

I believe that this memorandum is the earliest written suggestion of the idea that ultimately became Section 14(f) of the Securities Exchange Act of 1934. At the time I wrote it, the Commission was reviewing and recommending changes in the takeover bid legislation which had been introduced by Senator Harrison Williams of New Jersey. That legislation was focused on hostile takeovers, and did not address the problem of friendly transfers of a controlling block of stock in a publicly-held company, followed by the replacement of all of the previous directors by designees of the purchaser, without any vote of shareholders. I had become interested in that subject while teaching at Cornell Law School and working on an article on voting rights in large corporation.

My initial suggestion was modified before the Commission submitted it to Congress, most notably to change the proposal that new directors be prohibited from taking office unless they were elected by the shareholders into a provision requiring that before they could take office the corporation must furnish to the shareholders information substantially equivalent to what they would receive if the directors were nominees for election at a shareholders' meeting. I believe that change was suggested by General Counsel Philip Loomis, who felt it intruded less into areas of corporate procedure generally governed by state corporation law.

Surprisingly, the proposed Section 14(f) attracted no comments from witnesses during the congressional hearings, other than a "no objection" from the New York Stock Exchange, and was incorporated without change in the final version of the so-called "Williams Act" signed into law on July 29, 1968. That, coincidentally, was the day on which I left the Commission to return to Cornell Law School. I subsequently wrote a law review note about the provision, *Section 14(f): A New Approach to Transfers of Corporate Control*, 54 Cornell L. Rev. 65 (1968). When I sent a copy of that note to Chairman Cohen, it elicited the attached response, dated December 24, 1968.

David L. Ratner  
March 2003

MEMORANDUM

October 28, 1966

TO: The Chairman

FROM: David L. Ratner

RE: Takeover Bid Legislation

There is a gaping hole in our scheme of proxy regulation covering the election of directors.

We require that stockholders be furnished with information about nominees prior to each annual meeting, whether or not proxies are solicited and whether or not the nominees have previously been elected by the stockholders. We have special rules prescribing the information to be furnished when there is a contest for seats on the board. However, when a "controlling" block of stock is sold, and the agreement provides that the seller will procure the resignations of all or a majority of the existing directors and their replacements by designees of the buyer, the other stockholders not only do not get a chance to vote on the new directors; they normally do not even hear about the transfer of control until it has actually taken place, and no information about the new directors need be supplied to them until the next annual meeting. The problem is aggravated by the fact that many of these transactions involve complex financial arrangements between the buyer and seller or with third parties which are precisely the types of arrangements of which it is most important that stockholders be fully informed.

Two recent notorious examples, extensively litigated in the New York courts, involved Lionel Corporation and Republic Corporation. Judge Friendly in Essex Universal Corp. v. Yates (see excerpt attached) noted that these transfers of control often result in serious adverse consequences to the stockholders. However, legal attacks on these transactions (usually based on the argument that the payment of a premium for transfer of control is illegal) have generally been unsuccessful, and the courts and commentators have been unable to develop adequate standards to deal with the problem.

Our proxy rules are inapplicable to these situations not because of any deficiency in the federal laws but because of the provisions in state laws which permit the directors to fill vacancies on the board in a period between the annual meetings. These provisions have been interpreted to permit the entire board to resign seriatim at the direction of the old "controlling" stockholder, and select designees of the new "controlling" stockholder to fill their places. I think that this line of interpretation is a perversion of the original intent of these statutes, but I don't think there is any reasonable prospect either that it will be reversed or that the state laws will be amended to rectify the situation.

Illinois is the only state that clearly requires a stockholder vote; the Delaware law, which was previously ambiguous, was amended in 1961 (ostensibly for technical reasons) in such a way that it now clearly permits the directors to select their replacements. The Model Business Corporation Act prepared by the American Bar Foundation, which was patterned largely on the Illinois Act, departs from its model in this area and provides that “any vacancy occurring in the board of directors may be filled by the affirmative vote of a majority of the remaining directors though less than a quorum.” The explanation is that this “enables a corporation to have a full board without the expense and delay incident to holding a special meeting of shareholders.”

I do not believe we should permit anomalous provisions or interpretations of state law to frustrate important objectives of the federal scheme of securities regulation. It seems to me essential that the disclosures required by the proxy rules should be made before a new board of directors is installed pursuant to a private agreement for transfer of control. Even if the controlling interest consists of a majority of the outstanding shares, so that there would be no need to solicit proxies from public shareholders, it is still important that the disclosures be made in advance, as Section 14(c) recognizes.

There are several methods of working toward this objective:

1. We could require all nominees for director to undertake that they would not resign from the board during their term of office as part of an arrangement to transfer control of the corporation, unless the election of their successors was submitted to the stockholders. However, this method is cumbersome, and it is not clear that we have statutory authority to require such undertakings.
2. We could attempt to induce the stock exchanges to include in their listing agreements an undertaking that the company would submit any such substitution of directors to a vote of stockholders. The New York Stock Exchange presently requires stockholder approval as a prerequisite to listing securities where their issuance will result in a change in the control of the company, even though such issuance would not require a stockholder vote under the law of the state of incorporation. This rule, of course, does not cover the situation with which I am concerned, in which there is merely a transfer of already outstanding shares. Furthermore, the stock exchange approach has the infirmity of not reaching unlisted companies.
3. We could propose that the pending takeover bid legislation be expanded to add to the 1934 Act a provision comparable to Section 16(a) of the Investment Company Act. This provision would prohibit any person from serving as a director of a company having a class of securities registered under the Act unless elected to that office by the holders of the outstanding voting securities, with an exception for the filing of vacancies occurring between meetings so long as at least two-thirds of the directors holding office had been elected by such holders.

I believe that the third method is the most appropriate way of dealing with the problem. Sol Freedman informs me that Section 16(a) has not given rise to any serious difficulties,

and I do not see any reason why a comparable provision in the 1934 Act should do so, or why anyone should object to the substance of the proposal.

While the method of selecting directors has customarily been governed by state law, the proposed provision is no more of an incursion except in terms of the number of companies affected) into state jurisdiction than is the comparable provision in the Investment Company Act, which also applies to companies incorporated under state law. Furthermore, under the decision in J.I. Case Co. v. Borak, a valid election of directors of any company with securities registered under the 1934 Act must be conducted in compliance with federal, as well as state, law.

I have discussed this proposal with Phil Loomis, who feels that it could be a worthwhile addition to the takeover bid legislation (in fact, he is the one who suggested the analogy to Section 16(a) of the Investment Company Act).

Please let me know your thoughts on this proposal.

## ESSEX UNIVERSAL CORPORATION v. YATES

Cite as 305 F.2d 572 (1962)

I have no doubt that many contracts, drawn by competent and responsible counsel, for the purchase of blocks of stock from interests thought to “control” a corporation although owning less than a majority, have contained provisions like paragraph 6 of the contract *sub judice*. However, developments over the past decades seem to me to show that such a clause violates basic principles of corporate democracy.

To be sure, stockholders who have allowed a set of directors to be placed in office, whether by their vote or their failure to vote, must recognize that death, incapacity or other hazard may prevent a director from serving a full term, and that they will have no voice as to his immediate successor. But the stockholders are entitled to expect that, in that event, the remaining directors will fill the vacancy in the exercise of their fiduciary responsibility. A mass seriatim resignation directed by a selling stockholder, and the filling of vacancies by his henchmen at the dictation of a purchaser and without any consideration of the character of the latter’s nominees, are beyond what the stockholders contemplated or should have been expected to contemplate. This seems to me a wrong to the corporation and the other stockholders which the law ought not countenance, whether the selling stockholder has received a premium or not.

Right in this Court we have seen many cases where sudden shifts of corporate control have caused serious injury; *Pettit v. Doeskin Products, Inc.*, 270 F.2d 95 (2 Cir., 1959), cert. denied, 362 U.S. 910, 80 S.Ct. 660, 4 L.Ed.2d 618 (1960); *United States v. Crosby*, 294 F.2d 928 (2 Cir., 1961), cert. denied *Mittelman v. United States*, 368 U.S. 984, 82 S.Ct. 599, 7 L.Ed.2d 523 (1962); and *Kirtley v. Abrams*, 299 F.2d 341 (2 Cir., 1962), are a few recent examples. To hold the seller for delinquencies of the new directors only if he knew the purchaser was an intending looter is not a sufficient sanction. The difficulties of proof are formidable even if receipt of too high a premium creates a presumption of such knowledge, and, all too often, the doors are locked only after the horses have been stolen.

Stronger medicines are needed—refusal to enforce a contract with such a clause, even though this confers an unwarranted benefit on a defaulter, and continuing responsibility of the former directors for negligence of the new ones until an election has been held. Such prophylactics are not contraindicated, as Judge Lumbard suggests, by the conceded desirability of preventing the dead hand of a former “controlling” group from continuing to dominate the board after a sale, or of protecting a would-be purchaser from finding himself without a majority of the board after he has spent his money. A special meeting of stockholders to replace a board may always be called, and there could be no objection to making the closing of a purchase contingent on the results of such an election. I perceive some of the difficulties of mechanics such a procedure presents, but I have enough confidence in the ingenuity of the corporate bar to believe these would be surmounted.

Hence, I am inclined to think that if I were sitting on the New York Court of Appeals, I would hold a provision like Paragraph 6 violative of public policy save when it was entirely plain that a new election would be a mere formality -- i.e., when the seller owned more than 50% of the stock. I put it thus tentatively because, before making such a decision, I would want the help of briefs, including those of *amici curiae*, dealing with the serious problems of corporate policy and practice more fully than did those here, which were primarily devoted to argument as to what the New York law has been rather than what it ought to be. Moreover, in view of the perhaps unexpected character of such a holding, I doubt that I would give it retrospective effect.\*

\* See Mr. Justice Black dissenting in *Mosser v. Darrow*, 341 U.S. 207, 276, 71 S. Ct. 080, 95 L.Ed. 927 (1951) Levy, *Realist Jurisprudence and Prospective Overruling*, 109 U.Pa.L.Rev. 1 (1960).

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
Office of the Chairman

DEC 24 1968

Professor David L. Ratner  
Cornell Law School  
Myron Taylor Hall  
Ithaca, New York 14850

Dear Dave:

Thanks for the note on the Ratner Amendment. I am still amazed how easily that one jumped all the legislative hurdles. I guess it just proves that truth and virtue conquers all.

My best to you and Char.

Sincerely,  
Manuel F. Cohen  
Chairman