



6-1-1968

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Recommended Citation

Neill G. McBryde, *Corporations -- Reserved Powers and Fundamental Corporate Changes -- Protection of Minority Stockholders' Interests*, 46 N.C. L. REV. 931 (1968).

Available at: <http://scholarship.law.unc.edu/nclr/vol46/iss4/12>

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performing his greatest role as a citizen and yet is reduced to a status where he can no longer enjoy the rights which protect his civilian counterpart."⁸²

THOMAS C. NORD

Corporations—Reserved Powers and Fundamental Corporate Changes—Protection of Minority Stockholders' Interests

In the recent decision of *Brundage v. The New Jersey Zinc Company*,¹ the New Jersey Supreme Court upheld a corporate merger approved by two-thirds of the stockholders of the corporation. The merger was effected pursuant to a state statute² which was enacted subsequent to New Jersey Zinc's incorporation,³ but which nevertheless was applicable to New Jersey Zinc under the statutory reservation of powers of the state. This reservation, subjecting corporate charters to "alteration, suspension and repeal" in the discretion of the legislature,⁴ was contained in the corporation act under which New Jersey Zinc was chartered. In allowing less than all of the stockholders to validate this fundamental corporate change, the court disavowed the longstanding precedent of *Zabriskie v. Hackensack & New York Railroad Company*.⁵

In *Zabriskie*, a railroad sought to extend its line beyond that allowed in its original charter under the authority of a legislative enactment amending the charter to allow the extension. The court held that this action could not be taken even though only a single stockholder dissented, since the reserved powers could not be used to validate corporate changes affecting the stockholders' interest without unanimous consent. It applied the reasoning of the English case of *Natusch v. Irving*,⁶ which held that a joint stock company formed to sell life insurance could not undertake to sell marine insurance—an activity which was unlawful when the company was formed, but which Parliamentary statute subsequently made law-

⁸² Pearl, *The Applicability of the Bill of Rights to a Court Martial Proceedings*, 50 J. CRIM. L.C. & P.S. 561, 565 (1960).

¹ 48 N.J. 450, 226 A.2d 585 (1967).

² N.J. STAT. ANN. § 14:12-1 (Supp. 1967).

³ The New Jersey Zinc Co. received its charter in 1880.

⁴ Ch. 67 [1875] N.J. Laws (now N.J. STAT. ANN. § 14-1 (1937)).

⁵ 13 N.J. Eq. 178 (Ch. 1867).

⁶ 47 Eng. Rep. 1196 (Ch. 1824).

ful—without unanimous stockholder consent. *Zabriskie* recognized that the concurring opinion of Justice Story in *Trustees of Dartmouth College v. Woodward*⁷ had stated that although the corporate charter constituted a contract between the state and the corporation, a reservation of powers by the state would preclude state action from constituting an impairment of this contract in violation of article I, section 10 of the Constitution.⁸ It held, however, that the subsequent adoption of the statutory reservation by New Jersey was not meant to change the *Natusch* situation where fundamental corporate changes directly affected the stockholders' contractual rights in addition to those rights of the corporation in its contract with the state.⁹

Zabriskie thus interpreted the reservation of powers as applying only to the amendments relating to the contract between the corporation and the state. The reservation was not considered to apply to or be a constituent part of the corporation's contract with its stockholders or of the stockholders' contract *inter se*. Any legislative enactments in exercise of the reserved powers which affected these latter contractual obligations without unanimous approval were considered invalid.¹⁰

The *Brundage* decision, noting the changed nature and role of the corporation today in contrast to that found in the *Zabriskie* period, accepts the more modern view that "each successive legislative authorization becomes a part of the stockholder's contract because of the implied consent that this should be so, by virtue of the state's power to amend and repeal, which power existed at the birth of the corporation."¹¹ The authorization might be a direct amendment imposed on the corporate charter or a grant of power enabling

⁷ 17 U.S. (4 Wheat) 518 (1819).

⁸ *Id.* at 712 (concurring opinion).

⁹ See *Durfee v. Old Colony & F.R. R.R.*, 87 Mass. (5 Allen) 230 (1862), where the contractual arrangements between the stockholders and the corporation and between the stockholders *inter se* are examined.

¹⁰ The court reasoned as follows:

It was a reservation to the State, for the benefit of the public, to be exercised by the state only. The state was making what had been decided to be a contract, and it reserved the power of change, by altering, modifying, or repealing the contract. Neither the words nor the circumstances nor apparent objects . . . can, by any construction, extend it to giving a power to one part of the corporators as against the other, which they did not have before.

18 N.J. Eq. 178, 185 (Ch. 1867).

¹¹ N. LATTIN, CORPORATIONS 51 (1959).

a certain percentage of stockholders to enact such amendment. Unanimity is not required.

Prior to *Brundage*, there was a series of New Jersey decisions¹² anticipating *Zabriskie's* demise, which ignored the limitations of *Zabriskie* whenever there was a substantial "public interest" in the legislative enactments involved. By virtue of the "public interest" doctrine the infringement on the stockholder's interest increasingly expanded in scope, culminating in *A. P. Smith Manufacturing Company v. Barlow*¹³ which stated that the retrospective application of a charitable contribution statute to a corporate charter was a valid exercise of the state's reserved powers, despite its obvious effect on the stockholders' contractual rights.

A parallel line of cases¹⁴ in New Jersey had voided certain corporate actions which had been authorized by "reserve power" post-incorporation statutes because they deprived minority share interests of their "vested rights." In these cases, the "public interest" was held not to justify the legislative authorization of destruction or change of these "vested rights." The decisions have never adequately defined this concept but generally a "vested right" has been considered a present property interest, the destruction of which constitutes an impairment of the contractual rights of the stockholder under article 1, section 10 of the Constitution, or a taking of property without compensation which is a violation of the "due process" clause of the fourteenth amendment.¹⁵

Most of the courts which have held the reservation of powers

¹² See *In re Collins-Doan Co.*, 3 N.J. 382, 70 A.2d 159 (1949); *Bingham v. Sav. Inv. & Trust Co.*, 101 N.J. Eq. 413, 138 A. 659 (Ch. 1927), *aff'd*, 102 N.J. Eq. 302, 140 A. 321 (E. & A. 1928); *Grausman v. Porto Rican Am. Tobacco Co.*, 95 N.J. Eq. 155, 121 A. 985 (Ch. 1923), *aff'd. on other grounds*, 95 N.J. Eq. 223, 122 A. 815 (E. & A. 1928); *Murray v. Beattie Mfg. Co.*, 79 N.J. Eq. 604, 82 A. 1038 (E. & A. 1912); *Berger v. United States Steel Corp.*, 63 N.J. Eq. 809, 53 A. 68 (E. & A. 1902).

¹³ 13 N.J. 145, 98 A.2d 581, *appeal dismissed*, 346 U.S. 861 (1953).

¹⁴ See *Wessel v. Guantanamo Sugar Co.*, 134 N.J. Eq. 271, 35 A.2d 215 (1944); *Buckley v. Cuban Am. Sugar Co.*, 129 N.J. Eq. 322, 19 A.2d 820 (1940); *Longsdale Sec. Corp. v. Int'l Mercantile Marine Corp.*, 101 N.J. Eq. 554, 139 A. 50 (Ch. 1927). *But see* *Franzblau v. Capital Sec. Co.*, 1 N.J. Super. 519, 64 A.2d 644 (1949). For cases in other jurisdictions, see *Keller v. Wilson & Co.*, 21 Del. Ch. 391, 180 A. 584 (1935); *Breslav v. New York & Queens Elec. Light & Power Co.*, 249 App. Div. 181, 291 N.Y.S. 932 (1936), *aff'd per curiam*, 273 N.Y. 593, 7 N.E.2d 708 (1937).

¹⁵ See *Keller v. Wilson & Co.*, 21 Del. Ch. 391, 180 A. 584 (1935) where the court makes the flat statement that the destruction of a vested right of a stockholder could violate both the due process and the contract clause.

to be applicable to the stockholders' contract have abandoned the vested rights concept.¹⁶ They recognize the inherent inconsistency in holding that the reservation is a part of the stockholder's contract and constitutes his consent that it be subject to change by the legislature, while at the same time holding that his interests have become "vested" under the same contract and unchangeable by legislative enactment.¹⁷ Once it is recognized that the stockholders' relationship with the corporation is contractual and the provisions of the charter are incorporated into this contract, it is illogical to contend that a right or interest "vests" when legislation in exercise of the reserved powers expressly becomes a part of the charter, except in cases where an actual legal debt has been created such as a declared dividend.

A few courts, however, have applied the vested rights concept to corporate actions where a pre-incorporation statute is involved.¹⁸ These courts generally fail to discern the distinction between the use of the concept when there is a reservation of powers problem, i.e., a post-incorporation statute, and when there is a pre-incorporation statute which authorizes the corporate action.

With the confusion in applying this term to corporate amendments, it is not surprising that the vested rights doctrine has often been used by the courts as a mere label to affix to the stockholders' interest when the equities of the transaction were in his favor. The established practice of the New Jersey equity courts¹⁹ of scrutinizing all fundamental corporate changes to insure essential "fairness" would seem to be a more direct and proper means of protecting the minority stockholder's interest. The whole tenor of *Brundage* points to the need of discarding outmoded concepts in this area of corporate law, and it is probable that the "vested rights," as well as the "public interest," terminology is rendered obsolete by this opinion.

Although the court in *Brundage* expressly accepts the broader

¹⁶ See *McNulty v. W. & J. S. Sloane*, 184 Misc. 835, 54 N.Y.S. 2d 253 (Sup. Ct. 1945), for the landmark opinion repudiating the "vested rights" concept.

¹⁷ See H. BALLANTINE, CORPORATIONS 649 (1946); Becht, *Corporate Charter Amendments: Stock and the Alteration of Dividend Rates*, 50 COLUM. L. REV. 900, 925 (1950).

¹⁸ See *Consolidated Film Indus., Inc. v. Johnson*, 22 Del. Ch. 407, 197 A. 489 (Sup. Ct. 1937).

¹⁹ See H. BALLENTINE, CORPORATIONS 657 (1946), where it is pointed out that New Jersey is one of a few states that reviews the question of

view on the reservation of powers, it curiously qualifies its disavowal of *Zabriskie*:

Its notions [Zabriskie] as to unanimity may have had some force in the days when commerce was conducted largely through individuals and small partnerships or closely held corporations; they have no force in today's society of large corporate enterprises . . . with their stockholders spread throughout the nation.²⁰

The language implies that *Zabriskie* doctrine will still be applicable in the close corporation context.²¹ There are several reasons, however, why a contrary interpretation is more realistic.²² First, *Brundage* requires that the application of the reserved powers to tripartite nature of contractual obligations be recognized regardless of the size of the corporation. Whenever a corporation is recognized as a legal entity, the court must be consistent in its interpretation of the contractual incidents involved unless it is willing to adopt the fiction that a close corporation is qualitatively different from the large public corporation and not of the same genus. Also, if the *Brundage* reasoning is not applied to the close corporation, this would create practical problems for the court in defining

"fairness" of amendments whenever there is substantial prejudice, though short of fraud.

²⁰ 48 N.J. at 469, 226 A.2d at 595.

²¹ The failure of the New Jersey legislature to enact specific provisions dealing with the special problems of the close corporation lends support to this position. Present New Jersey statutory and case law invalidate charter provisions allowing (1) high voting and quorum requirements at stockholder meetings, *see* N.J. STAT. ANN. § 14:10-9 (quorum requirement); *Clausen v. Leary*, 113 N.J. Eq. 324 (Ch. 1933) (voting requirement); *but see Katcher v. Ohsman*, 26 N.J. Super. 28 (Ch. Div. 1953); (2) stockholders' agreements restricting the actions and discretion of directors, or allowing management of the corporation like a partnership, *see, e.g., Jackson v. Hooper*, 76 N.J. Eq. 592 (E. & A. 1910); and (3) dissolution provisions in case of deadlock. Yet, the enforceability of these types of provisions would seem to be imperative in the close corporation context to insure that the individual stockholder is protected from corporate action detrimental to his interest in the *absence* of the unanimity requirements of *Zabriskie*. Certainly in those states which do have close corporation provisions, the need for a restricted view of reserved powers or for the "vested rights" doctrine is diminished considerably. In the 1967 Preliminary Draft made by the Commissioners appointed to revise the New Jersey Business Corporation Act, all these provisions were recommended for inclusion: § 14A:5-9, to -12 (high quorum and voting requirements for stockholder meetings); § 14A:5-21(2) (stockholder agreements restricting the normal powers and discretion of directors); and § 12-5 (dissolution).

²² *See* the New Jersey Business Corporation Act (Preliminary Draft 1967) § 14A:1-5 where the Commissioners in the Comment interpret *Brundage* as unqualifiedly overruling *Zabriskie*.

the close corporation and in determining the nature of the "public interest" in legislation relating to it.

The opinion itself supports a broader reading since the section qualifying the disavowal of *Zabriskie* can be construed to be dictum; and, significantly, the next full paragraph in the opinion summarizes the court's position *without* qualification:

The power reserved . . . should be liberally construed as part and parcel of the tripartite arrangement between the State, the corporation, and the stockholders, and thus viewed, as permitting reasonable corporate charter amendments having legitimate business ends.²³

There are, however, several problems in interpreting this statement. "Reasonable corporate amendments" would seem to refer to those amendments which satisfy the basic requirements of "fairness," but the terms "fairness" and "reasonableness" are not necessarily compatible. The "reasonableness" of an action usually refers to the intent of the majority and whether they acted in good faith; whereas "fairness" logically concerns the intrinsic character and effect of the transaction. Also, there is the question of whether the phrase "legitimate business ends" embodies substantive requirements such that the "public interest" and "vested rights" concepts might still be applicable. Most likely this is just a general statement that any amendment furthering business needs is valid; and "legitimate" probably means that an amendment must not violate public policy.

A significant factor in determining whether the *Brundage* reasoning will be applied to all corporations, regardless of size, is the tradition of the New Jersey equity courts of requiring "fairness" in any fundamental corporate change. The *Brundage* opinion stresses the importance of the independent determination of "good faith" and "fair treatment"²⁴ required in the merger transaction, and this type of safeguard can easily be enforced in the close corporation context to protect the minority interests.

The reasoning employed in *Brundage* is, of course, not limited to the merger, consolidation, or reorganization area. Undoubtedly, such fundamental changes as the elimination of accrued dividends, the issuance of prior preferred to eliminate accrued dividends in-

²³ 48 N.J. at 470, 226 A.2d at 595.

²⁴ 48 N.J. at 470, 226 A.2d at 596.

directly, and the compulsory amendment altering liquidation preferences—which have been held invalid in prior New Jersey cases²⁵—will be re-examined under the broad interpretation of reserved powers in *Brundage*.²⁶

Although the court leaves many questions unanswered in *Brundage*, its overall significance in the development of corporate law is threefold: (1) it represents an increasing awareness by the courts that the needs of the modern corporate require both legislative flexibility in enabling corporations to adjust to changing economic conditions and the compromising of minority interests in favor of a more democratic process within the corporation; (2) it possibly represents a shift in the means employed to protect the minority interests—from the random application of such nebulous concepts as “vested rights” and from the harsh requirement of unanimity, to the direct imposition of equitable limitations on majority shareholder action; and (3) it should provide the impetus for the remaining states which hold to a more restricted view of the reserved powers to reconsider their position in light of modern corporate needs.

NEILL G. MCBRYDE

Credit Transactions—Knowledge and Priority Under Uniform Commercial Code Sections 9-301(1)(a) and 9-312(5)

In *Bloom v. Hilty*¹ the plaintiff sold and delivered to Charles Hilty a quantity of gas drilling pipe. At the time of the sale it was orally agreed that title to the pipe would remain in the plaintiff until the full purchase price was paid. Subsequently Hilty executed a chattel mortgage to the defendant covering the pipe sold to Hilty by the plaintiff. At the time the mortgage was executed the defendant knew of the plaintiff's claim of an interest in the pipe. The defendant duly perfected his security interest by filing a financing statement. The plaintiff did not perfect his interest.

In holding that the defendant's interest was entitled to priority

²⁵ See H. BALLENTINE and G. STERLING, CALIFORNIA CORPORATIONS LAWS 9 (1938); Gibson, *How Fixed Are Class Shareholder's Rights*, 23 LAW & CONTEMP. PROB. 283, 294 (1958); Lattin, *A Primer on Fundamental Corporate Changes*, 1 W. RES. L. REV. 3, 26 (1949).

¹ 427 Pa. 463, 234 A.2d 860 (1967).