the holding company stock acquired a security that could be readily traded and whose value was greatly enhanced by virtue of the public offering and the public market, whereas the owners of the balance of the stock of United, who had not participated in the exchange, had no market for their securities and practically could dispose of them only to the holding company or persons associated with it.

The trial court sustained a demurrer to the complaint without leave to amend. The California Supreme Court, with one dissent, reversed the decision. Justice Traynor, speaking for the majority, found that the class action was not derivative and that there was no necessity to show that the injury was unique to the plaintiff. The court felt that a cause of action resulted from the breach of fiduciary duty which the majority shareholders owed to the minority shareholders. On the subject of damages, the court held that since the minority shareholders should have been offered an opportunity to participate in the exchange resulting in the formation of the holding company, damages for the breach were not to be limited to the results of an appraisal of the value of the shares of the minority shareholders. Rather, as the court stated, "[s]ince the damage is real, although the amount is speculative, equity demands that the minority stockholders be placed in a position at least as favorable as that the majority created for themselves."[30] This language indicates some departure from the proposition that a controlling interest is entitled to command a premium price in the market, although it could also be interpreted as a judicial resolution of all doubts against the fiduciary who has failed to measure up to his responsibilities.

30. 1 Cal. 3d at 117-18, 460 P.2d at 478, 81 Cal. Rptr. at 606.

The court's articulation of its basis for the decision leaves something to be desired. For example, the proposition that a holder of a majority of the stock of a corporation owes a per se fiduciary duty to the minority and must refrain from conduct that would adversely affect the value of the stock owned by the minority is difficult to support when applied to practical realities. Consider the situation where the owner of 51 percent of the stock of a corporation is presented with an opportunity to sell for two, three, four, or ten times more than it would appear the stock is worth, the offer being contingent on the sale of 100 percent of the outstanding stock. Under the fiduciary doctrine of *Jones v. H.F. Ahmanson & Co.*, must the controlling shareholder sell his stock in order that the minority shareholders can take advantage of this exceptional opportunity? It seems apparent that a court would be faced here with a constitutional limitation upon the enforcement of this alleged fiduciary obligation. The owner of any share of stock, including the owner of 51 percent or more, must be free to say "no" to any offer regardless of how ridiculous his decision might appear to someone else. Otherwise, he is being deprived of one of the principal rights of ownership—the right to continue to own.

It is submitted that it was not necessary to go as far as the *Ahmanson* court chose to go in finding a fiduciary obligation stemming from ownership of a *controlling* interest. As previously noted, there is no concept in statutory corporation law that differentiates between the ownership of one percent, 51 percent, or 99 percent of the stock insofar as the rights, powers, and duties of a shareholder are concerned.[31] Except in unusual circumstances, the owner of a single share of stock has the same shareholder rights as the owner of a majority interest. Furthermore, the rights of a shareholder to receive corporate information and to inspect the books, records, and physical properties of the corporation are not absolute and are considerably more limited than the rights of officers and directors.[32]

When the foregoing propositions are considered, a question arises as to whether the majority shareholders in *Ahmanson* were acting simply as shareholders or whether they were using powers vested in them as directors and officers to secure a personal profit. Some assistance may be obtained through an examination of what is required when a corporation enters into an underwriting agreement,

31. See pp. 1195-96 *supra*.

32. *See* 1 F. O'NEAL, CLOSE CORPORATIONS § 3.63 (2d ed. 1971).

files a registration statement with the SEC, and disseminates a prospectus—the process followed by the *Ahmanson* control group in promoting the public sale of the holding company's stock. The registrant's legal obligation is to make full disclosure—that is, to set forth in the prospectus all facts that a potential investor would reasonably desire to know in making an investment decision, and, in addition, "all facts necessary to make the facts stated not misleading."[33] This obligation has been interpreted to require the registrant to provide full information with respect to all subsidiaries which the registrant controls.[34]

In view of the limited rights to information vested in shareholders, how could the controlling group in *Jones v. H.F. Ahmanson & Co.* have supplied the requisite detailed information about the holding company's subsidiary, United, except by following one of two possible courses: (1) using powers vested in the members of the group as directors or officers and not as shareholders or (2) conspiring with an individual who held the office of officer or director?[35]

The defendants asserted in *Ahmanson* that, in the use of their own shares, they owed no fiduciary duty to the minority stockholders of

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33. 15 U.S.C. § 77q(a)(2) (1970).

34. SEC regulations require that certain information describing the business he contained in the prospectus. See Form S-2, Information Required In Prospectus, Items 9(a) ("Briefly describe the business done and intended to be done by the registrant *and its subsidiaries*"), 9(b)(1) ("If the registrant *and its subsidiaries* are engaged in more than one line of business . . ."), 12 ("Briefly describe any pending legal proceedings other than ordinary routine litigation incidental to the business to which the registrants *or any of its subsidiaries* is a party.") (emphasis added), *reprinted in* 1 CCH FED. SEC. L. REP. ¶ 7145 (1972).

Complete financial statements are also required to be filed with the SEC and included in the prospectus, partieularly where, as in the *Ahmanson* case, the subsidiary constitutes the principal valuable asset of the holding company.

A section entitled "Undertakings," appearing at the end of the instructions eoncerning the making of the registration statement, additionally provides:

> The following undertaking shall be included in every registration statement:
>
> Subject to the terms and conditions of Section 15(d) of the Securities Exchange Act of 1934, the undersigned registrant hereby undertakes to file with the Securities and Exchange Commission sueh supplementary and periodic information, documents, and reports as may he prescribed by any rule or regulation of the Commission heretofore or hereafter duly adopted pursuant to authority conferred in that section. Form S-2, Undertakings To File Reports, *reprinted in* 1 CCH FED. SEC. L. REP. ¶ 7145 (1972).

By sueh reports, the registrant must provide the SEC with prompt notice of any development or event taking place which would be significant to an investor in determining whether or not to buy or sell the stock of the registrant, and must include in such a description events affecting subsidiaries.

35. For a discussion of conspiracy as a possible cause of action in sale of control situations, see notes 45-54 *infra* and accompanying text.

United. This argument proves too much, for it admits that all of the actions which were required to be taken by the control group as directors and officers in advancement of the plan to create a public market for the United stock through the holding company device were taken not for the benefit of United or its shareholders but for the sole benefit of one particular group of shareholders. In light of this, could not the case have been decided on the simple basis that the defendants' activity represented a breach of fiduciary duty on the part of those directors of United who were also stockholders of the holding company as well as a conspiracy to breach that fiduciary duty on the part of those stockholders of the holding company who were not directors of United?

Brown v. Halbert

Brown v. Halbert[36] was a class action involving a sale of a controlling block of stock in a California savings and loan association. Halbert and his wife each owned 265 of the outstanding 1000 shares of the Tulare Guarantee Savings and Loan Association. Halbert was president of the Association and was on the five-man board of directors, while his wife served as assistant secretary-treasurer. Two other shareholders joined with the Halberts in the sale—Morris, a director of the Association and owner of 23 shares, and Tienken, who owned 20 shares.

Four minority shareholders, three of whom were the remaining members of the Association's board of directors, brought a class action setting forth two causes of action alleging that Halbert as president and director owed a fiduciary duty to the corporation which he breached in order to facilitate the sale of his personally-owned stock at a profit. The first cause of action sought the imposition of a constructive trust upon the profits of the sale for the benefit of the minority shareholders of the Association. The second cause of action contained an additional allegation that the breach of fiduciary duties depreciated the value of the stock owned by the plaintiffs and other minority shareholders and sought damages on this basis.[37] The trial court entered judgment in favor of the defendants. On appeal, the California First District Court of Appeal reversed on the first cause of action, holding that Halbert had indeed possessed a fiduciary obli-

36. 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (Dist. Ct. App. 1969).

37. The second cause of action constituted a cause of action at law and thereby qualified the case for a jury trial.

gation which he had breached by the sale, and that he should have acted affirmatively and openly to insure that the minority shareholders had substantially the same advantages enjoyed by the majority.[38] The case was remanded solely for the purpose of determining, allocating and distributing the trust fund under the constructive trust cause of action. The appellate court appears to have ruled that the trust fund was to be computed by determining the average price per share for all shares sold by both the minority and majority shareholders and then deducting this amount per share from the sales price actually received by the majority shareholders; the trust fund remaining was to be distributed to minority shareholders in such a manner that all shareholders who sold would receive the same price per share. Minority shareholders who did not sell would not participate in this trust fund.[39]

Two important elements of the practical problems confronted in control cases are presented by this case: (1) the aspect of valuation and related evidence and (2) the terms of the contract by which the defendants disposed of their stock.

The majority shareholders sold their stock for $1,548.05 per share, 2½ times book value; book value was approximately $600.00 per share. Immediately after the sale, the purchasers offered the minority shareholders $300 per share, ½ book value. The two experts who testified both recognized that control could be sold for a "justifiable" premium. The defendants' expert testified that control should sell for 2½ times book value and that the minority interest should sell for book value. The plaintiffs' expert testified that control should sell for 10 percent above an average value per share and that minority stock would logically sell for 10 percent below the average value per share. A value for the entire corporate business was first determined and was divided by the number of shares outstanding to arrive at the average value per share. The defendants' expert made no attempt to validate the $300 per share offered the minority by the control purchasers.

In *Brown*, the problems of valuation of the premium for control are apparent. First, how can one reconcile the sale at $1,548.05 per share by a defendant who owned 20 shares with the sale at a price of $600.00 per share by one of the plaintiffs who owned 19 shares? Sec-

38. *Id.* at 272, 76 Cal. Rptr. at 794.

39. The case was settled after the appellate court decision, so there are no further proceedings to clarify the unresolved issues.

ond, recognizing that a franchise to operate a savings and loan association is granted by the state and is in itself a valuable asset with no book value, how can one justify the valuation of one share of stock to include no portion of this intangible value, whereas other shares of the same stock are valued at 2½ times book value? Finally, *Brown* demonstrates the principle that a justifiable premium for control is directly related to what the owners of control can legally do vis-á-vis the minority shareholders.

In *Brown*, the defendants' expert testified that the value of the minority interest plus the value of the controlling interest equalled the value of 100 percent of the corporation. On this basis, he gave as his valuation of the corporation the sum of $1,167,000. If, therefore, the purchasers had been successful in their plan to buy all of the minority stock at $300 per share, their total cost would have been $1,028,000. A bargain purchase indeed would have been secured. If the courts allow the owners of the controlling block of stock to elect themselves to the board of directors and then to use their vested powers as directors to oppress the minority shareholders and pressure them into selling their stock cheaply, then one may be sure that the value of the control block will be greatly enhanced and that the premium will increase to the extent that the courts allow such coercive conduct by the control group.

A second practical problem of control presented by *Brown* appears in the contractual aspects of the sale. The total consideration for the controlling block was approximately $887,000. Because no sophisticated purchaser is likely to obligate himself for such a large amount of money without having a strong legal position from which to close the transaction, the purchaser will require a boiler-plated written contract to insure that he receives precisely the anticipated consideration. *Brown* involved such a contract which followed the standard pattern used in corporate transactions of this nature. The agreement included a representation of the total number of shares outstanding, a statement of the agreement to sell a certain number of shares at a certain price, a recital of representations, an agreement to close the transaction through escrow, and a section devoted to representations, warranties, and agreements. The warranties required that at the close of the sale the sellers would resign as officers and directors and arrange for new elections; that prior to the closing the Association would neither declare dividends nor make any unusual payments of compensations not in keeping with past business practice; that the Association would not have in existence on the closing date certain types of contracts which could not be cancelled within

60 days; that the Association on the closing date would have neither issued nor arranged to have issued any stock other than that outstanding on the date of the agreement.[40] All of the shareholders who participated in the sale at the premium price bound themselves to these warranties. How could Halbert have carried out these provisions strictly in his capacity as a shareholder? Or, to phrase the inquiry another way, how could Halbert have functioned as a director acting for the benefit of the corporation and all of its shareholders after he had made this agreement?

It is hornbook law that a fiduciary may not undertake obligations which interfere or conflict with the performance of his fiduciary duties.[41] Suppose, for example, on the day after the agreement was signed, someone had walked into the offices of the Association and offered $2,000,000 for its assets or presented an offer of merger with the same beneficial price for all shareholders. Would Halbert as a director and as the president have been capable of functioning as a trusted spokesman for the Association and all of its shareholders? When a director, by means of an agreement made for his personal benefit, limits his freedom of action in his capacity as a director, it appears that he has immediately breached his fiduciary obligation to

40. The warranties provided:

1. That upon close of this escrow [the sellers] will submit such resignations as officers and directors of the Association as may be requested by the buyer, and will hold such directors' and/or stockholders' meetings as may be requested by the buyer for the purpose of electing new officers and directors of said Association.

2. That prior to the close of escrow herein the Association will not declare any dividend to the stockholders or make any payments or compensations which are not in keeping with the past business operations of the Assoeiation, and that the Association will be operated in accordance with normal and customary procedures and policies of the Association and of the savings and loan business.

3. That the Association will not have at the date of close of escrow any contracts or plans of the following classes outstanding which cannot be cancelled by the Association without liability to it within sixty days: Employment contracts, contracts with escrow agencies, contracts respecting the right to handle any existing or future insurance of the Association or its borrowers, insurance agency contracts, contracts with loan solicitors, or other contracts materially adverse to the Association, or any retirement, profit-sharing, deferred compensation, bonus or pension plans other than such as are approved in writing by buyer . . . .

. . . .

7. That as of the close of escrow the Association shall not have issued or agreed to issuc any shares of guaranty capital stock other than the 1,000 shares now outstanding.

Agreement (Jan. 14, 1963), *recorded in* Reporter's Transcript on Appeal at 60, Brown v. Halbert, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (Dist. Ct. App. 1969).

41. *See, e.g.*, Alexander v. Theleman, 69 F.2d 610, 613 (10th Cir. 1934).

the corporation, and it is immaterial that the events never occurred that would have resulted in easily provable damage both to the corporation and to the other shareholders. In this situation, it cannot be said that there is no damage to the corporation and to its shareholders, and, although at this stage in a sale of control transaction the damage is not compensable because the amount and nature of monetary damage cannot be legally established, a court might justifiably grant equitable relief rather than denying relief altogether.

Another contractual provision of interest in *Brown* provided as follows:

> [To confirm the representations made by sellers concerning the status of the business] buyer shall have the right to approve the financial conditions of loans and general business condition precedent to the consummation of this sale. If the warranties made by sellers to buyers are not borne out by buyers' examination of the Association, this agreement shall be null and void, and the $20,000.00 deposit will be returned to buyer.[42]

In order to execute this provision, Halbert was required to disclose to the buyers a significant amount of information concerning the Association, which he had acquired not by virtue of being a shareholder but rather through his position as a director and an officer of the Association. Additionally, without the consent of the board of directors, Halbert agreed to give access to all of the corporate records to a party who was not legally entitled thereto.[43] Due to these agreements, the buyers sent in a team of investigators who spent several days going over all of the records and properties of the Association.

Under these facts, it seems totally unnecessary to find a fiduciary duty on the part of the controlling shareholder in order to establish his misconduct. Individuals whose behavior resembles Halbert's should be liable because they have misused their positions as directors or officers. Moreover, those shareholders who, in selling their stock, go along with the directors and officers should be held liable because they have accepted the benefits of the condemned activities.[44]

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42. Agreement (Jan. 14, 1963), *recorded in* Reporter's Transcript on Appeal at 60, Brown v. Halbert, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (Dist. Ct. App. 1969).

43. Query: Would the directors' giving their consent to the buyers to examine the records for the purpose of permitting the controlling shareholders to sell their stock have validated the situation? Would this action have been just another breach of fiduciary obligation by the other directors?

44. One portion of the evidence in *Brown v. Halbert* dramatically illustrates the difficulty with the proposition that control can be given a premium price as a matter of valuation and that the minority should be willing to accept this result. After the closing, a directors meeting was held (apparently for the purpose of reorganizing the board), and the attorney for the buyers

SOME PRACTICAL ASPECTS OF "SALE-OF-CONTROL" LITIGATION

Although it might seem more logical to deal with the practical aspects of representing sellers, buyers or other individuals interested in control transactions before considering the problems involved in sale-of-control litigation, it should be noted that one primary objective in the representation of participants in a sale-of-control transaction is to protect them from the risk of litigation in the future. To accomplish this objective, the attorney must have in mind the factual and legal issues that are likely to be presented and the strategies that might be adopted in litigation resulting from a sale of control. This proposition indicates that a consideration of the role of the plaintiff's lawyer is extremely important.

In litigating an allegedly illegal sale of control, the plaintiff should always include a cause of action founded on conspiracy.[45] When shareholders, none of whom alone holds a controlling interest, band together in a cooperative association to control the company, not for the purpose of directing its management in an effort to enhance the company's profitability and safety, but rather with a view towards

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made the following statement:

> I think it might be a good idea to clear the atmosphere around here, Mr. Halbert . . . .
>
> But what I wanted to say was that we were willing to pay the premium for the control of the Association, only not for 100% of the shares. That is a lot of money. Gentlemen, you are trying to make us spend another three or four million dollars and we are not going to do it . . . . Now, we are happy to have any minority stockholders go along with us for the ride if they understand clearly, it would be our idea, I know I am expressing your opinion, that is one reason we'd prefer not to have any more dividends on the Guarantee stock because we'd like to draw it in, increase the assets of the Association . . . . I like this business, if you do sell, then you'll get a capital gain, [if not] you will be going along with us for a ride. We are not going to try to force you out. On the other hand, if you want to sell out at this time, we just aren't interested as businessmen in paying fifteen hundred dollars a share for minority stock. If you want to get out and don't want to go along, I think a figure at three hundred dollars isn't something to sneer at . . . . Minutes, Post-Closing Director's Meeting, *recorded in* Reporter's Transcript on Appeal at 596, Brown v. Halbert, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (Dist. Ct. App. 1969).

To this, Mr. Brown (a director and one of the minority shareholders) later responded:

> I am not trying to compare my head with his legal mind, but if we ride along with you as minority shareholders and go through these years of growth and you build the assets up to the place where it is attractive to somebody else and you sell, we are still in the same position we are now. We are minority stockholders and our stock conceivably wouldn't be worth any more than it is now. In fact, it doesn't look to me like it's worth anything now except what people . . . (at this point Mr. Brown became inaudible). *Id.*

45. *See* Sisak v. Wings & Wheels Express, Inc., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,991 (S.D.N.Y. 1970); Boggess v. Hogan, 328 F. Supp. 1048 (N.D. Ill. 1971).

maximizing their opportunity to sell their personally owned stock at a profit, it is apparent that the cooperative association has become a conspiracy formed to misuse fiduciary powers for personal gain. Such an association necessarily involves the band of shareholders' acting in capacities which entail fiduciary duties to the other shareholders or in their exerting control over persons who are in such fiduciary capacities.

A conspiracy is commonly defined as a combination between two or more persons to do something that is unlawful or to do something that is lawful in itself in an unlawful manner.[46] It is a civil tort.[47] Thus, a legal cause of action can be posited in any sale-of-control case where the plaintiff's rights are violated by virtue of concerted action among the seller, the buyer, the members of the board of directors and, perhaps, the lawyers representing them.[48]

What are the advantages to be gained from including at least one cause of action founded upon an alleged conspiracy in a sale-of-control situation? Since conspiracy constitutes a legal cause of action, the right to trial by jury is assured. This tactic becomes important in light of the fact that the judge is required to take a position as to the law prior to the jury's decision. Because of the complexity of the law in this area, and because of the probability that large sums of money will be involved, an appeal is extremely likely. The jury instructions given will tend to shed considerably more light on the judge's opinion concerning the applicable law than will the findings of fact and conclusions of law in a non-jury case which are usually prepared in great measure by the prevailing parties' counsel after the judge has reached his decision.[49]

A further advantage of a conspiracy cause of action is the standard of proof required to establish the existence of a conspiracy in a

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46. 16 AM. JUR. 2D *Conspiracy* § 1.

47. *Id.* § 43. *See generally* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 46 (4th ed. 1971).

48. There is no principle of law that exempts a lawyer from liability if he knowingly engages in an unlawful conspiracy, even though he does so in his capacity as a lawyer representing one or more of the parties. *See* Celano v. Frederick, 54 Ill. App. 2d 393, 203 N.E.2d 774 (1964).

49. In *Brown v. Halbert*, the court stated:

> At the outset, it must be noted that the verdict of the jury was only advisory on the equitable issues. We note that 114 instructions were given to the jury, to some of which we will hereafter refer . . . . Their significance lies chiefly in that they reflect the reasoning by which the Trial Court concluded there was no liability on the first cause of action. 271 Cal. App. 2d at 254, 76 Cal. Rptr. at 782.

Then the court proceeded to direct several pages of discussion to the issues raised by the jury instructions. *Id.* at 259-69, 76 Cal. Rptr. at 785-92.

sale-of-control situation. The plaintiff need not prove an actual agreement among the conspirators; instead a conspiracy may be inferred from the course of dealing between the participants.[50] The standard of proof is illustrated in the following representative jury instruction:

> Plaintiff, in order to prove the existence of a conspiracy need not show you an express formal agreement between the eonspirators. You may infer the existence of a conspiracy from a course of dealing or through an exchange of words or from the acts done. An unlawful conspiracy may be and often is formed without simultaneous action or agreement on the part of the conspirators. Plaintiffs are seldom capable by direct testimony or evidence to prove a conspiracy. Therefore, the law allows you as members of the jury to infer the existence of a conspiracy from things actually done, taking into consideration all the facts and circumstances surrounding the conduct of the parties who are charged with the conspiracy.[51]

The conspiracy cause of action should also include an allegation that the defendants have been guilty of oppression, fraud and malice, and a prayer on account of this conduct for exemplary or punitive damages should be considered.[52] Even in situations where it is uncertain that sufficient evidence of fraud, oppression or malice can be produced to secure an award of punitive damages, the allegation is a sensible tactic because the scope of the admissible pretrial discovery and proof at the trial may be broadened to include each defendant's ability to pay, a relevant element in the determination of the amount of punitive damages.[53]

Inclusion of a conspiracy cause of action has the additional advantage of broadening the class of persons liable to the plaintiffs, should they succeed. Any participant in an unlawful conspiracy is equally liable with his co-conspirators whether or not any benefit flowed to him from the conspiracy.[54] Furthermore, as soon as the plaintiff has proved that a particular defendant was a member of the conspiracy, then all of the acts and declarations of the other co-conspirators are chargeable against that defendant.

Advantages are also to be gained by pleading a federal cause of action. The most likely federal cause of action to be pleaded is a

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50. *See, e.g.*, Hedrick v. Perry, 102 F.2d 802, 806 (10th Cir. 1939); Fink v. Sheridan Bank, 259 F. Supp. 899, 902-03 (W.D. Okla. 1966).

51. *See generally* 3 REID'S BRANSON, INSTRUCTIONS TO JURIES 467 (1970).

52. *See* Walton v. Anderson, 6 Cal. App. 3d 1003, 85 Cal. Rptr. 345 (Dist. Ct. App. 1970).

53. *See* Doak v. Superior Court, 257 Cal. App. 2d 825, 65 Cal. Rptr. 193 (Dist. Ct. App. 1968).

54. *See* J.C. Peacock, Inc. v. Hasko, 196 Cal. App. 2d 363, 16 Cal. Rptr. 525 (Dist. Ct. App. 1961).

violation of rule 10b-5[55] promulgated under section 10(b) of the Securities Exchange Act of 1934.[56] Also available in certain circumstances may be a cause of action under the antitrust laws.[57] The advantages of a federal cause of action are evident: defendants otherwise not subject to service of process, or upon whom service in state courts may be secured only with great expense and difficulty, are easily reached. Furthermore, the rules of pleading and the discovery procedures in federal actions are frequently more liberal than those under state law. Fortunately, access to the federal courts is not secured at the expense of foregoing causes of action under state law, for under the doctrine of pendent jurisdiction, it is often possible to join state causes of action with the federal cause of action, thereby having all causes tried within the same forum.[58] This procedure could result in the federal court's deciding that the federal cause of action was not well founded but at the same time finding for the plaintiff on one or more of the state causes of action.

Sale-of-control cases frequently present the plaintiff with an opportunity to bring a class action.[59] Several considerations should be carefully weighed before deciding to proceed in this manner. It should be realized that the plaintiff(s) undertaking to act as class representative will bear sole liability for all of the defendant's taxable costs in the event plaintiff loses. Furthermore, at some point in the proceeding, members of the class must be given notice and the corresponding opportunity to join in the action or to elect not to be bound by the results of the action.[60] The plaintiff must bear the costs of

55. 17 C.F.R. § 240.10b-5 (1972).

56. 15 U.S.C. § 78j (1970). *See* Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1972). There appears to be a drift away from the rule that 10b-5 actions must involve a buyer or seller of shares. A transaction involving the sale of securities other than those representing equity of the controlled corporation may be sufficient to provide jurisdiction. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1972).

57. *See generally* Sisak v. Wings & Wheels Express, Inc., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,991 (S.D.N.Y. 1970). Where, as in *Perlman v. Feldmann*, the purpose or effect of the sale is to foreclose others from being able to purchase the corporation's product, it would seem that an antitrust conspiracy cause of action could be stated.

Of course, diversity of citizenship might provide the necessary federal jurisdiction. *See* Swinney v. Keebler Co., 329 F. Supp. 216 (D.S.C. 1971).

58. *See, e.g.*, Boggess v. Hogan, 328 F. Supp. 1048 (N.D. Ill. 1971); Bailey v. Meister Brau, Inc., 320 F. Supp. 539 (N.D. Ill. 1970). *See also* Marshall v. Spang & Co., 321 F. Supp. 1310 (W.D. Pa. 1971).

59. For example, *Ahmanson* and *Brown* both involved class actions.

60. *See* FED. R. CIV. P. 23.

giving notice, which can be very substantial. Finally, once a class action is commenced, it may not be dismissed or settled without court approval.[61]

While the propriety of the plaintiff's lawyer's contacting others similarly situated has been questioned as potentially involving a violation of professional ethics,[62] in any event it is advisable that the lawyer (1) inform his client of the potential liability for costs and (2) urge his client to contact other persons similarly situated, asking them to join as parties-plaintiff and thereby share this liability for costs.

Analysis of sale-of-control litigation up to this point has emphasized the role of the plaintiff's lawyer. What can the *defendant's* lawyer do to protect his client? The foremost defense to litigation is the avoidance of exposure.[63] However, if litigation has commenced, the following considerations should not be overlooked. If the defendant's lawyer has previously acted as counsel for the company as well as for the selling shareholders, he may find himself greatly embarrassed in the conduct of the defense. Under these circumstances, defense counsel is well advised to locate a substitute counsel who has no previous connection with the corporation. The attorney-client privilege between a corporation and its counsel is a rather dangerous area. It is submitted that the privilege should lie between the management and counsel and not between the corporation as such and counsel, so that only the management could waive the privilege and compel the giving of testimony. There are theoretical and practical reasons for this opinion. From the theoretical point of view, it would seem that the justification for the existence of the privilege is that it facilitates complete and truthful communication between attorney and client, thereby resulting in the transmission of reliable legal advice. Under this analysis, if the minority shareholders can on behalf of the corporation cause a waiver of the attorney-client privilege, the purpose of the privilege is frustrated and the lawyer would be well advised to inform his client in advance that he might be forced to testify with respect to any questions presented to him concerning the relationship of the corporation to its minority shareholders. From a practical standpoint, it is suggested that when the corporation's management changes, its lawyer changes as well. It is difficult under such circumstances for counsel to develop a feeling of loyalty to the corpo-

61. *See id.*; J. MOORE, 3B FEDERAL PRACTICE ¶ 23.80 (2d ed. 1969).

62. S. WECHSLER, PROSECUTING & DEFENDING STOCKHOLDER SUITS (P.L.I. 1972).

63. For discussion of representation in sale-of-control transactions, see pp. 1216-17 *infra*.

ration. The very phenomenon creates a conflict of interest insofar as the attorney's state of mind is concerned. Unfortunately, however, the courts have not viewed the corporate attorney-client privilege in this fashion. Management should recognize that the minority shareholders may be able to force a waiver of the privilege in sale-of-control cases of this nature.[64]

Litigation might develop in such a pattern that at some point the defense lawyer is faced with a motion on the part of the plaintiffs to be allowed to amend their complaint in order to name the lawyer as party defendant on the ground that he knowingly participated in a conspiracy intended to violate the rights of the plaintiffs. While securing independent outside counsel at the inception will not necessarily avoid this possibility nor make the situation more comfortable for the lawyer involved, it will certainly lessen the lawyer's personal embarrassment and damage to the client's cause.

Some Practical Aspects of Representing the Seller or the Buyer in Connection with the Sale Transaction

At the outset of a sale-of-control transaction, the lawyer should thoroughly explain to his client (whether seller or buyer) that, if the transaction becomes the subject of litigation, the expected benefits will be materially diminished whether or not the litigation is successfully defended. Prompt recognition and anticipation of this problem is essential so that a conscious decision can be made early in the negotiating stage as to the advisability of assuming whatever risks of litigation appear to be involved. In evaluating these risks, counsel should not overlook the fact that the burden of proof may be upon the defendants under the general rule that those occupying fiduciary positions must defend their acts when challenged by the *cestuis que trust*.[65]

The dominant or controlling shareholder possesses advantages emanating from his position of strength alone and thereby has the power to determine to a considerable extent the form that the transaction will take. He can guide the negotiations toward the type of transaction which is most desirable for him, whether it be a sale of

64. *See* Radiant Burners, Inc. v. American Gas Ass'n, 320 F.2d 314 (7th Cir. 1963); Garner v. Wolfinbarger, 280 F. Supp. 1018 (N.D. Ala. 1968), *vacated*, 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974 (1971).

65. *Brown v. Halbert* exemplifies this general rule. See 271 Cal. App. 2d at 252, 76 Cal. Rptr. at 781.

assets, merger, tender offer, or consolidation. If the transaction cannot be negotiated on satisfactory terms, he need not proceed with it.

The dominant or controlling shareholder must not ignore the effect upon other shareholders of the disposition of control of the corporation and should be advised to consider this effect at all stages of the transaction. He should communicate as fully as possible with minority shareholders, endeavoring to extend to them the same opportunity to dispose of their stock that he possesses. By all means he should avoid any affirmative action excluding the minority from participation in the transaction. If the controlling or dominant shareholder is unwilling to forego a premium for his stock, these precautionary measures will make it more likely that existing problems will be disclosed before the transaction becomes binding or is closed, while a decision to withdraw from the transaction to avoid the problems is possible. They also may provide an opportunity for the buyer to set up defenses based on waiver, consent or estoppel, with respect to all or some of the minority shareholders. Insofar as possible, a written record should be maintained concerning the measures, as witnesses rarely agree as to the content of verbal communications.

The buyer's counsel should be aware of the risk of litigation, particularly with regard to the possibility that the buyer (and perhaps buyer's counsel) will be named as a co-conspirator. In a legitimate sale, it should make no difference to the buyer whether the desired percentage of stock is supplied by the controlling shareholder or proportionately by all of the shareholders. If forced to deal with the control group alone, the buyer can secure some protection through the use of appropriate representations, warranties and indemnities, and through a provision that a portion of the consideration will be held in escrow as a security deposit for the period of the statute of limitations. This escrow provides a fund for the payment of any damages resulting from breaches of warranties or representations.

Conclusion

This article has attempted to provide ideas and suggestions of practical benefit in the representation of clients both in transactional and litigational situations which involve the sale of corporate control. Because of the diversity of situations covered, any attempt at summation must necessarily be of a general nature. With this thought in mind, one final suggestion is offered concerning the attitude a lawyer should adopt when dealing with problems of control and problems of business representation generally. The trend of the sale-of-control cases is away from mechanistic reasoning that liability will be imposed only in exceptional cases; instead, recent decisions have tended to impose fiduciary obligations on the selling shareholders, placing upon them the burden of proof to justify the fairness of the transaction to the minority shareholders. Despite the fact that this approach may be overinclusive, this trend has its counterpart in many other areas of business litigation. Therefore, the lawyer must recognize that where profit is the motive[66] and where the strong are in a position to injure the weak and concurrently have the power to avoid or minimize injury but fail to do so, then the courts will find a theory upon which liability can be imposed. So, in representing the strong, the safe course is to comply with the highest standards of business ethics, and in representing the weak, it is advisable to provide the court with numerous theories on which it can base a determination of liability.

66. In *Perlman v. Feldmann*, the defendants, after paying the judgment, still retained over $6,000,000. In *Jones v. H.F. Ahmanson & Co.*, the value of the defendants' stock, had the minority shareholders been given the same opportunity to sell, would still have been in excess of $50,000,000. In *Brown v. Halbert*, the defendants still retained over $700,000 after paying the minority shareholders.