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COMMENTS

EXPENSES OF A PROXY FIGHT —

THE PROBLEM OF REIMBURSEMENT BY THE CORPORATION

Until recently, the questions presented by proxy fights in the various corporations throughout America concerning whether or not the corporation should be compelled to bear some or all of the expenses incident to such fights have received comparatively little attention from the courts. Even when they were considered, the subject was not dealt with fully or adequately. Of course, the chief reason for this is that few cases have ever arisen on this subject, and those that did arise did not present all of the issues involved to the court. As far as search reveals, only seven cases have dealt specifically with this problem.¹

The area of concern in this article encompasses not only whether the management group which is in control of the corporation can finance their fight for control from the corporate treasury, but also whether the insurgent group which is not in control, but would like to be, can call upon the corporation to bear some or all of their expenses. Separate problems arise in both of the situations above mentioned, because we must consider whether management which loses the contest should be able to charge the corporation the same as if they had won. Suppose management draws directly on the treasury to pay for their expenses, but at the time that they are ousted from office there remains certain amounts which the directors have paid personally and which have not been taken out of the treasury. Can the old management then make a valid demand on the new management to reimburse them for those expenses? Suppose the insurgents win the election, and then seek to take all of the expenses of their fight out of the corporate treasury. Is this a valid act? Or suppose the insurgents lose the election, but ask the management to reimburse them for their expenses in-

¹ Peel v. London & North Western Lock & Hdwe. Co., (1907), 1 Ch. Div. 5; Hand v. Missouri-Kansas Pipe Line Co., 54 F. Supp. 649 (D. Del. 1944); Hall v. Trans-Lux Daylight Picture Screen Corp., 20 Del. Ch. 78, 171 A.226 (1934); Empire Southern Gas Co. v. Gray, 20 Del. Ch. 95, 46 A.2d 741 (Ch. 1946); Lawyers Advertising Co. v. Consolidated Ry. Lighting & Refrigeration Co., 187 N.Y. 395, 80 N.E. 199 (1907); Rosenfield v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 128 N.E. 2d 291 (1955); Steinberg v. Adams, 90 F. Supp. 604 (S.D. N.Y. 1950); see Friedman, *Expenses of Corporate Proxy Contests*, 51 COL. L. REV. 951 (1951).

curred in waging their fight for control. Is management bound to reimburse them; or even if management wishes to reimburse them, can it validly do so?

What of the type and amount of expenses incurred by each side? Should all expenses be allowed, some of them, or none of them? What kind of tests can the courts use to determine which expenses should be allowed as a charge against the treasury, assuming that some expenses can be allowed? Should the allowance of any reimbursement to either side depend upon stockholder approval? If so, what percentage of vote should be necessary to authorize it?

All of these problems and many more face the court every time a proxy fight case is brought before it. Through the various decisions on point some fairly definite and constant rules have been established. However, there are still great areas of this field as yet untouched by any authoritative court ruling or legislative direction. It is the purpose of this article to point out what the law on these questions is as propounded by the courts, to suggest places for improvement, and to further inquire into some of the issues which as yet have not been litigated.

In the recent case of *Rosenfield v. Fairchild Engine & Airplane Corp.*² there was a hard fought battle for control of the corporation. Each side spent sums in excess of \$100,000. While the management group was in office, it drew upon the corporate treasury and reimbursed itself for most of the expenses incurred. However, they lost the election, and at the time the insurgent group took office, there still remained some \$28,000 which the management group had paid, but which had not been taken from the corporate treasury. When the insurgents took office, they not only voted to reimburse themselves for all of their expenses,³ but also reimbursed the old management group for the

² *Rosenfield v. Fairchild Engine & Airplane Corp.*, *supra* note 1.

³ Here the dissent violently objected to the allowance of any such reimbursement, saying at page 300 (128 N.E.2d 291), "The corporation lacks power to defray the expenses of the insurgents in their entirety." Three of the four majority judges specifically approved this reimbursement, but seemingly conditioned the validity of such act upon the affirmative vote of the stockholders. This condition, however, was not explicit, and it is not clear whether they think that this affirmative vote is absolutely necessary before such an expenditure can be made, or whether that vote is mere affirmation of an already valid act. The concurring judge (the 4th majority judge) made no mention one way or the other of reimbursement to the insurgents who won the election.

\$28,000.⁴ A minority stockholder brought a derivative action to recover all the moneys paid out of the corporate treasury, seeking not only to recover the entire amount expended by the management, but also that amount paid to reimburse the winning insurgents. On both counts his action failed, and the reimbursements were allowed to stand as made.⁵

The facts of this case raised almost every problem mentioned above that is vital to a proxy fight: Can management recover for its expenses while in office? Can management so recover after it has been ousted from office? Can the insurgent group reimburse itself for expenses spent in gaining control of the corporation? What expenses are legitimate ones to charge against the corporation, assuming that at least some of them are legitimate?

In considering these and other problems, it will be helpful to segregate the topics under three main heads: I. Expenses of the Management Group; II. Expenses of the Successful Opposition; and III. Expenses of the Unsuccessful Opposition.

I. Expenses of the Management Group

The theory upon which all reimbursements by the corporation are made is that the stockholders have a right to know exactly what is going on in their corporation. To insure that adequate disclosure of all pertinent information and material concerning the issues to be raised at the coming election is made to the stockholders so that they may make an intelligent choice of the directors at such election, the corporation should bear the cost of so informing them. Otherwise, such expenses would have to be borne by the individual directors and their followers, which

⁴ The majority neglected to specifically mention their approval of the reimbursement to the old management of the \$28,000. However, in view of their square holding that management's expenses were properly chargeable to the corporation when the contest is conducted in good faith over questions of policy, it appears that there was no question but that this reimbursement was proper. The dissent sought to require stockholder approval for this reimbursement.

⁵ This result of the case is somewhat weakened by the fact that the concurring judge whose opinion tipped the scales in favor of the defendant corporation allowed the reimbursements to stand only because the plaintiff had failed to segregate the unwarranted and excessive items of expense allegedly incurred by each faction in the contest. It was clearly indicated that had such expenses been specifically challenged, at least some of them would have been disallowed.

is generally unworkable because of the tremendous amount of expense involved.

Regardless of any opinions to the contrary, it is now firmly established that management is entitled to reimburse itself from the corporate treasury for its expenses incurred in the proxy fight, when such fight is concerned with questions of corporate policy.⁶ As a recent case has aptly put it:

Where the controversy is concerned with questions of *policy* as distinguished from *personnel of management*, . . . the incumbent directors may . . . make such corporate expenditures as are reasonably necessary to inform the stockholders of the considerations which the directors deem sufficient to support the wisdom of the policy advocated by them and under attack; and in the same communications . . . they may solicit proxies in its favor.⁷

Of course, the amounts spent while the directors are still in office comes directly out of the corporate treasury and there is no true reimbursement question involved. It is only when management loses the election without having already paid all of their expenses from the treasury that reimbursement comes into play. However, unless otherwise excepted, reimbursement, as used herein, includes both the amounts taken from the corporate treasury while management is still in office, and those amounts remaining unpaid when the opposition takes over. This privilege to use the corporate treasury at the time the expenses are incurred gives management a great advantage over the contesting group which must pay the expenses of their fight from their own pockets, with only a hope of winning the election and reimbursing themselves.⁸

For years, and in fact ever since the question first arose, the courts have stated that proxy fight expenses will be allowed as a charge against the corporation's treasury only when a question of *policy*, as opposed to a *mere matter of personnel*, is involved.⁹ At first blush this requirement seems acceptable, but analyzation demonstrates that there are in fact few, if any, situations

⁶ See note 1, *supra*.

⁷ *Hall v. Trans-Lux Daylight Picture Screen Corp.*, *supra* note 1.

⁸ To date, as far as search reveals, there has been no case which allowed the losing contesting group to secure reimbursement; hence, unless they win, as the law now stands, their expenses are personal and they can get no relief from the corporation.

⁹ All of the cases cited in note 1 *supra* purportedly followed this guide in making their decision in the particular case. See Comment, 49 *MICH. L. REV.* 605 (1951).

when *policy* can be separated from *personnel*.¹⁰ The two are so interwoven that a change in one necessarily involves a change in the other. It is the personnel of the corporation that represents the corporate policies, and hence when another group is fighting to win the election, new policies as well as new personnel are in issue. Further, although the courts have consistently given lip service to this rule, there has never been a case which disallowed any expenditure on the basis that it was not over a question of corporate policy, with the possible exception of one case decided in 1907.¹¹

Therefore, considering the problem realistically, it is submitted that the better rule would be to acknowledge that the management group has a call upon the treasury no matter what issue is being contested, subject to the limitation that such expenses must be reasonable, and to do away with the legal fiction that a *policy* issue must be involved. Regardless of any other qualifications, however, each and every expense must meet the test of reasonableness or be disallowed when challenged.¹²

Whether this suggested rule is adhered to or not, once the courts are satisfied that a question of *policy* is involved, they are liberal in allowing all expenses reasonably necessary to give the stockholders complete notice of all issues involved in the fight. Thus it has been established that it is proper for management to give the notice to stockholders by an advertisement in the newspapers.¹³ A Texas case has held that management may include self-addressed stamped envelopes in the material sent to the stockholders, to facilitate their answer and expression of ideas.¹⁴ Management may properly charge the corporation for

¹⁰ "It is impossible in many cases of intracorporate contests over directors, to sever questions of policy from those of persons." *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 20 Del. Ch. 78, 85, 171 A. 226, 229 (1934). "The simple fact, of course, is that generally policy and personnel do not exist in separate compartments. A change in personnel is sometimes indispensable to a change of policy. A new board may be the symbol of the shift in policy as well as the means of obtaining it." *Steinberg v. Adams*, 90 F. Supp. 604, 608 (S.D. N.Y. 1950). "As in political contests, aspirants for control are invariably presented under the guise of policy or principle." *Rosenfield v. Fairchild Engine & Airplane Corp.*, 309 N.Y. 168, 128 N.E.2d 290, 299 (1955).

¹¹ *Lawyers Advertising Co. v. Consolidated Ry. Lighting & Refrigeration Co.*, *supra* note 1.

¹² Wording to that effect is found, in varying degrees of forcefulness, in the *Hall*, *Steinberg*, and *Rosenfield* cases, *supra* note 1.

¹³ *Lawyers Advertising Co. v. Consolidated Ry. Lighting & Refrigeration Co.*, *supra* note 1.

¹⁴ *Bounds v. Stephenson*, 187 S.W.1031 (Tex. Civ. App. 1916) *err. ref.*

the cost of any follow-up material necessary, to answer the opposition's charges or further explain management's positions.¹⁵ However, as very ably pointed out in an excellent book, last minute telegrams and long-distance telephone calls sent by management in an effort to obtain proxies should not be allowed as proper corporate expenditures.¹⁶ The purpose of using corporate funds, to insure presentation of both sides of the controversy so that the stockholder is enabled to weigh the merits of each and make his choice of the one appearing the most desirable to him, has already been accomplished, and these last minute pleas serve no purpose other than the personal interests of the directors making them.

Likewise, it appears that proxy solicitors are not, or at least should not be hired by the use of corporate funds, with the exception that such hiring should logically be permitted when it is necessary to obtain a specified percentage of the outstanding shares in order to take some corporate action, such as a merger, consolidation, or stock reclassification.¹⁷ Use of proxy solicitors should also be allowed when quorum problems are present if the result of the vote obtained by their use serves no personal interest of the directors hiring them.¹⁸

In the situation just mentioned, allowance of expenses for proxy solicitors is justified by the fact that in such cases the directors have no personal interest in the outcome of the change effected thereby, except insofar as the whole corporation is benefited. Therefore, if there is a benefit to the entire corporation, the fact that some oppose the merger, consolidation, or stock reclassification, should make no difference.

Professional solicitors, however, in any other case, serve no purpose other than to enhance the chances of one side or the other winning the election. The pressure brought to bear upon the stockholders by them does not aid in the least the dissemina-

¹⁵ *In Re Zickl*, 73 N.Y.S.2d 181 (1947); *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 20 Del. Ch. 78, 87, 171 A.226, 229 (1934); *cf. Rasscover v. American Linseed Co.*, 135 F. 341 (2d Cir. 1905).

¹⁶ EMERSON & LATCHAM, *SHAREHOLDER DEMOCRACY* 73 (1954). See Hill, *Book Review*, 9 Sw. L.J. 257 (1955).

¹⁷ FRIEDMAN, *EXPENSES OF CORPORATE PROXY CONTESTS*, 51 COL. L. REV. 951 (1951); *cf. In Re Zickl*, *supra* note 15.

¹⁸ *Ibid.*; Comment, 49 MICH. L. REV. 605 (1951).

tion of information to the stockholders, and in fact defeats, in part at least, the purpose of allowing management to use corporate funds to help wage the proxy fight. The stockholder is often badgered into casting his vote in accordance with the proxy solicitor's wishes, thus destroying his right and desire to make an intelligent choice based upon his own opinion of the merits of each side. Once the printed material has been fully dispersed to the stockholders, there is no need for further contact with them, since such further contact will usually involve personal persuasion rather than information dispersion.

Of course, if the respective sides to the contest desire to hire proxy solicitors at their own expense, there appears to be no reason to prohibit it entirely, provided that all expenses incurred in that connection are borne personally by the respective groups and their followers. It is only when one group or the other, or both seek to have the corporation bear the expense of the solicitors that the prohibition arises.

Further considerations must be indulged in here, however, for if these expenses are borne by the individual sides to the controversy, they are not deductible on the income tax returns of the individual contributors.¹⁹ This disallowance of deductions for these expenditures is a powerful deterrent to the use of proxy solicitors, and perhaps it is just as well, because the best interests of the corporation are made secondary to the best interests of the group hiring them whenever proxy solicitors are used.

Some proxy fights become very expensive affairs with both sides attempting to "top" the other in favors bestowed upon the stockholders. Elaborate parties are thrown, models hired to "circulate," entertainers are hired to perform, etc. These expenses also seem to fall within the prohibition against proxy solicitors. Although a certain amount of this type of "proxy solicitation" may perhaps be legitimate, it is basically foreign

¹⁹ There has been no case to date specifically holding that such expenditures cannot be deducted. However, from the language of sections 162 and 212 of the 1954 Internal Revenue Code and the case law interpreting them (see *Bingham's Trust v. Commissioner*, 325 U.S. 365 (1945) for an interpretation of section 23 (a) (2) of the 1939 Code which is now section 212 of the 1954 Code), it is doubtful if such would come within the definition of expenses that are "ordinary and necessary for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

to the interests of the corporation. It is hardly conceivable that such expenditures aid in the furtherance of information dissemination to the stockholders in any way other than in the contacts and conversations which necessarily occur at these parties. Here again, however, is the personal contact with the almost sure pushing of personal motives rather than the virtues of the respective corporate issues.

Although there has never been a ruling on any of the above mentioned expenses, there is wording in the *Fairchild* case to the effect that such expenses, at least when pointed out to the court as unwarranted, should be disallowed unless the propriety thereof is proved to the courts' satisfaction. This reasoning is sound, and should be followed. The only difficulty arises in determining just what expenses are unwarranted and not to be allowed and those that are to be allowed. It is submitted that only those expenses which bear a *substantial relationship* to the purpose behind allowing any expenses (i.e., full information dispersion to the stockholders) should be permitted as a charge against the corporate treasury. This rule is supported by reason, although to date there has been no case law so holding, or any legislative action in that direction. It is also a generality, but under the present circumstances, it is at least a step in the right direction.

To say that only those expenditures can be allowed which tend directly to accomplish this result is too restrictive, since it is conceivable that local custom or other situations may arise where the expenditures, though considered reasonable and necessary by all involved, would fall short of the required relationship in the eyes of the law. This is a problem that cannot be solved by hypothetical indulgences. Rather, it must be developed in the courts by the application of the substantial relationship test to the facts of each case. By using this doctrine as a guidepost, workable rules capable of practical application can be established.

There seems to be no distinction made, as far as reimbursement of management goes, as to whether management wins or loses the contest.²⁰ As long as the court has found a *policy* issue

²⁰ Steinberg v. Adams, *supra* note 1; Rosenfield v. Fairchild Engine & Airplane Corp., *supra* note 1.

involved, reimbursement follows almost as a matter of course, irrespective of the outcome of the election.

II. Expenses of the Successful Opposition.

Although there have been only two cases on the point,²¹ both of them hold that the successful opposition group is entitled to be reimbursed after they get into office. Thus, although it is scanty, the only law on the subject allows reimbursement.

When it is understood that the reason underlying the allowance of reimbursement to the management group for their expenses in the proxy fight is to assure that the stockholders will get an adequate presentation of all the issues involved, it becomes apparent that for the same reason the insurgent group, under certain limitations later mentioned, should also be entitled to have the corporation bear their expenses.²² Before an adequate presentation of all questions involved can be made, it is essential that there be at least two opposing factions. Otherwise, stockholders would receive the benefit of the views of only the management, and hence would receive a slanted view. This is not to imply "slanted" in the nature of anything improper, but it is only human nature that one expounds his own merits and plays down his faults, and the same is true of corporate directors. The two-faction contest thus puts before the stockholders different, and often opposite, views with all the ramifications of each. Hence, since the benefit to the corporation of full disclosure is present whether the contesting faction wins the election or not, the corporation should reimburse them for their expenses. When the contesting group gains control of the corporation, the argument is even stronger in favor of reimbursement. It is evident in such a case that a majority of the stockholders agree with the proposals of the new management as being the soundest and in the best interests of the corporation. Therefore, if the ousted management group whose views were rejected is entitled to reimbursement, a fortiori the contesting group which wins the election should be so entitled.

²¹ *Ibid.*

²² Friedman, *Expenses of Corporate Proxy Contests*, 51 COL. L. REV. 951 (1951); EMERSON & LATCHAM, *SHAREHOLDER DEMOCRACY*, Chapter VI (1954).

A fairly recent case has expounded the same view, and in fact so held.²³ In that case the contesting group was successful in ousting the management, and after doing so proceeded to reimburse themselves for their expenses. The court, expressly making no distinction between management and contestants, said:

My own choice is to draw no distinction between the "ins" and the "outs." I see no reason why the stockholders should not be free to reimburse those whose expenditures succeeded in ridding a corporation of a policy frowned upon by a majority of the stockholders. Once we assert that incumbent directors may employ corporate funds in policy contests to advocate their views to the stockholders, even if the stockholders ultimately reject their views, it seems permissible to me that those who advocate a contrary policy and succeed in securing approval from the stockholders should be able to receive reimbursement, at least when there is approval by both the board of directors and a majority of the stockholders.²⁴

With the exception of the court's adherence to the *policy* requirement, it is submitted that these views are sound.

III. Expenses of the Unsuccessful Opposition

The case law on this point is entirely lacking, and as far as search reveals, there is no authority whatsoever on the problem. However, the same reasoning which allows both the management group and the successful contesting group to secure corporate reimbursement also applies, although less strongly, to reimbursement of the losing contestants. The fact that the contestants lose the election does not justify saying that the corporation received no benefit from their participation, and hence should not bear any of their expenses.

The losing faction, just as the other factions involved in the contest, serves to insure broad presentation of all information about the questions involved in the coming election to the stockholders, and this is none the less true just because they happen to fail to convince a majority of the stockholders that their position is the best one. However, lest there be wholesale minority

²³ Steinberg v. Adams, *supra* note 1.

²⁴ *Id.* at 606.

participation in these elections, with as many contestants for control as there are dissatisfied stockholders, certain requisites should be established that contestants have to fulfill before they are entitled to be reimbursed.

One of the requisites should be that such contestants must receive at least a stated percentage of the total votes cast at the election.

Just what percentage is proper is open to debate, but as two very excellent recent treatises have stated, the percentage should perhaps be from 10 to 15 percent.²⁵ A survey of the voting under Rule X-14A-8 of the SEC Regulations governing proxy solicitation has determined that 30% of the proposals at annual stockholder elections obtained an affirmative vote of less than 5%; and 6% of the proposals obtained less than 8%.²⁶ On the basis of this survey, the above percentages of 10% and 15% appear to be just about right as a minimum standard. However, if the percentages established first appear to be either too high or too low, correction could easily be made.

Further justification for reimbursing the losing contestants, provided they present a meritorious position and obtain the requisite percentage of votes cast, may be found in Section 14 of the Securities and Exchange Act of 1934,²⁷ and the regulation of proxies authorized by that section. That section has been extensively dealt with by Emerson and Latcham,²⁸ but here it is sufficient to say that Rule X-14A-8 requires management to provide a method whereby stockholders may present ideas and suggestions to other stockholders for their consideration and vote. By extending the theory behind this act, that the legislature has power and authority to prescribe rules and regulations governing the various problems presented by proxy solicitations and contests, which must be followed by the corporations of the nation, it is possible for the commission to amend the proxy regulations and require management to reimburse unsuccessful opposition groups when they meet the above stated requirements.

²⁵ Friendman, *Expenses of Corporate Proxy Contests*, *supra*, note 22; EMERSON & LATCHAM, *SHAREHOLDER DEMOCRACY*, *supra* note 22.

²⁶ EMERSON & LATCHAM, *SHAREHOLDER DEMOCRACY*, Chapter VIII (1954).

²⁷ 48 Stat. 881 (1934), 15 U.S.C. sec. 78(n) (1946).

²⁸ EMERSON & LATCHAM, *SHAREHOLDER DEMOCRACY* (1954); see Friedman, *SEC Regulation of Corporate Proxies*, 63 HARV. L. REV. 796 (1950).

However, a failure on the part of the SEC to so act does not preclude the desired result, since the way is then left open for the states themselves to deal with the situation, either by legislation or judicial decision. Of course, a charter or by-law provision allowing such reimbursement would adequately handle the outcome, but such is an unlikely inclusion in by-laws.

In conclusion, it is submitted that litigation will be facilitated, the bench will be aided, and solidarity and uniformity will be developed in the law if the following rules are followed in the future: (1) The management group is entitled to draw on the corporate treasury to finance their proxy fight whenever the expenses are fair and reasonable, whether they win the election or not. (2) The contesting group is entitled to be reimbursed for expenses incurred in their proxy fight when they win, if their expenditures are fair and reasonable. (3) The contesting group is entitled to be reimbursed when they lose if they gather a designated percentage of the total votes cast (10%–15%) and if the expenditures are fair and reasonable.

Gerry N. Wren.

REHABILITATION OF THE FIRST OFFENDER:

SUGGESTIONS FOR IMPROVEMENT OF THE PRESENT TEXAS LAW

Retribution is no longer the dominant purpose of the criminal law. Reformation and rehabilitation of offenders have become important goals of criminal jurisprudence.¹

This statement by Mr. Justice Black expresses the viewpoint of the modernized codes of criminal jurisprudence, and it is felt that the times and conditions have made it apparent that legislation aimed at the proper type of rehabilitation must be made effective for those deemed worthy. Texas could well follow the examples of the federal laws and other jurisdictions which have demonstrated that the proper type of probation is effective in eliminating

¹ *Williams v. State of New York*, 337 U.S. 241, 248, (1948).