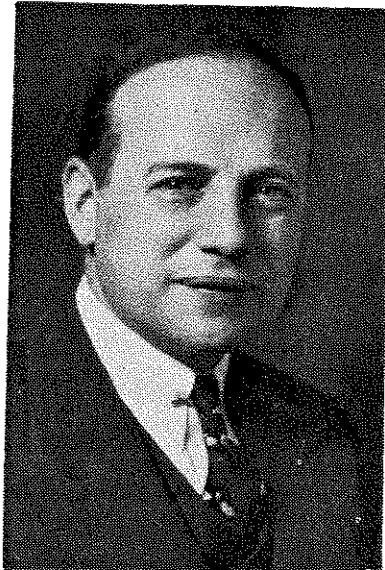


# DICTA

## CONTROLLING VERSUS OUTSIDE STOCKHOLDERS

By Benjamin Graham

\* \* \*



Mr. Benjamin Graham is President of Graham-Newman Corporation, an investment company organized in 1936 and registered with the Securities and Exchange Commission as an open-end investment company. Mr. Graham is a Director and member of the Executive Committee of the Atlantic Gulf and West Indies Steamship Lines; a director of the New York & Cuba Mail Steamship Company; Chairman of the Board of Government Employees Insurance Company; and President and Director of Market Street Railway.

He is the senior author of "Security Analysis" by Graham & Dodd, co-author of "Interpretation of Financial Statements," and author of the "Intelligent Investor," of "Storage and Stability," and of "World Commodities and World Currency."

\* \* \*

The practical working of corporate democracy is intimately bound up with the question of corporate control. If the average or outside stockholder of a given company has no real power to influence the choice of its directors, then the basic concept of democracy or ("power of the people") is there inapplicable. The mass of stockholders may demand information, they may assert the right to discuss and criticize at annual meetings, but they cannot govern or control a single corporate decision—except sometimes, in a negative sense, those requiring a two-thirds or three-quarters approval.

Financial men distinguish between three kinds of corporate control—"absolute," where an individual or cohesive group owns a majority of the stock; "working," where as little as 20% of the shares, so concentrated, may actually "run the company"; and "open-market," where the holdings of the "insiders" are so small that an outside group can acquire control by steady purchase. Interesting enough, the latter category does not envisage actual exercise of control by the outside or public stockholders acting en masse and independently of management. The latter is theoretically possible, and has actually been known to occur. But such definitive exercises of corporate democracy are exceedingly rare. In most cases of the kind, the

# VIRGIN

Vol. V, No. 21

## Third Year Class Makes Plans For Mutual Gift Fund

### Dividends Accrued Over Twenty-Year Period To Buy Gift In '73

At a meeting held shortly before the Easter vacation, the Third Year Class decided to accumulate funds for a class gift to the Law School by investing individual contributions in a mutual fund company over a twenty-year period.

The class was almost unanimous both in its decision to make some sort of gift, and in its approval of the Mutual Fund plan. This investment plan was favored over three other proposals because of its great flexibility. As a result, the success of the plan as a whole cannot be jeopardized by the unforeseen failure of individual members to meet their pledges.

#### Profits Accrue Steadily

Each member of the class will be asked to pledge a definite annual contribution to the Fund. Each year, all the contributions

(Continued on page 3)

Delta Theta Phi's

information, they may assert the right to influence and determine at annual meetings, but they cannot govern or control a single corporate decision—except sometimes, in a negative sense, those requiring a two-thirds or three-quarters approval.

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Thus we are very far from having a corporate democracy in any sense analogous to our political democracy, in which the full power to choose leaders and pass upon major policies resides in and is wielded by the mass of the citizens. Such a condition can arise in corporate affairs only when both (a) there is no absolute or strong working control, in the hands of insiders, and (b) the outside stockholder is able and willing to form independent judgments about specific corporate questions. To translate theoretical power into effective democratic action will require a great advance in stockholder education. This writer believes, further, that the initiative and direction in this area will have to come from the numerous agencies that have special qualifications to form expert and impartial opinions on corporate issues—e.g., investment fund managements, investment counsel, Stock Exchange houses, security-analysts groups.

Something of a paradox emerges out of this rather pessimistic view of the present state of corporate democracy. It is possible that the outside stockholder may derive more positive protection out of the *trusteeship obligation* of majority interests towards the *minority*, than through exercising his potential right to form a controlling majority of his own by joining with his fellow outsiders. The fiduciary obligations of the majority are a matter of legal principle, subject to widening judicial interpretation. If the minority is mistreated—as mistreatment has been and will be defined

(Continued on page 3)

This year's over-all topic for DICTA examination is  
Corporate Democracy

## Baseball Fracas Cements Bonds Of Sigma Nu Phi Fraternity

Sigma Nu Phi pledges romped over their elder brethren to win the keg of beer staked on the result of their inter-fraternity softball game on Saturday afternoon.

Although the exact score was somewhat in question due to the fact that the old men had one of their stooges on the score pad, most reliable observers place the score at approximately 16-11 in favor of the peach-fuzzed juveniles. The oldsters reluctantly concede this score to be correct, so it is safe to conclude that they were soundly drubbed.

### Forbes Sticks Out

Dan Ely after a wicked but successful slide into second now finds

the regulation three, outs were recorded.

"Harry Gams" Forbes was setting the sartorial style in his hyper-abbreviated shorts.

Jack Barret, Bill Ballance, Mike Kahn, and Ed Large were all good for circuit clouts for the new members, but the bearded wonder had a surprise in the person of aging Homer Grasberger. This shiney-domed relic made three mighty connections at the plate and each time forgot his sea legs long enough to scamper off in the general direction of first base.

The old men even while licking their wounds of defeat are now conspiring for a return engage-

vestment plan with three other programs its great flexibility the success of the plan cannot be jeopardized by foreseen failure of members to meet their plan.

### Profits Accrue Steadily

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(Continued on page 3)

## Delta Theta Phi's Initial Luncheons Feature Speakers

Delta Theta Phi's recently initiated program of bi-weekly fraternity luncheons has proved so successful that it will be continued, according to John H. Young III, Dean of Lee Senate.

The first of the legal fraternity's luncheons was held at the Varsity Grill shortly before Easter Vacation. Featured in the speaker's role was Jack Kegley, '51, a member of Delta Theta Phi, and now assistant Commonwealth Attorney for Albemarle County. In his informal talk, Mr. Kegley regaled his audience with incidents from some of the more amusing cases he has handled since beginning his practice, and emphasized the examination of witnesses on the stand as one of the more enjoyable duties of his present post.

### Priest Speaks

At the more recent meeting last Thursday at the Albemarle Hotel Associate Professor A. J. Gustin Priest highlighted the affair with an informative and amusing discussion of the art of cross-examination.

Introduced by Homer Eliades, Mr. Priest responded that he was probably one of the few fortunate professors to have both a Homer and a Plato in his classes. Thus setting the tone for his talk, Professor Priest went on to discuss the damaging results of asking a witness one question too many or of failing to ask the essential question. He drew from his personal experiences and from those of outstanding English, Canadian, and American prosecutors and advocates to illustrate his talk.

### Illustrates Point

To illustrate the sin of the superfluous question, Professor Priest recalled an assault and battery case in which the defendant was charged with biting off the plaintiff's ear in a fight.

"Did you actually see the defendant bite off the plaintiff's ear?"

## Prettyman Before Law Class

Barrett Prettyman of the Circuit Court of Columbia, will ministrative Law subject, "Effective in Administrative Law morning at members of the Year Class are

an has a long and rd of practice be- gencies. During ears he has been ney and General ternal Revenue tion, many years e in the District is knowledge of ministrative prac-

### Suggestions

unford Boyd, in- ministrative Law he lecture would practical aspects and practice be- ent agency." He Prettyman will tical suggestions wyer can do to ' before the var- boards.

an has been on 945. Before his practiced law in Virginia. He re- from Randolph 1910, and five his L.L.B. from 1946 he received or of Laws from as written many les in various one of his latest servations Con- Advocacy," soon April, 1953, edi- ia Law Review.

## Gift Fund . . .

(Continued from page 1)

will be invested in shares of stock in a mutual fund company, which in turn invests all its capital in stocks and bonds. All dividends accruing to the Fund will be automatically re-invested. At the end of twenty years, a class reunion and meeting will be held to decide what to do with the Fund.

Since no specified amount of money must be invested with the company annually, occasional defaults on pledges will not seriously endanger the success of the Fund. Adverse effects of stock market fluctuations will also be minimized, because investments will be made continuously over a twenty-year period. If the Class contributes about \$1,000 each year, the Fund will probably be worth about \$30,000 or \$35,000 by 1973.

### Committees Handle Details

A committee composed of Robert Tinsley, Robert Arnold, Pat Charles, John Ewald, F. Richards Ford, Dan Mahoney, Daniel Payne, and James Trinkle, is working out details of the plan now. They will probably settle most of the major problems at a meeting to be held this week.

It is anticipated that Tinsley, the Class President, will appoint a permanent committee to supervise the operation of the Fund until the reunion in 1973. The work of the permanent committee will be purely administrative—they will supervise the collection of individual contributions, but will merely turn them over to the company for investment. Plans are also being considered to charge the committee with the duty of sending out a class news letter each year along with the bills to contributors.

## Postscripts

CPL. JOHN BLAKE LOWE, JR., here in 1950-51, has just changed his address from Have- lock, North Carolina, to First Marine Aircraft Wing, c/o Fleet Post Office, San Francisco, Cali-

## DICTA . . .

Cite as "Graham, Virginia Law Weekly *DICTA*, Vol. V, No. 21, (1953)"

(Continued from page 1)

—then a *single* stockholder may obtain court relief for all the minority. But if the public holders constitute a numerical majority, the courts may well require that abuses be cured via a stockholder vote overruling and possibly replacing the management. This is exasperatingly difficult to obtain, even when the issues appear crystal clear.

This paradox is actually operative in two important sectors of the corporate front—Chapter X reorganizations and break-ups or recapitalizations under the Public Utility Holding Company Act of 1935. Here the ideal of corporate democracy is sharply circumscribed by the realistic concept that public securityholders cannot be trusted to vote in their own interest without the guidance and superior control of the SEC and the courts. No matter how large a majority may favor a plan or deal, it may still be turned down if found unfair or unfeasible by the regulatory bodies. As a consequence, a single determined securityholder, with right on his side, may prevail against overwhelming numerical odds. This possibility, in turn, makes majority groups more attentive than otherwise they might be to the views of minority holders.

In ordinary corporate affairs, however, a dissatisfied individual holder, or minority group, has no legal forum for a complaint, unless it relates to certain specific and limited types of overreaching by those in control. As this layman understands the case, there is redress against the following: (1) Unfair business transactions between the company and controlling persons, including payment of clearly excessive compensation. (2) The diversion of "corporate opportunity" from the company to a controlling person. (3) By statutory provision or (Sec. 16b, etc., of the Securities Exchange Act of 1934), the making of short-term profits in the purchase and sale of the company's securities. Relief under the first two categories is clearly appropriate; that under the third is open to objection, I think, as implying wrongdoing in transactions that may be entirely innocent.

However, it is our thesis that there are far more important areas of conflict of interest between controlling and outside stockholders, which have so far escaped legal recognition and which therefore permit overreaching of the less powerful by the more powerful group. These areas relate to competence of management, to control of assets, and to dividend policy. Of these, the most obvious is dividend policy, and I shall devote most of my attention to this question.

The outside stockholder is harmed by an inadequate dividend when the company's position would permit payment at an adequate rate. He suffers both in income and in the market value of his holdings. Since these are the only two places in which he can obtain concrete benefit from his investment, the damage done him by an unduly low dividend is comprehensive. It may be made up later, of course, by a more liberal dividend policy; but since low dividends almost

## Libel Show

(Continued

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**Postscripts**

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OLIVER J. NEIBEL, JR. (LL.B., '52) received word on March 14th that he had passed the Washington State Bar Examination, which he had taken on January 22nd.

ALFRED U. KREBBS, Class of 1932, has changed his address from 1407 N. Glebe Road, Arlington, Virginia, to 3220 N. Albemarle Street, Arlington.

**Phi Delta Epsilon**

The initiation of new members into Phi Delta Epsilon fraternity will be held at 4:15 P. M. today at Madison Hall.



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The outside stockholder is harmed by an inadequate dividend when the company's position would permit payment at an adequate rate. He suffers both in income and in the market value of his holdings. Since these are the only two places in which he can obtain concrete benefit from his investment, the damage done him by an unduly low dividend is comprehensive. It may be made up later, of course, by a more liberal dividend policy; but since low dividends almost invariably induce a substantial number of holders to sell out at an unfairly low price, much of the harm done must be termed irreparable.

The position of a controlling stockholder, as regards dividends, is completely different. He has the right to view the concern as one would his private business. In the typical case dividends are not needed to meet his living expenses, and they do involve a high-bracket tax. The inclination, therefore, is often strongly towards a "conservative" dividend policy, which means that almost any excuse is welcomed for keeping the dividend down. Such excuses are always easy to find; in fact, one may be readily manufactured at any convenient time by a simple decision to expand the scope of the business, thus increasing the need for retaining earnings.

Controlling stockholders may not be as much concerned as outside holders by the unduly low market price that follows in the wake of an unduly low dividend. For the most part, the former's investment is permanent and unmortgaged. Low market prices make for lower gift and estate taxes; they may also create opportunities to acquire additional shares on a bargain basis. If those in control desire to "cash in," they usually arrange a merger or sell out at a realistic price related to earning power and assets, and thus far above the market levels prevailing for some time past. If necessary for sale or other purposes, the dividend may always be increased to a suitable figure.

To what extent do we actually find a policy of inadequate dividends carried out apparently in the interests of controlling stockholders and contrary to that of the outside or public owner? The occurrence would seem to vary about inversely with the size of the enterprise. Most of the really large companies endeavor to be entirely fair in their disbursement rate; they are conscious of an obligation to protect the position of all stockholders; where the pay-out is rather low—as it has been in many cases since 1946—the reasoning behind the policy is tenable if not always convincing.

Most of the abuses in the field of dividend policy have occurred among the smaller corporations, especially in cases where there is concentrated control in a single family. A typical case is Company D, now listed on the New York Stock Exchange. In 1946, shares were sold to the public, apparently for the first time, and priced at 23. The book value was 22½, the last year's earnings (adjusted) \$2.41, the currently declared dividend at the rate of \$1.00 annually.

*(Continued on page 4)*

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**DICTA...**

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(Continued from page 3)

In 1948 the earnings were over \$3 per share (before deducting an inventory reserve, never used), and the year-end book value had increased to \$29.67. However, early in that year the dividend was omitted and the price dropped to 11. At that time, the company had no debt or preferred stock, and the net current assets alone were over \$19 per share.

Another kind of example was provided in a recent article by Norvin Greene, appearing in the November 1952 issue of *The Analysts' Journal*. Here compared companies X and Y, in the same business, of almost the same size, and sharing similar operating results and financial position. Yet Company X sold at 24 $\frac{3}{4}$  (against book value of \$16.60), while Company Y sold at 15 $\frac{3}{4}$  (against book value of \$18.60). The difference was clearly due to the "investor relations," including notably the respective dividend policies. Company X had paid \$2.15 in 1951 while Company Y paid only \$1.40. Other differences—in the place of listing, frequency of reports, data given in reports—also favored Company X.

No doubt scores of instances could be given of lesser-sized companies which have sold shares to the public at very full prices, and have later pursued dividend policies which are completely inadequate in relation to the price paid by the outside stockholders, and which inevitably entailed a drastic shrinkage of market value of their investment. Some of these unfortunate happenings may be justified by adverse business developments; but in many more cases, the average earnings were sufficient to pay an adequate dividend, and the low rate was defended in terms of the need for larger capital. Is it too much to say that in the latter instances, the business was being run in a way to confer benefits on the controlling stockholders and to inflict injury on those outsiders who in good faith had contributed capital to the enterprise?

It is interesting to speculate on the possibility that some day the doctrine of the fiduciary obligation of controlling persons toward minority stockholders may be expanded to protect the latter against serious loss due to an essentially arbitrary or selfish dividend policy. Perhaps conscientious underwriting houses—recognizing how vulnerable is the price of newer common-stock issues to unfavorable developments of all sorts—will in due time require managements to express their intention of maintaining a reasonably adequate dividend, unless unsatisfactory business conditions make such a dividend clearly inadvisable. A representation of this kind would make controlling interests think twice before they jeopardized the dividend rate by expansion or by other avoidable decisions. It would also bring into clearer focus the right of minority holders to legal relief if they suffered from dividend policies which at the same time helped rather than hurt the insiders.

One of the anomalies of the dividend problem is that it results in large part from failure on the part of the

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One of the anomalies of the dividend problem is that it results in large part from failure on the part of the entire financial community to think through the proper role of dividends in investment policy under present conditions of high tax rates and high reinvestment needs because of expansion and inflation. Most of the underlying conflict of interest between insiders and outsiders in the matter of dividends could be neatly resolved by resort to a carefully formulated and clearly expressed policy of periodic stock dividends representing the retained portion of current earnings. But new thinking to meet new underlying conditions comes very slowly to Wall Street.

The second broad area in which insiders may benefit while outside stockholders are penalized, is that of control of assets. The right to hold and administer corporate assets is a normal perquisite of control; that it confers certain advantages—e.g., the right to place insurance etc.—may hardly be gainsaid, but these are not objectionable per se if the business is a sound one, properly run. But there have been numerous instances in which the structure of the business itself is demonstrably of value only to those in control, and the outside stockholder loses through its continuance. Holding companies belong in this general category. The classic example, I think, is that of Mission Corporation—because the inherent unfairness of the set-up to minority owners was forcibly expressed by its own president at a time when he was opposing a highly unusual merger deal proposed by the controlling stockholder. The details of this case—on which *finis* has not yet been written—will repay careful examination by students of the question of control.

Probably the most controversial idea of all would be that outside stockholders are entitled to relief from poor management by the controlling people. It is generally held that a minority holder accepts the management of the majority for better or for worse; only in the rare instances of a clear-cut wastage of assets by an equivalent of gross negligence can he hope for some legal protection. (The pending move for a receiver to take over the R-K-O Pictures Corp. is an example—necessarily somewhat spectacular—of such a situation.) It is conceivable, however, that in due time minority stockholders as a class will establish in the courts their right to at least *reasonably good* management—on the ground that the perpetuation of its own inferior management by the majority represents the placing of its own selfish interest

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