

CONSTITUTIONAL LIMITATIONS UPON LEGISLATIVE
POWER TO ALTER INCIDENTS OF THE SHAREHOLDER'S
STATUS IN PRIVATE CORPORATIONS

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If, in this day of bank failures, corporation receiverships, defaulting bonds and passed dividends one were to walk up to an owner of twenty-five shares of stock in the American Telephone and Telegraph Company¹ and question him as to the incidents of his status as a shareholder in that corporation, his answer or reply would probably consist of little more than a cynical smile. The ordinary stockholder of today is resigned to his fate. If a dividend is declared on his holdings he considers himself lucky, almost as though he had received something for nothing. If dividends are never declared and if the value of his shares depreciates he accepts such a loss as the result of his own foolishness.

Perhaps in the last few years this characteristic laxity has been disappearing to some extent, especially among the larger stockholders, who have both greater interests to protect and a greater knowledge of their rights with which to protect them. But the important thing to note is that the average stockholder is a small stockholder,² and the tendency seems to be toward an even greater dispersion of holdings. Add to this the fact that the average stockholder is the ordinary garden variety of American citizen, lacking both the means and the knowledge necessary to an adequate protection of his rights,³ and the problem becomes even more acute. Thus it appears that the question as to what are the incidents of the shareholder's status and how these incidents may be protected is an important one, and one deserving of more attention than it has been given. It is with this in mind

¹ Approximately 25 shares is the average individual holding in A, T&T. The 18,662,275 outstanding shares are held by 700,851 persons. *Moody's Financial Service*, 1933.

² The following figures will serve to illustrate the fact that the tendency is toward small holdings in the hands of a great number of individuals. Cities Service Co. 40,154,673 shares outstanding, 650,000 shareholders. United States Steel Corp. 12,300,000 shares outstanding, 251,025 shareholders. Radio Corp. of America 14,393,965 shares outstanding, 287,813 shareholders. General Motors 44,900,000 shares outstanding, 351,761 shareholders. *Moody's Financial Service*, 1933.

³ Sears, *The New Place of the Stockholder*, p. 60.

that an attempt will here be made to deal with some of the more important rights of the shareholder and to determine how, if at all, these rights are protected.

All of the many phases of this subject could not possibly be adequately treated in a paper of this nature. The incidents resulting from the shareholder's status in a corporation are many and varied,⁴ and several problems may revolve about each of these several incidents. Thus this paper will be confined to an attempt to discuss the constitutional protection that may be afforded the more important rights of the present day shareholder. Because of the nature of the subject and the problems involved, no clear cut division is possible, but for the sake of convenience, and possibly greater clarity, the following topics will be treated separately: Exercise of the Reserve Power—Generally; Dividend Rights; Voting Rights; Stockholders' Liability and Stock Assessments; The Pre-emptive Right; Merger and Change in Corporate Enterprise.

I EXERCISE OF THE RESERVE POWER — GENERALLY

The problems arising under this topic are all the offspring of the famous and oft-cited *Dartmouth College Case*.⁵ An extended discussion of this case is here unnecessary. Suffice it to say that the United States Supreme Court held that a corporate charter constituted a contract between the corporation and the state and that this contract is within the constitutional clause preventing the impairment of the obligation of contract by subsequent state legislation.⁶ Almost immediately it became apparent to the various states that in creating corporations by the issuance of charters they were establishing instrumentalities over which they retained little or no control. To obviate this difficulty and to protect themselves from the dire results that might otherwise follow, the state legislatures were quick to seize upon the suggestion made by Justice Story in his concurring opinion. He pointed out that if a state legislature wished to amend or repeal a corporate charter it should reserve the power to do so.⁷ State

⁴ Sears, *The New Place of the Stockholder*, p. 198. Sears sets out fourteen different rights, powers and remedies.

⁵ *Trustees of Dartmouth College v. Woodward* (1819) 4 Wheat 518, 4 L.Ed. 629.

⁶ United States Constitution, Art 1, Sec. 10.

⁷ 4 L. Ed. 629, 1. c. 677.

statute books or constitutions soon contained a reservation of the power to alter, amend and repeal corporate charters, and those states that did not make such statutory or constitutional reservations inserted a reserving clause in each individual charter.

The reservation of this power to alter, amend and repeal corporate charters by no means put an end to all problems and questions arising between state legislatures and corporations. The effect was merely to change the form of the question. What constitutes a valid exercise of this reserve power, or just what may the legislatures do by virtue of these clauses? A slight examination of the cases leads one to the conclusion that the courts are still looking for the answer.

It can probably be said with a fair degree of certainty that a majority of the courts have concluded that under this reserved power the legislature can pass any legislation that does not effect a substantial impairment of the object of the charter grant and does not destroy rights that have vested under that grant. This seems to be the position taken by the United States Supreme Court.⁸ Under this view of the cases the constitutional question involved is one of due process of law, rather than impairment of the obligation of contract. The cases presenting this view are all careful to announce that the reserve power is not without limit, but the only limitations expressed are that amendments and alterations must be reasonable and consistent with the original object of incorporation, and in no cases can vested rights be disturbed or property taken without due process of law.⁹

A few courts, namely those of New Jersey, Alabama and Utah, have approached the problem differently and have placed other limitations upon the exercise of the reserve power. The essence of their approach and the result that follows is this: the ordinary corporate set-up involves three contracts; that between the state and the corporation, one between the corporation and the stock-

⁸ *Looker v. Maynard* (1900) 179 U. S. 46, 45 L. Ed. 79; *Spring Valley Waterworks Co. v. Schottler* (1884) 110 U. S. 347, 28 L. Ed. 173; *New York & N. E. R. R. Co. v. Bristol* (1894) 151 U. S. 556, 38 L. Ed. 269; *Greenwood v. Union Freight R. R. Co.* (1882) 105 U. S. 131, 26 L. Ed. 961.

⁹ *Stanislaus County v. San Joaquin etc. Co.* (1903) 192 U. S. 201, 48 L. Ed. 406; *Stearns v. Minnesota* (1900) 179 U. S. 223, 45 L. Ed. 162; *Lake Shore etc. R. Co. v. Smith* (1898) 173 U. S. 690, 43 L. Ed. 861; *Shields v. Ohio* (1877) 95 U. S. 319, 24 L. Ed. 357; *Fidelity Bldg. & Loan v. Thompson* (Tex. 1932) 51 S. W. (2d) 578.

holders, and the contract of the stockholders *inter sese*.¹⁰ Having established this distinction between the contractual relationships involved, these courts then go on to hold that the state's reserve power extends only to the contract between the state and the corporation.¹¹

The difference in these two approaches is of course readily apparent, and in dealing with stockholders' rights the difference becomes a profoundly important one. As was pointed out above, under the majority view the only constitutional protection afforded the shareholder is under the due process clause,¹² but under the approach taken by the courts of New Jersey, Utah and Alabama there is also a question as to whether or not there is an impairment of the obligation of contract. The latter is certainly a greater protection for the rights of the stockholder, as will be shown later when the various rights are treated individually. As to most of the incidents of his status the shareholder has no vested property rights within the due process clause, but as to almost all of them he can prove a contract obligation that would be protected by the Constitution.

It is submitted that the New Jersey, Alabama and Utah cases have adopted the better and the only logically correct conclusion. The amazing thing about those courts conforming to the majority view is that they recognize the triple contractual relationship involved, but then go on to hold the reserve power extends to each of these contracts.¹³ To reach this result these courts deal in terms of "legislative intention" and "inclusion by implication," saying that it was the intention of the legislature to extend the

¹⁰ *Yoakam v. Providence Biltmore Hotel Co.* (1929) 34 F. (2d) 533; *Avondale Land Co. v. Shook* (1911) 170 Ala. 379, 54 So. 268; *Morris v. American Public Utilities Co.* (1923) 14 Del. Ch. 136, 122 Atl. 696; *Somerville v. St. Louis Milling & Mining Co.* (1912) 46 Mont. 268, 127 Pac. 464; *Pronik v. Spirits Distributing Co.* (1899) 58 N. J. E. 97, 42 Atl. 586; *Garey v. St. Joe Mining Co.* (1907) 32 Utah 497, 91 Pac. 369. The cases cited point out the three contractual relationships. For further discussion on this point see *Berle & Means, Modern Corporation and Private Property*, at p. 23; also Stern, *Limitation of the Power of a State Under a Reserved Right to Amend or Repeal Charters of Incorporation*, 53 Am. L. Reg. 1.

¹¹ *Avondale Land Co. v. Shook* (1911) 170 Ala. 379, 54 So. 268; *Garey v. St. Joe Mining Co.* (1907) 32 Utah 497, 91 Pac. 369; *Berger v. United States Steel* (1902) 63 N. J. E. 809, 53 Atl. 68.

¹² United States Constitution, Amendment XIV, Sec. 1.

¹³ *Somerville v. St. Louis Milling & Mining Co.* (1912) 46 Mont. 268, 127 Pac. 464; *Melaven v. Schmidt* (1929) 34 N. M. 443, 283 Pac. 900; *Coombes v. Getz* (1932) 285 U. S. 435, 76 L. Ed. 866.

reserve power to all these relationships and therefore the reserve power is a part of each by implication. The very origin of the reserve power clauses refutes such reasoning. As was stated before, these clauses came into being only to obviate difficulties arising under the decision in the *Dartmouth College Case*, to leave corporations in the same position they would have occupied had the Supreme Court held in that case that charters are not contracts within the meaning of the Constitution. Obviously, to accomplish this the reserve power would not have to extend to all the affairs of the corporation.¹⁴

Even if it is admitted that the intention of the legislatures, in reserving the power to alter, amend and repeal corporate charters, was to have the reservation go to all three contractual relationships, the question still remains whether or not they had the power to do this. Clearly the state is a party to only one of these three contracts, so how can it reserve to itself the power to change the other two? If the state has such authority it would seem to follow that the legislature could pass a general act making all private contracts subject to revision by subsequent legislation.

Many of the courts evade this last difficulty by seizing upon the fact that all three of these contracts are embodied in one instrument, and hence, they say, the reserve power applies to them all.¹⁵ This is doing nothing more than subordinating substance to form; it ignores the realities of the situation. The agreements of the stockholders, and of the corporation with the stockholders are coupled with the actual charter or articles of incorporation only as a matter of convenience, and perhaps for the sake of permanence. In substance they are clearly separate from the contract between the state and the corporation.¹⁶

The view, as to the exercise of the reserve power, herein supported, has been consistently followed by the courts of only three states,¹⁷ but it is approved by several eminent writers on the law

¹⁴ *Santa Clara County v. Southern Pac. R. Co.* (1883) 18 Fed. 385, l. c. 406; *Avondale Land Co. v. Shook* (1911) 170 Ala. 379, 54 So. 268, l. c. 270; Cook, *Corporations* (8th ed.) sec. 501.

¹⁵ *Dam Co. v. Gray* (1849) 30 Me. 547; *Oldtown & Lincoln R. Co. v. Veasie* (1855) 39 Me. 571.

¹⁶ *Yoakam v. Providence Biltmore Hotel Co.* (1929) 34 F. (2d) 533.

¹⁷ New Jersey, Utah and Alabama. See *supra*, note 11.

of corporations. Cook says, "There is a strong tendency in the decisions, and a tendency which is deserving of the highest commendation, to limit the power of the legislature to amend the charter under this reserved power. It should be restricted to those amendments only in which the state has a public interest. Any attempt to use this power of amendment for the purpose of authorizing a majority of the stockholders to force upon the minority a material change in the enterprise is contrary to law and against the spirit of justice. Under such reserved power the legislature has only the right to amend the charter which it would have had in case the *Dartmouth College Case* had decided that the federal Constitution did not apply to corporate charters. The power to make a new contract for the stockholders is not thereby given to the legislature. The legislature may repeal the charter, but cannot force any stockholder into a contract against his will. The best view taken of this reserved power is that under it a fundamental amendment of the charter does not authorize a majority of the stockholders to accept the amendment and proceed, but that unanimous consent of the stockholders is necessary."¹⁸

This general treatment of the subject as a whole has been put here with the hope of better introducing the problems connected with the individual incidents. Much of what has been said will be applicable to each of the individual problems to be treated hereafter.

II DIVIDENDS

Upon looking over the various individual incidents of the shareholder's status, one is most likely to conclude that the most important single incident, particularly from the stockholder's point of view, is that one concerning dividends. The average stockholder,¹⁹ who cannot hope by virtue of his holdings to gain any measure of control over the corporate policies, purchases his few shares with little else but the possibility of dividends in

¹⁸ Cook, *Corporations* (8th ed.) Sec. 501. See also Stern, *Limitation of the Power of a State Under a Reserved Right to Amend or Repeal Charters of Incorporation*, 53 *American Law Register* 1; Berle & Means, *Modern Corporation and Private Property*, p. 23; Power of States to Alter Charters, 31 *Col. Law Rev.* 1163.

¹⁹ *Supra*, note 2.

mind. This fact alone warrants the placing of this incident in a position of prominence.

The fact that the right to dividends has been singled out as one particular incident does not mean that it raises only a single legal problem. The problems are many and varied, and they will necessarily differ with the types of stock and the circumstances of the corporation involved.

What seems to be the greatest protection for the stockholder's right to dividends can be dismissed here with a mere statement because it does not involve a constitutional question. The protection referred to is that afforded the shareholder by the courts of equity, by which courts will entertain suits to prevent the withholding of dividends for other than business reasons and to prevent unauthorized discrimination²⁰ between stockholders in the declaration and payment of dividends.²¹ Although the fact does not clearly appear in many of the opinions, one can be quite certain that these equity cases are based on the conception that the directors stand in a fiduciary capacity toward their shareholders.²² These cases point out the general rule that the earnings or profits of a corporation remain the property of the corporation as such, and the shareholders have no property interest therein prior to the declaration of a dividend. Only the directors have the power to declare dividends, and so long as this power is not exercised arbitrarily the action, or inaction, of the directors is final.²³

The right to dividends gives rise to constitutional questions chiefly in those cases involving preferred stock. Often a corporation will be in need of additional capital. Let us suppose that under the existing capital structure of the corporation there are

²⁰ Of course, some discrimination may be provided for by the charter, such as that between preferred and common shareholders.

²¹ *Dodge v. Ford Motor Co.* (1919) 204 Mich. 459, 170 N. W. 668; *Bassett v. U. S. Cast Iron Pipe & Foundry Co.* (1909) 75 N. J. E. 539, 73 Atl. 514; *Collins v. Portland Electric Power Co.* (1926) 14 Fed. (2d) 671; *Channon v. H. Channon Co.* (1920) 218 Ill. App. 397.

²² *Berle & Means, Modern Corporation and Private Property*, p. 260 et. ff.

²³ *Wilson v. American Ice Co.* (1913) 206 Fed. 736 at p. 742: "Money earned by a corporation remains the property of the corporation and does not become the property of the stockholders, unless and until it is distributed among them by the corporation. . . . (What is to be done with the earnings) is to be determined by the directors . . . ; and, unless in case of fraud or bad faith, their discretion in this respect cannot be controlled by the courts. . . ." See also *Dodge v. Ford Motor Co.* supra, note 21.

outstanding two issues, common and preferred, and that the corporation has not been able to pay a dividend on the common stock for some time. Obviously an additional issue of common stock would not be particularly attractive to investors, there being little expectation of common dividends in the near future. To meet this difficulty, and to offer an issue that will be marketable, our corporation will probably attempt to create and sell a prior preference stock. Immediately the original shareholders will set up their howl, claiming, among other things, that their right to dividends is impaired by this new issue. To make the constitutional question a more clear-cut one, let us suppose that the attempt to issue this new stock is being made under the authority of a statute passed by the state of incorporation subsequent to the formation of our company. The complaining stockholders might claim constitutional protection for their dividend rights on two grounds: that they are being deprived of vested property rights without due process of law; that if the statute authorizing new issues is held to apply to this corporation, which was organized prior thereto, its effect is to impair the obligation of contract.

On his first contention the complainant would probably not get very far. The great weight of authority is that the right to unearned dividends is not a vested one.²⁴ The facts here supposed are substantially the same as those in the case of *General Investment Co. v. American Hide & Leather Co.*²⁵ In that case it was held that the issuance of new stock with preference over existing preferred stock does not violate vested rights.

Only one case has been found holding the right to dividends as such to be a vested right. In the case of *Allen v. White*²⁶ a charter amendment, authorized by a statute subsequent to incorporation, attempted to change the method of profit distribution. It was held that the stockholder's right to dividends was a vested right that could not be so changed. While the court in the opinion

²⁴ *Gibbons v. Mahon* (1890) 136 U. S. 549, 34 L. Ed. 525; *General Investment Co. v. American Hide & Leather Co.* (1925) 98 N. J. E. 326, 129 Atl. 244; *Peters v. U. S. Mortgage Co.* (1921) 13 Del. Ch. 11, 114 Atl. 598; *Morris v. American Public Utilities Co.* (1923) 14 Del. Ch. 136, 122 Atl. 696; *Southern Pacific Co. v. Lowe* (1918) 247 U. S. 330, 62 L. Ed. 1142.

²⁵ (1925) 98 N. J. E. 326, 129 Atl. 244.

²⁶ (1919) 103 Nebr. 256, 171 N. W. 52.

talks in terms of vested rights, it seems that the same result might have been reached on another basis, since the amendment complained of would have effected a fundamental change in the corporation in other respects than distribution of profits.

Approaching the supposed case from the contract angle it is possible to find more protection for the shareholder's right to dividends. Whether or not the complainant would prevail on this point would, of course, depend on whether or not the court adopted the view supported in the first part of this paper. Does the reserve power extend to the matter of dividends? It seems quite clear that the agreement as to how dividends shall be paid is a part of the contract of the stockholders *inter sese*,²⁷ or of that between the corporation and the stockholders. By no stretch of the imagination can it be held a part of the contract between the corporation and the state, nor does the state have a direct public interest in the matter. Thus the reserve power of the legislature could not be so extended without impairing the obligation of contract.²⁸ This has been the view adopted by the New Jersey courts under their general policy regarding the exercise of the reserve power.²⁹ The fact that the statute is not direct, but merely authorizes the stockholders to make the change with the assent of a certain majority, does not change the matter. The effect is the same, and the shareholder's original right to dividends should not be changed without his consent.³⁰

One of the clearest cases in point is that of *Pronik v. Spirits Distributing Co.*³¹ There an attempt was made to change the dividend preferences of outstanding stock. When the change was resisted by a stockholder the New Jersey court, clearly distinguishing the three contracts involved, held that the reserve power did not extend to the contract between the corporation and its shareholders, nor to that of the stockholders *inter sese*. At first glance the case of *General Investment Co. v. American Hide &*

²⁷ *Supra*, note 10 & 11.

²⁸ *Supra*, note 11.

²⁹ *Pronik v. Spirits Distributing Co.* (1899) 58 N. J. E. 97, 42 Atl. 586; *General Investment Co. v. American Hide & Leather Co.* (1925) 98 N. J. E. 326, 129 Atl. 244; *Lonsdale Securities Corp. v. International Mercantile Marine Co.* (1927) 101 N. J. E. 554, 139 Atl. 50.

³⁰ *Lonsdale Securities Corp. v. International Mercantile Marine Co.* (1927) 101 N. J. E. 554, 139 Atl. 50.

³¹ (1899) 59 N. J. E. 97, 42 Atl. 586.

*Leather Co.*³² might seem to be *contra* to the usual New Jersey view, but it is important to note that that case did not involve subsequent legislation and that the change was in accordance with provisions that were definitely a part of the contract between the corporation and the shareholders.

The other view is well illustrated by the case of *Hinckley v. Schwarzschild-Sulzberger Co.*³³ At the time the corporation involved was organized the Corporation Laws of New York required the unanimous consent of shareholders for the issuance of preferred stock. Subsequently a statute was passed allowing such stock to be issued with the assent of two-thirds of the stockholders. A common stockholder sought to enjoin an issue proposed in compliance with that statute, but the court held that the statute constituted a valid exercise of the reserve power, and thus it did not impair any vested rights or contractual obligations.³⁴

When we come to the cases involving cumulative preferred stock we find that the problem is magnified by the cumulative provision and that the courts have afforded the holder of this class of stock a greater measure of protection as to his dividend rights. Of course, the cumulative provision guarantees the holder a certain annual dividend, and if the earnings of any one year are not sufficient to warrant the payment of this dividend, it must be paid out of future earnings before any dividends can be paid on the junior classes of stock. So, if after several such dividends have been passed, the corporation proposes to change dividend rights on its stock and to wipe out the amount owing on these passed dividends, the holder of such shares has a just complaint. The cases are pretty well in accord on the proposition that dividends that are accrued but unpaid under a cumulative provision constitute vested rights that cannot be divested by amendment under the reserve power.³⁵

³² (1925) 98 N. J. E. 326, 129 Atl. 244.

³³ (1905) 95 N. Y. Supp. 357.

³⁴ See also *Davis v. Louisville Gas & Electric Co.* (1928) 16 Del. Ch. 157, 142 Atl. 654; *Yoakam v. Providence Biltmore Hotel Co.* (1929) 34 Fed. (2d) 533; *Morris v. American Public Utilities Co.* (1923) 14 Del. Ch. 136, 122 Atl. 696.

³⁵ *Morris v. American Public Utilities Co.* (1923) 14 Del. Ch. 136, 122 Atl. 696; *Lonsdale Securities Corp. v. International Mercantile Marine Co.* (1927) 101 N. J. E. 554, 139 Atl. 50; *Yoakam v. Providence Biltmore Hotel*

Before leaving the subject of dividends it might be well to point out that the problems raised and discussed here will probably not arise with such frequency in the future. This is so because it is now the practice of most corporations when originally organized and when issuing stock to provide that there may be new issues with the consent of a certain majority of the stockholders. Thus the stockholder takes his shares subject to this provision, which is really part of the contract between the corporation and the shareholder, and he can have no complaint when there is a new issue. Some might be prone to think that such provisions are a detriment to the stockholder, but so long as those in control exercise their powers in good faith the stockholder is probably greatly benefited. There are many times when a corporation is in need of immediate capital. If the assent of every stockholder had to be obtained before the needed capital could be acquired with a new issue, the entire plans and policies of the corporation might be blocked, even though these plans and policies are actually beneficial to the corporation and the stockholders as a whole. Such conditions also offer wonderful opportunities for the corporate trouble-maker, and such rascals are not unknown.³⁶ The courts of equity afford the shareholder adequate protection against fraudulent or arbitrary action by the directors or those in power.³⁷

III VOTING RIGHTS

The right to vote in the election of directors and on certain corporate policies was originally one of the most prominent features of being the holder of shares of stock in a corporation. This was particularly true when corporations were small and when stock in each corporation was closely held by a select group who had bought their stock with the express purpose of exercis-

Co. (1929) 34 Fed. (2d) 533; *Roberts v. Roberts-Wicks Co.* (1906) 184 N. Y. 257; *Colgate v. United States Leather Co.* (1907) 73 N. J. E. 72, 67 Atl. 657. Many of these cases point out that these accrued dividends are in the nature of a debt, although the shareholder is not technically a creditor of the corporation.

³⁶ One Venner is a perfect example. His name will be found innumerable times in the reports as party plaintiff to a suit against a corporation, he usually being a very small shareholder and standing on some very technical right.

³⁷ Berle & Means, *Modern Corporation and Private Property*, see chapter on Corporate Powers As Powers in Trust.

ing some control over the company. With the advent of large corporations and small holdings in many hands, the right to vote has decreased in importance so far as the average stockholder is concerned. Furthermore, it has become the practice of many corporations to issue non-voting stock to the general investing public and to confine the voting stock to a particular group that is to run the company's business.

The cases seem to present the problem in three divisions: can the right of vote, once granted, be taken away entirely; can the method of voting be changed; are voting trusts valid? It can be said, though with some reservation, that there is a tendency to hold the right to vote to be of little actual importance or value to the average stockholder. Many cases can be found upholding, as a valid exercise of the reserve power, statutes changing voting rights.³⁸

In spite of the tendency pointed out, few cases can be found holding that the voting right can be entirely taken from the shareholder once it has been given him. The best view on this point is well expressed in the case of *Lord v. Equitable Life Assurance Society*.³⁹ In that case a corporate reorganization was attempted, one effect of which would have been to extinguish the voting rights of the original shareholders. When a stockholder complained his right to vote was preserved by the courts. In his opinion Justice Vann said, "The right to vote for directors is the right to protect property from loss and make it effective in earning dividends. In other words, it is the right which gives the property value and is part of the property itself, for it cannot be separated therefrom. . . . To absolutely deprive him (the stockholder) of the right to vote is to deprive him of an essential attribute of his property. Under ordinary circumstances the Legislature could not by direct action essentially impair the right to vote, nor could it do so indirectly, by authorizing the directors,

³⁸ In re Morse (1928) 247 N. Y. 290, 160 N. E. 374; Looker v. Maynard (1900) 179 U. S. 46, 45 L. Ed. 79; Gregg v. Granby Mining & Smelting Co. (1901) 164 Mo. 616, 65 S. W. 312; Miller v. State (1873) 15 Wall. 478, 21 L. Ed. 98; In re Sharood Shoe Corp. (1912) 192 Fed. 949; Harden v. Eastern States Public Utilities Co. (1923) 14 Del. Ch. 156, 122 Atl. 705; Morris v. American Public Utilities Co. (1923) 14 Del. Ch. 137, 122 Atl. 696; Page v. Whittenton Mfg. Co. (1912) 211 Mass. 424, 97 N. E. 1006.

³⁹ (1909) 194 N. Y. 212, 87 N. E. 443.

with the consent of only a majority of the stockholders, to so amend the charter as to have that effect."⁴⁰

It is apparent in the case discussed that the decision was based on the fact that the right to vote is a vested property right, the divestment of which, in the manner proposed, would constitute a denial of due process of law. Obviously the same result can be reached on the contract theory. That the voting right is a matter of internal affairs of the corporation, a matter between the corporation and its stockholders or a matter among the stockholders *inter sese*, can hardly be questioned. It is clear that if we adopt the view that the reserve power extends only to the contract between the corporation and the state, any statute attempting to affect voting rights would impair the obligations of contract.

Again a New Jersey case is found to best illustrate the application of the contract theory. That case is *Matter Of Election Of Directors*.⁴¹ The Newark Library Association was incorporated in 1847, subject to the legislature's reserve power. At the time of incorporation it was provided that stockholders should have one vote per share up to five shares, and one vote for each five shares over that number. In 1897 the New Jersey Legislature passed an act giving stockholders one vote for each share, regardless of the number of shares held. In holding the Act of 1897 invalid as to this corporation the court clearly pointed out that the method of voting is a contract or agreement between the shareholders, and that this contract is not to be impaired by subsequent legislation, the reserve power not extending thereto.⁴²

When we come to the question of changing the method of voting, without entirely negating the right, we are chiefly concerned with statutes authorizing cumulative voting. These statutes authorize a shareholder, at an election of directors, to cast a number of votes equal to the number of shares he holds,

⁴⁰ 87 N. E. 443, 448 & 449.

⁴¹ (1899) 64 N. J. L. 217, 43 Atl. 435.

⁴² This case was reversed on a subsequent appeal. (1900) 64 N. J. L. 265, 45 Atl. 622. The reversal was on the ground that the corporation was primarily an educational institution effected with a public interest, and furthermore there appeared to be no real objection to the new voting plan. This reversal did not disturb the theory on which the lower court based its decision. For other New Jersey cases in point see *Berger v. United States Steel Corp.* (1902) 63 N. J. E. 506, 53 Atl. 14; *Colgate v. United States Leather Co.* (1907) 73 N. J. E. 72, 67 Atl. 657; *Outwater v. Public Service Corporation* (1928) 103 N. J. E. 461, 143 Atl. 729.

multiplied by the number of directors to be elected. He may cast this entire number of votes for one officer or he may distribute them.⁴³ The purpose of these statutes, of course, is to give a minority the opportunity of getting at least one representative on the board of directors. When such a statute is passed some of the stockholders, principally those in the majority group, are adversely affected thereby, and many of them have taken their troubles to the courts.

The majority of the courts seem to hold that these cumulative voting statutes are a valid exercise of the reserve power. Such a view was recited by the United States Supreme Court in *Looker v. Maynard*.⁴⁴ The court points out that because of the reserve power there was no impairment of contract obligations, and since the right to vote is not a vested right there was no denial of due process of law. Although the impairment of contractual obligations is mentioned the court seems to base its decision almost wholly on the other point. The reasoning in the opinion is unsatisfactory, the court relying almost entirely upon two previous cases, *Sherman v. Smith*⁴⁵ and *Miller v. New York*.⁴⁶ Neither of these two cases seem competent authority for the decision in *Looker v. Maynard*.⁴⁷ In the first case mentioned the stockholder took his stock subject to an express provision authorizing the change he later complained of. The Miller case seems poor authority for two reasons: The case involved a railroad, over which the state has a greater degree of control in the exercise of its police power without regard to the reserve power; there was a dissenting opinion in the case pointing out that the reserve power could not extend to the contract of the stockholders *inter sese*.⁴⁸

Applying the contract theory to these cases it is certain that the opposite result would be reached. The dissenting opinion in the principal case is authority for such a statement.⁴⁹ No New Jersey cases in point have been found, as evidently that state

⁴³ See Missouri Constitution, Art. XII, Sec. 5.

⁴⁴ (1900) 179 U. S. 46, 45 L. Ed. 79.

⁴⁵ (1862) 1 Black 585, 17 L. Ed. 163.

⁴⁶ (1873) 15 Wall. 478, 21 L. Ed. 98.

⁴⁷ *Supra*, note 44.

⁴⁸ Justice Bradley's dissenting opinion; concurred in by Justice Field, 21 L. Ed. 98, 104.

⁴⁹ *Supra*, note 48.

has never had a provision for cumulative voting. However, the *Newark Library Case*,⁵⁰ and the case cited therewith,⁵¹ clearly indicate that such a statute would be held an impairment of the obligation of the contract of the stockholders *inter sese*.

The use of the voting trust device gives rise to some interesting problems, but since no constitutional questions are involved an extended discussion is here unnecessary. A reading of the cases discloses the fact that the general rule is set out in the leading *Shepaug Voting Trust Cases*⁵² where it was held that voting trusts are void as against public policy because they involve a separation of the voting power and the beneficial interest. The theory behind the rule is that the stockholder having the beneficial interest coupled with the voting power will most likely exercise that power for the benefit of the corporation and the stockholders as a whole, whereas, on the other hand, if one holds the voting power without any beneficial interest it is quite possible that he will use his power to subserve his own ends without regard to the better interests of the corporation and its stockholder. Although the *Shepaug Voting Trust Cases* were the first in point, the rule they announced has been quite generally followed.⁵³ Some qualifications have been placed upon the rule, and voting trusts have been held valid when they are clearly for the benefit of all concerned and when the voting power is not irrevocably separated from the beneficial interest.⁵⁴ In New York the problem has been settled by statute, and any voting trust conforming to the statute is valid.⁵⁵

IV STOCKHOLDER'S LIABILITY AND STOCK ASSESSMENTS

The chief consideration of the ordinary stockholder, so far as his shares are concerned, is his pocketbook. When he purchases his stock and pays for it in full, he assumes that the most he

⁵⁰ *Supra*, note 41.

⁵¹ *Supra*, note 42.

⁵² *Bostwick v. Chapman* (1890) 60 Conn. 553, 24 Atl. 32.

⁵³ *Bache v. Central Leather Co.* (1911) 78 N. J. E. 484, 81 Atl. 571; *Thomas Maddock Co. v. Beardot* (1913) 81 N. J. E. 233, 87 Atl. 66; *Billings v. Marshall Furnace Co.* (1920) 210 Mich. 1, 177 N. W. 222.

⁵⁴ *Brightman v. Bates* (1900) 175 Mass. 105, 55 N. E. 809; *Carnegie Trust Co. v. Security Life Insurance Co.* (1912) 111 Va. 1, 68 S. E. 412; *Thompson-Starrett Co. v. E. B. Ellis Granite Co.* (1912) 86 Vt. 282, 84 Atl. 1017.

⁵⁵ *New Stock Corporation Law*, Sec. 50 as amended by Laws of 1925 c. 120. See *In re Morse* (1928) 247 N. Y. 290, 160 N. E. 374.

can lose is the amount of his original investment. However, many of the cases lead one to the conclusion that he is not entirely correct in this assumption. It would be a great surprise to most stockholders to learn that the stock they hold and have paid for in full may be subject to future assessments or additional liability.

It seems to be the general rule that when the charter, or law under which the corporation was organized, is subject to the reserve power, subsequent statutory or constitutional provisions for additional liability are perfectly valid, and they are held to be applicable to prior stockholders, or to holders of stock previously issued, or to stockholders of corporations previously organized.⁵⁶

It will be noticed that the cases cited as authority for the rule stated, all involve the liability of stockholders for corporate debts, and that this liability is sought to be imposed under statutes enacted subsequent to incorporation. The apparent harshness of the rule and the unexpected results that it may produce might lead one to believe that it is unjust, but a closer examination of the problem will show that the rule is founded on sound principles. As was well pointed out in the case of *Perkins v. Coffin*,⁵⁷ the problem does not really involve any of the three contracts which result from the corporate set-up, unless it is the contract between the state and the corporation. Nor is the reserve power necessarily involved. Although some of the courts do speak of these cases as a valid exercise of the reserve power,⁵⁸ it is clear that they are more easily justified under the states' police power. Obviously there are many public interests involved, and the state can exercise its police power for the protection of creditors. The public interests are multiplied in those cases involving banking corporations, and it will be found that the majority of cases in point do involve such institutions.

The problem of stock assessments presents more and greater difficulties than that of stockholders' liability. There may be

⁵⁶ *Sherman v. Smith* (1862) 1 Black 587, 17 L. Ed. 163; *Maxwell v. Thompson* (1921) 195 App. Div. 616, 186 N. Y. S. 208; *Perkins v. Coffin* (1911) 84 Conn. 275, 79 Atl. 1070; *Melaven v. Schmidt* (1929) 34 N. M. 443, 283 Pac. 900; *Fredericks v. Hammons* (1928) 33 Ariz. 323, 264 Pac. 687. *Contra*, *Schramm v. Done* (1930) 135 Ore. 16, 293 Pac. 931.

⁵⁷ (1911) 84 Conn. 275, 79 Atl. 1070.

⁵⁸ *Fredericks v. Hammons* (1928) 33 Ariz. 323, 264 Pac. 687.

times when a corporation is in need of additional capital, and it does not wish to float new stock or bond issues to raise this capital. An assessment of the stockholders may then be attempted as a means of raising the needed funds. To present the issue more clearly let us suppose that at the time of incorporation it was provided that the stock should not be assessed without the unanimous consent of the shareholders. Subsequent to incorporation the legislature, acting under the reserve power, passes an act permitting corporations to levy stock assessments with the assent of a certain majority of the stockholders. A minority shareholder complains of an assessment attempted in compliance with the statute and carries his complaints to the courts. The cases are in conflict as to what his rights are in the matter, and whether or not they are protected in any way.⁵⁹

The issue outlined above was squarely presented in the case of *Somerville v. St. Louis Mining & Milling Co.*⁶⁰ The Montana court clearly distinguished the three contracts involved, but then went on to hold that the reserve power extended to all three. The decision is based chiefly on a previous Montana case⁶¹ involving the exercise of the reserve power. The result is clearly in accord with the general rule regarding the exercise of the reserve power.⁶²

The case of *Garey v. St. Joe Mining Co.*⁶³ involved the same issue, but the Utah court reached the opposite result by holding the statute, as applied, to constitute an impairment of the obligation of contract. This, of course, was based on the theory that the reserve power extends only to the contract between the state and the corporation, and as a result greater protection is afforded the shareholder. The case of *Enterprise Ditch Co. v. Maffit*⁶⁴ reached a similar result, but the decision is based on the theory of vested rights rather than contract rights. It is the only case found holding the right to limited liability to be a vested right.

⁵⁹ *Somerville v. St. Louis Milling & Mining Co.* (1912) 46 Mont. 268, 127 Pac. 464; *Garey v. St. Joe Mining Co.* (1907) 32 Utah 497, 91 Pac. 369; *Enterprise Ditch Co. v. Maffit* (1899) 58 Nebr. 642, 79 N. W. 650.

⁶⁰ (1912) 46 Mont. 268, 127 Pac. 464.

⁶¹ *Allen v. Ajax Mining Co.* (1904) 30 Mont. 490, 77 Pac. 47.

⁶² *Supra*, notes 8 and 9.

⁶³ (1907) 32 Utah 497, 91 Pac. 369.

V THE PRE-EMPTIVE RIGHT

The pre-emptive right is, in essence, the right of each shareholder to maintain his original position in the corporation. That is, if the corporation as originally organized issues one thousand shares and a particular shareholder owns one hundred of these shares, he has a right to one-tenth of the dividends, a right to one-tenth of the assets upon dissolution, and he also holds one-tenth of the voting power. If, subsequently, the corporation issues additional shares, the shareholder must have an opportunity to subscribe to one-tenth of this new issue if he is to maintain his original position. It is the pre-emptive right that gives him this opportunity.⁶⁵

This right seems to have been first announced in the case of *Gray v. Portland Bank*.⁶⁶ Gray was awarded damages because his application, as a shareholder, for part of a new issue was denied. The exact basis for the decision is not made clear by a reading of the opinion. Sewall, J. seems to imply that under the charter the original shareholders were entitled to pro rata subscriptions, and that if they did not subscribe voluntarily, the corporation could compel the subscription.⁶⁷ On the other hand the opinion of Sedgwick, J. seems to say that the original shareholders have an option to subscribe, which option cannot be taken away by arbitrary action on the part of the directors. Thus he would seem to allow recovery because the directors violated a duty imposed upon them by their fiduciary capacity.⁶⁸ Regardless of what may have been the real basis for the decision this is considered the leading case on the point and the one that established the pre-emptive right.

The later cases, which proceed on the precedent established by the principal case, reach the conclusion that this pre-emptive right is a property right belonging to the shareholder, a right that he acquires by virtue of his status as a shareholder.⁶⁹ If

⁶⁴ (1899) 58 Nebr. 642, 79 N. W. 650.

⁶⁵ The illustration involves the simplest corporate structure. The problems are a bit more complicated when there are several classes of stock outstanding, with different preferences and participation rights, but fundamentally the problems and the rights are the same.

⁶⁶ (1807) 3 Mass. 364.

⁶⁷ (1807) 3 Mass. 364, l. c. 375.

⁶⁸ (1807) 3 Mass. 364, l. c. 382.

⁶⁹ *Luther v. C. J. Luther Co.* (1903) 118 Wis. 112, 94 N. W. 69; *Stokes v. Continental Trust Co.* (1906) 186 N. Y. 285, 78 N. E. 1090; *Petrie v.*

the pre-emptive right is such a vested right, it is, of course, constitutionally protected. Subsequent legislation could not take away the right without violating due process of law. This, however, does not mean that a corporation at the time of its organization could not, by agreement with the shareholders, prevent this right from ever coming into existence.

In considering the pre-emptive right several situations must be distinguished from the simple situation outlined above. This right is pretty closely confined to new stock issued for the purpose of increasing the capital of the corporation.⁷⁰ The stockholder has no option on a new issue, the purpose of which is to take over another corporation.⁷¹ In such a case the shareholder is in no way prejudiced, for his shares are still represented by the same amount of corporate property, and his proportionate interest is substantially the same. Nor does the pre-emptive right extend to the sale of treasury stock.⁷² The sale of such stock in no way alters the shareholder's original position; his proportion to the original amount of stock remains as before. Furthermore, shares authorized but unissued are to be distinguished from new issues. When such shares are sold the existing shareholders cannot claim a pre-emptive right with regard thereto.⁷³ Here again the stockholder cannot complain that his proportionate interests are reduced.

The desirability of upholding the pre-emptive right doctrine under present corporate conditions has been seriously questioned by some writers. It has been pointed out that "in large corporations with scattered holdings, the advantage to the shareholders in creating an effective means of obtaining new capital on favorable terms, would more than make up for the possible dilution of potential minority voting strength."⁷⁴ It has also been pointed

Bruce (1928) 157 Tenn. 131, 7 S. W. (2d) 43; *Titus v. Paul State Bank* (1919) 32 Ida. 23, 179 Pac. 514; *Dunn v. Acme Auto & Garage Co.* (1918) 168 Wis. 128, 169 N. W. 297; *Hammer v. Cash* (Wis. 1920) 173 N. W. 465; *Thom v. Baltimore Trust Co.* (Md. 1930) 148 Atl. 234.

⁷⁰ *Thom v. Baltimore Trust Co.* (Md. 1930) 148 Atl. 234, points out that the pre-emptive right is limited to stock issued for money needed to increase the company's cash assets.

⁷¹ *Supra*, note 70.

⁷² *Borg v. International Silver Co.* (1925) 11 Fed. (2d) 147.

⁷³ *Dunlay v. Avenue M Garage* (1930) 253 N. Y. 274.

⁷⁴ *Drinker, The Pre-emptive Right Of Shareholders*, 43 Harv. Law Rev. 586. The writer suggests that incorporators should be required by statute

out that the fiduciary concept of the directors' position is sufficient to protect the shareholder in the maintenance of his proportionate interests.⁷⁵

VI MERGER AND CHANGE IN THE CORPORATE ENTERPRISE

When two corporations carrying on similar or closely allied business enterprises seek to merge and continue as a single corporation, the transactions necessary to effect such a combination may necessarily alter the rights of the shareholders of either or both of the corporations involved. Very often such mergers will involve a revision of the capital structure of one or both of the merging companies. The shareholders will be asked to turn to their stock and receive therefor stock in the new corporation, which stock may not carry with it the rights and incidents that accompanied the relinquished shares. Such consolidations are usually attempted under an authorizing statute, so the stockholder who feels that his rights are infringed may complain that the statute is unconstitutional.

The problems arising out of mergers and changes of the corporate enterprise involve many of the rights that have been previously discussed, but since they arise in a different manner a brief treatment here will not be entirely repetitious.

It is clear at the outset that if a statute authorizes a merger to be consummated in such a way as to divest the shareholders of either corporation of vested rights, that statute would be held unconstitutional as a denial of due process of law.⁷⁶ Furthermore, mergers will be enjoined when they force the shareholders to relinquish their holdings at less than their actual value,⁷⁷

to indicate whether or not the pre-emptive right to subscribe to new shares is reserved.

⁷⁵ *Supra*, note 74. See also Morawetz, *Pre-emptive Right Of Shareholders*, 42 *Harv. Law Rev.* 186; Berle & Means, *Modern Corporation And Private Property*, p. 247.

⁷⁶ *Outwater v. Public Service Corporation* (1928) 103 N. J. E. 461, 143 *Atl.* 729. In this case the merger involved an exchange of voting stock for non-voting stock, and since the right to vote was held a vested right the merger was enjoined. *Lord v. Equitable Life Assurance Society* (1909) 194 N. Y. 212, 87 N. E. 443. Here again the corporate change was enjoined in so far as it deprived a shareholder of his right to vote.

⁷⁷ *Jones v. Missouri Edison Electric Co.* (1906) 144 *Fed.* 765. The merger attempted in this case was surrounded by a strong odor of fraud, so the decision is really based on the concept that the directors and the majority stockholders exerting control stand in a fiduciary capacity.

their effect being practically a taking of property without due process of law.

It is apparent from the previous discussion of the shareholder's individual incidents, that if the stockholder's constitutional protection is dependent upon his establishing vested rights as to each incident he wishes to protect, he will be afforded a very meager protection. Most of the merger cases bear out the general rule that the majority of the shareholder's rights are not vested rights, and therefore a merger statute authorizing an alteration of these rights is a valid exercise of the reserve power.⁷⁸ Furthermore, statutes authorizing the buying off of shareholders who do not assent to a merger have also been upheld under the reserve power.⁷⁹

Once more, if we take a different tack, and consider the contractual elements involved, different results can be reached on a more logical basis, and the shareholder can be given more protection. Mergers often involve a change of dividend rights, par values and voting rights. It has previously been shown that these are matters of contract between the stockholders *inter sese* or between the corporation and the stockholders, and that it cannot be logically held that the reserve power extends to these matters. Thus a merger statute which ultimately altered these rights would be as much an impairment of contractual obligations as any statute directly changing them. *Outwater v. Public Service Corporation*⁸⁰ adopts this approach, the traditional New Jersey view, and holds that merger legislation, enacted under the reserve power cannot effect a perversion of the contractual obligations of the stockholders *inter sese*. Such a view, which might at first appear to be too strict, would not prevent all corporate mergers,

⁷⁸ Colby v. Equitable Trust Co. (1908) 124 App. Div. 262, 108 N. Y. S. 978; Atlantic Refining Co. v. Hodgman (1926) 13 Fed. (2d) 718; Lord v. Equitable Life Insurance Society (1909) 194 N. Y. 212, 87 N. E. 443; Allen v. Ajax Mining Co. (1904) 30 Mont. 490, 77 Pac. 47; Bigelow v. Calumet & Hecla Mining Co. (1909) 167 Fed. 721; Polk v. Mutual Reserve Fund Ass'n of N. Y. (1907) 207 U. S. 310, 52 L. Ed. 222; Globe v. Erie County Mutual Ins. Co. (1902) 169 N. Y. 613, 62 N. E. 1096; Windhurst v. Central Leather Co. (1927) 101 N. J. E. 543, 138 Atl. 772.

⁷⁹ Winfree v. Riverside Cotton Mills Co. (1912) 113 Va. 717, 75 S. E. 309; Allen v. Ajax Mining Co. (1904) 20 Mont. 490, 77 Pac. 47; see Cook, *Corporations* (8th ed.) Sec. 2623.

⁸⁰ (1928) 103 N. J. E. 461, 143 Atl. 729.

but it would require that stockholders' rights be converted rather than destroyed.⁸¹

A change or extension of the corporate enterprise may affect the incidents of the shareholder's status, although it does not directly alter them. Such a change might subject the corporate assets to incumbrances not intended at the time of incorporation, and it might force the shareholder into a business entirely different than that planned when he purchased his stock. That the stockholder is not without protection, merely because his rights may be only indirectly affected, is shown by the case of *Zabriskie v. Hackensack & New York Railroad Co.*⁸² In that case a fourteen mile extension of the railroad, authorized by an amendment passed under the reserve power, was enjoined on the ground that it would change the corporate enterprise. Again the New Jersey court points out that the reserve power does not authorize a change of the rights of the corporators as between themselves.⁸³

CONCLUSION

Throughout this paper an attempt has been made to point out the various ways in which the incidents of the shareholder's status in a corporation might be protected by constitutional limitations, and to further show how the courts have treated these possibilities. It has been found that in most of the states the legislatures, with the reserved power to alter, amend, and repeal corporate charters at their disposal, are limited only by the due process clause of the United States Constitution, and

⁸¹ *Supra*, note 80. See also *Windhurst v. Central Leather Co.* (1927) 101 N. J. E. 543, 138 Atl. 772. This *Windhurst* Case might at first glance seem *contra* to the usual New Jersey view, but it must be noted that the plaintiff failed to show any injury, and furthermore he seems to have been guilty of laches.

⁸² (1867) 18 N. J. E. 178.

⁸³ *Zabriskie v. Hackensack etc. R. Co.* (1867) 18 N. J. E. 178 "It is also settled, upon the principles of the common law, in this state and in most states of the Union, that when a number of persons associate themselves as partners, for a business and time specified in the agreement between them, or become members of a corporation for definite purposes and objects specified in their charter, which in such case is their contract, and for a time settled by it, that the objects and business of the partnership or corporation cannot be changed, or abandoned, or sold out, within the time specified, without the consent of all the corporators or partners; one partner or corporator, however small his interest, can prevent it. And this is so, although by law, a majority in either case can control or manage the business against the will and interest of the minority so long as it is within the scope of the partnership or the charter."

that this constitutes a negligible limitation, since few, if any, of the stockholder's incidents are rated as vested rights.

The other view, which seems to have been adopted by the unimposing minority of three states, has been supported here, not because it affords the poor victimized stockholder more protection, but because it seems the more logically and legally correct. It more fully comprehends the nature of the corporate set-up and more clearly distinguishes the various elements and interests involved.

A better conception of the reserve power would make it something analogous to the police power. That is, it should be used to alter or amend corporate charters only when the general public interest requires such action, instead of every time a corporation lobbyist may suggest it.