SECURITIES AND EXCHANGE COMMISSION
Legal Division

MEMORANDUM TO ALL ATTORNEYS

Re: Levy et al. v. Feinberg et al.
(Supreme Court of New York, Special Term)

The Commission filed a memorandum as amicus curiae in the above action. The memorandum dealt only with the issues raised by the case which related to the Rules and Regulations under Section 14 (a) of the Exchange Act.

Attention is directed to the holding that:

(1) Statements contained in proxy material to the effect that the solicitation is being made by the management for the reelection of existing directors or such other persons as would maintain the existing management and that prospects for the ensuing year are "very encouraging", are false and misleading where an option to purchase the majority interest in the corporation, owned by its president and director, has been granted under circumstances indicating that the option would be exercised and control assumed by the purchaser to the detriment of the corporation.

(2) The Commission's proxy rules require the disclosure of the option in the proxy statement.

Chester T. Lane
General Counsel
April 30, 1941

BY MR. JUSTICE BENVENGA.

Levy et al. v. Feinberg et al. – This is a stockholder's derivative action brought in behalf of the American Beverage Corporation (hereinafter referred to as "Beverage"), against certain of its officers, directors and majority stockholder.

Beverage is a Delaware corporation, engaged principally in the manufacture and sale of non-alcoholic beverages, with its principal office and place of business in Brooklyn.

McCullough was president and a director of Beverage from its organization until January, 1939. Its capital stock consisted of a million shares of common stock of the value of $1 each, of which 136,760 shares were outstanding. Of this, during the times hereinafter mentioned, approximately 72,000 shares were owned by McCullough and 64,760 by more than 500 other stockholders. In short, McCullough was its majority stockholder, owning approximately 53 percent of its outstanding common stock. He was the trusted representative of the minority stockholders and completely dominated and controlled the corporation.

In the summer of 1938 McCullough met the defendant Feinberg, the meeting having been arranged by the defendant Stemmler, a banker and a director of Beverage until January, 1939. Negotiations then started with a view to merging Beverage with Prendergast-Davies Co. (hereinafter referred to as "Prendergast"), a New York corporation engaged in the wholesale liquor business, owned and controlled by Feinberg and his wife. The negotiations terminated when McCullough rejected the proposal of merger. It is not unlikely that the rejection was due, at least partly, to the unsavory history of Prendergast.

In the course of these negotiations McCullough was handed a financial statement of Prendergast, showing net assets of about $120,000. In rejecting the proposal McCullough offered to pay Feinberg $120,000 cash for the latter's interest in Prendergast provided its assets and liabilities were correctly set forth.

Apparently, while the negotiations between Feinberg and McCullough were still pending, Little, a financial broker and partner of Stemmler, tried to arrange a meeting between McCullough and the defendant Clark, a Philadelphia banker and president of Kinsey Distilling Co., a Pennsylvania corporation. Clark, according to Little, had indicated that he was interested in Beverage. But not until the fall of 1938 did Stemmler and Little meet Clark. Then, according to Stemmler and Little, Clark revealed to them his intention of forming a large corporation by merging several distilling and distributing companies, and stated that he was interested in buying McCullough's stock.

Subsequently, at a meeting with McCullough arranged by Stemmler and Little, Clark disclosed his plan of merging Beverage with other companies, and offered to buy McCullough's interest in Beverage by giving him Kinsey Distilling stock, and then reducing it to cash within two or three months. This offer was also rejected by McCullough, who insisted on cash.

Finally, on December 2, Clark, at McCullough's terms, obtained from him, without consideration, an option expiring December 16 to purchase approximately 72,000 shares of his stock for $250,000. This option was given in the name of Stemmler, and assigned by him to Clark. Unable to exercise the option on the date of its expiration, Clark on December 15 requested an extension of thirty days. McCullough declined to grant the extension unless he received a down payment of $10,000. Clark agreed, and within a short time thereafter Mr. Mintzer, an attorney representing Feinberg, appeared with a banker's check for $10,000.

McCullough testified that not until then did he learn that Feinberg was interested in the option. Clark told him that "Prendergast-Davies are going into this deal." Very much surprised, McCullough inquired whether this was "something new," and Clark replies, "No, it's been under negotiation for some time and that's the program now." Thereupon, at Clark's request, and notwithstanding the devious and suspicious manner in which

Feinberg again came into the picture, McCullough unhesitatingly made out the option directly to Feinberg.

Under the option Feinberg, upon the payment of the balance of the purchase price of $240,000 within thirty days, became entitled to demand the delivery of the stock, and concededly, the delivery of a proxy to vote the stock.

On January 7, 1939, McCullough, as president of Beverage, caused to be mailed to the stockholders of record certain papers and documents which had received the approval of the directors. These included a notice of the stockholders' annual meeting, scheduled to be held on January 17 (three days after expiration of the option), a form of proxy, a proxy statement, a financial report and a letter signed by McCullough stating that the prospects for the ensuing year were "very encouraging."

The proxy statement requested that the stockholders execute proxies to McCullough, Avery and Killian specifying that the proxy "is being solicited by the management of the corporation," and that it is intended that the proxy holders will vote for the re-election of the directors then in office, or for the election of such different or additional persons "as will maintain the existing management of the corporation." The proxy statement added that the management knew of no other business to be transacted at the meeting.

Proxies representing 13,085 shares were sent in by stockholders.

Within a day or two after the mailing of the notices and other documents already referred to, Mr. Mintzer, Feinberg's attorney, informed McCullough that Feinberg was ready to exercise the option and asked McCullough to procure the resignation of the board of directors, McCullough requested their resignations, but they flatly refused to resign.

On January 14, the option was exercised by Feinberg, who paid the balance of $240,000 in the form of a banker's check. McCullough thereupon transferred the stock to Feinberg and executed and delivered his proxy to him.

Meanwhile on January 13, pursuant to a suggestion of the board of directors, Avery, counsel for Beverage, drafted a form of letter to be sent to the stockholders, informing them that since the mailing of the notices of the annual meeting on January 7, "a new group has acquired a majority of the voting shares of the corporation, which, we understand, will be voted for a new management," and that, therefore, the proxies received in response to the notices would not be voted for the re-election of the present directors. This letter was not sent out. Avery testified that, inasmuch as the stockholders could not receive the notice in time for the stockholders' meeting because of the intervening weekend, the proxy committee had decided not to mail the letter.

Subsequently, on January 17, at the annual stockholders' meeting, Feinberg voted his shares for a new board of directors, consisting of himself and his nominees. Later that day, at a meeting of the new board, the merger of Beverage and Prendergast was approved. Under the terms of the merger, Beverage assumed the liabilities of Prendergast.

Next day, January 18, Feinberg, the new president, directed Killian, who had been retained by the new group, to draw two checks totaling $115,000 on the funds of Beverage to the order of National Distillers and Seagram's in payment of debts owing to the payees by Prendergast. Before drawing the checks, Killian consulted McCullough, who admittedly told Killian to be very careful; that it might be criminal.

We may add that Feinberg financed the transaction by buying merchandise from National Distillers and Seagram's on the credit of Beverage and then using the proceeds of the sale of such merchandise to pay the balance of the purchase price. Hence, by assuming the liabilities of Prendergast, Beverage in effect reimbursed Prendergast for part of the purchase price. Moreover, the stock thereafter became Feinberg's personal property and Feinberg, in turn, the majority stockholder of the new corporation.

Indirectly, therefore, Beverage supplied Prendergast and Feinberg with the funds to purchase McCullough's stock, so that Prendergast, assuming it had tangible assets of about $112,000 at the time the option was exercised, as claimed by the defendants, wound up with a deficit of $137,000, the difference between the tangible assets and the price paid for the stock; and Beverage, whose prospects for 1939 were "very encouraging," was united with an insolvent corporation, and within a space of less than two years lost about $750,000, and but for a plan of settlement approved by the court would now have been out of business and not a going concern.

Moreover, if there really ever existed any intention of forming a corporation by merging Beverage with several other companies, it was immediately abandoned, and Beverage was merged with Prendergast, as Feinberg had originally planned and proposed.

The question presented is whether under the circumstances McCullough, as president, director and majority stock-holder of Beverage, violated any duty which he owed to that corporation and its minority stockholders.

In determining that question it is to be borne in mind that the option extension was given on December 15; that it expired on January 14 and was exercised on that day; that the notice of the annual meeting and other documents, including the proxy statement, were sent out on January 7; that the annual meeting was scheduled to be held on January 17 (three days after the expiration of the option), and that the proxy statement was intended to, and did create the impression that it was proposed to continue the existing management in office and that that no business would be transacted at the meeting other than the election of directors.

Moreover, in passing upon this question, it is to be noted that probably no duly elected official was ever more potent in shaping the affairs of a corporation than was McCullough in the case of Beverage. He was the trusted representative of the minority stockholders (cf. Field v. Western Life Indemnity Co., 166 Fed., 607, 610-611).

It is not disputed that, as president and director, McCullough's relation to the corporation was fiduciary. He was charged with the duty of a trustee and was at all times bound to act in good faith in caring for and dealing with the property of the corporation and in managing its affairs. In short, he owed the duty of constant and unqualified fidelity not only to the corporation, but to the stockholders as well (McClure v. Law, 161 N. Y., 78; Bosworth v. Allen, 168 N.Y., 157, 165-166; Billings v. Shaw, 209 N. Y., 265, 279-280; Stanton v. Schenck, 140 Misc., 621, 631-633).

Nor is it disputed that, as majority stockholder, McCullough stood in the same position in respect to the minority that an officer and director sustains toward all stockholders. The devolution of power imposed correlative duties. The law required of McCullough the utmost good faith in the control and management of the corporation, and every act to the detriment of the minority constituted a breach of trust and of duty (Farmers L. & T. Co. v. N. Y. & N. RR., 150 N. Y., 410, 430; Kavanaugh v. Kavanaugh Knitting Co., 226 N. Y. 185, 195-197; Blaustein v. Pan-American Co., 174 Misc., 601, 665-670). "Even majority stockholders may not for selfish purposes act in hostility to the interests of the corporation with the intention of defrauding non-assenting stockholders" (Godley v. Crandall & Co., 212 N. Y., 121, 133).

Indeed, it is well settled that a director-majority stockholder can be compelled to account to the corporation for an improper sale of his stock: (1) Where, in addition to the purchase price, he receives a bonus for relinquishing either his control or his office; (2) where, by a sale of his stock at a premium, he conspires fraudulently to turn over control to purchasers who mismanage the corporation; and (3) where, without adequate investigation, he negligently turns over control to purchasers who pay him a bonus for the sale of his stock, and the purchasers then proceed to loot the corporate assets. In short, he can be compelled to account where he receives a gain which can reasonably be traced to an abuse of his controlling position (McClure v. Law, supra; Bosworth v. Allen, supra; Billings v. Shaw, supra; Insuranceshares Corp'n v. Fiscal Corp'n, 35 Fed. Supp., 22; see also 26 Cornell L. R., 325, 54 Harvard L. R., 648, 39 Michigan L. R., 650, 25 Minnesota L. R., 525, 8 Univ. Chicago L. R., 335, 27 Virginia L. R., 546, discussing Insuranceshares case, just cited).

Consequently, McCullough, in his dealings with Feinberg, was bound to act in the utmost good faith toward the minority. He could not, directly or indirectly, make any profit or acquire any personal benefit or advantage not also enjoyed by the minority.

Looking at the substance of the transaction and disregarding its form (Dunnett v. Arn, 71 Fed. [2d], 912, 919), it is quite clear that the transaction between McCullough and Feinberg was not intended as a mere bona fide purchase and sale of stock, as defendants contend, but as a transfer of control and management of the corporation by McCullough to Feinberg, to which the sale of stock was a necessary, but nevertheless a secondary or incidental matter. In substance and effect, the transaction was a corporate transaction, involving the transfer of corporate property and assets. If, in such a case, McCullough acted in bad faith and failed to use due care, he should be compelled to account.

The Insuranceshares case (35 Fed. Supp., 22, supra) is in point. In that case an insurance investment trust sued former directors, officers and controlling stockholders for damages caused to the corporation by the sale of their stock to an irresponsible group which proceeded to loot the corporation. The transaction was described as "a sale of control, to which the stock was requisite, but nevertheless a secondary matter," as in this case. In that case also, as in this, "the buyers were primarily interested in getting control of the corporation together with such stock ownership as would make their control secure and untrammeled, and the sellers were primarily interested in getting as much money as possible for what they had to sell – both the control and their interest in the assets" (p. 24). In holding the controlling stockholders liable for the transfer of their assets, under the circumstances, the court, in a well reasoned opinion, laid down the rule that "the owners of control of a corporation occupy a fiduciary relationship to the corporation and its stockholders in respect to the transfer of control, and that they owe a duty of due care" (p. 28); that, in particular, "the owners of control are under a duty not to transfer it to outsiders if the circumstances surrounding the proposed transfer are such as to awaken suspicion and put a prudent man on his guard – unless a reasonably adequate investigation discloses such facts as would convince a reasonable person that no fraud is intended or likely to result" (p. 25).

That the transaction was not a bona fide sale of stock, but was intended as a transfer of control of the corporation, is shown by the following circumstances, among others, that Feinberg, without adequate investigation, paid more than three times the market value for the stock; that McCullough disregarded Feinberg's character or his means of paying for the stock; that the expiration of the option was timed to coincide with the date of the annual meeting; that the proxy documents contained false and misleading statements and representations; that McCullough kept the sale of the stock a secret until it was too late for the stockholders to do anything to safeguard their interest by making inquiries into the nature of the transaction, the character of the persons who had figured in it, or their means of paying for the stock, and generally, by McCullough's conduct on and after the giving of the option, including his conduct on the day of the annual meeting and the day following.

Certainly, when the check for $10,000 was delivered on account of the purchase price, McCullough knew that Feinberg intended to exercise the option, and that he would vote the stock for the election of a new board of directors. Indeed, McCullough went into the open market to buy shares of stock to make up the difference between what he actually had and what he agreed to sell. He then also knew, if he did not know it before, that Feinberg, who controlled Prendergast, and whose proposal of merger McCullough had but recently refused, was the principal in the transaction and not merely Clark's nominee. He also knew that Prendergast, whose net worth was about $112,000, and whose accounts receivable had been pledged with a Chicago firm, had become obligated to pay twice the amount of its assets in order that Feinberg might exercise the option. He likewise knew that Feinberg was buying the stock in order to acquire the control and management of Beverage, and that it was his intention to merge Prendergast with Beverage.

It is true that there is no direct evidence that McCullough knew that, as part of the plan for merger, it was Feinberg's intention that Beverage should assume the obligations of Prendergast, and thus indirectly pay for the stock. Even so, the circumstances were sufficient to put McCullough on his guard and to charge him with the duty of making "a genuine effort to obtain and verify such information as (he) reasonably could get about the means by which the purchase was to be financed, and the character, aims and responsibility of the purchasers, or, in the absence of adequate information, to refrain from making the sale" (Insuranceshares Corp'n v. Fiscal Corp'n, supra, at p. 27).

It is clear that had McCullough given the slightest consideration to the best interests of the corporation and its minority stockholders, as he concededly did not, he would not have acted without adequate investigation. So, had he retained any substantial interest, he undoubtedly would have rejected the offer, as he did when it was first proposed by Feinberg. In short, the inference is irresistible that McCullough was selling control, which was to be exercised to effect a merger which he would not tolerate as an officer, director and stockholder, presumably because it would not be to the best interest of himself or of the corporation and its stockholders.

That McCullough was not acting in good faith and that he preferred to close his eyes to the consequences of the transaction to the corporation and its stockholders is further shown by his failure to disclose the existence of the option to the stockholders in the proxy statements sent to them – as he was required to do by the rules and regulations of the Security and Exchange Commission. Indeed, he deliberately misled the stockholders into believing that there would be no change in the control and management of the corporation, and that its prospects for the ensuing year were "very encouraging." That this was for the purpose of facilitating the transfer of control would seem clear.

In my opinion, a person who stands in the position of McCullough, who, in addition to being the majority stockholder is the president and a director of the corporation and the trusted representative of the minority stockholders, should not be permitted to barter away corporate control by a private and secret sale of his stock at a premium, where the circumstances are such as to put a reasonable man on his guard and where an adequate investigation would disclose that the sale is not in the best interests of the corporation and its stockholders. A sale under such circumstances is a violation of the fiduciary duty of a director-majority stockholder, for which he should be compelled to account.

Judgment is directed for the plaintiffs against the defendant McCullough directing him to account to the corporation for any profit he may have made as a result of the sale of his stock. As for the other defendants, the evidence is not sufficient to show that they were parties to the fraud perpetrated by McCullough and Feinberg on the American Beverage Corporation and its stockholders. The complaint as to them is dismissed. Submit judgment, findings of fact and conclusions of law.

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