Updated Corporate Statutes Make New Jersey More Attractive to Businesses

An Analysis of the Recently Enacted Derivative Action Statute

by Edward T. Kole and Risa M. Chalfin

Signed into law in 1968, New Jersey's statute governing shareholder derivative actions remained virtually unchanged for more than 40 years.[1] As corporate structures and governance mechanisms evolved, New Jersey's laws did not keep pace, and the consequences were severe. In April 2013, New Jersey's legislators finalized amendments to the state's corporate statutes to restrict unfounded shareholder derivative actions. The much-needed amendments align New Jersey with surrounding jurisdictions, and should clear the courts of certain frivolous suits, streamline operations for existing companies and render the state fertile ground for emerging businesses.[2]

Commencing a Derivative Action

A shareholder derivative action allows a shareholder to bring a lawsuit against a corporation in order to stop or remedy a perceived wrong by the corporation. The action allows a shareholder to protect the interests of the corporation and compels the wrongdoer to compensate the corporation for any injury caused.[3] While protecting these essential rights of shareholders to identify and address wrongdoing, New Jersey's former statutes left corporations susceptible to frivolous litigation initiated by opportunistic shareholders.[4]

Under the new statutes, to commence a derivative action an individual must have been a shareholder of the corporation at the time the alleged act or omission occurred, and throughout the derivative proceeding.[5] Thus, the shareholder must be interested at the time of the wrongdoing, *and* must remain interested in order to bring a derivative action.[6]

The Demand Requirement: Opportunity to Cure

The new provisions require that the shareholder provide the business entity with an opportunity to address the alleged misconduct in anticipation of filing suit. Prior to commencement of a derivative action, a shareholder must provide written demand to the corporation, allowing the corporate board an opportunity to correct its actions outside of the scope of litigation.[7] The purpose of the written demand is to encourage the shareholder to exhaust all options within the corporate structure before involving the courts and to relieve the court of unnecessary intrusions into matters of corporate governance.

Largely based upon language within the American Bar Association's Model Business Corporation Act, this adaptation provides the corporation and *all* of its shareholders with several advantages.[8] First, it protects the corporation from the harassment of frivolous lawsuits. Second, if issues exist the corporate governing board may be able to resolve the problem without costly litigation. By virtue of this, it also lessens the burden on an already overburdened Judiciary. Finally, if litigation is necessary, the corporation may be in an advantageous position to assume the suit with greater financial resources and increased knowledge of the alleged wrongdoing.

Meeting Demands: The Role of Independent Directors

A corporation is required to have independent directors evaluate and respond to the shareholder's demand. Indeed, the amended statutes provide that once demand has been made, the board has the right to reject it within 90 days to prevent the filing of a derivative suit. If the corporation rejects the demand and the shareholder still opts to move forward, the complaint must establish that the board or committee was not independent and must allege the specific directors or board members who were not independent at the time of the decision.[9] Therefore, maintaining independent directors is essential.[10]

The test is straightforward: A director is independent only if he or she does not have a material economic interest in the challenged act or transaction and does not have a close relationship with the directors or officers who have material interest in the act

or transaction in dispute.[11] If, after a demand has been rejected, a proceeding is commenced, the corporation may move for dismissal asserting the board's independence and good faith. The court is obligated to rule for a dismissal unless the plaintiff can show the corporation's decision was made in bad faith.[12]

The court may also dismiss a matter if it is determined that maintaining a derivative proceeding "is not in the best interests of the corporation" based upon a determination in good faith by a majority of independent directors, a majority of a committee appointed by the board, or a court-appointed panel. The court may also base its dismissal on a vote of the majority shareholders, excluding those who benefited from the alleged adverse act. These avenues for relief make clear that the new statutes impose a higher burden on the plaintiff to demonstrate the viability of the claim.[13]

Additional Changes Benefit the Corporation

The new legislation has other noteworthy changes making New Jersey a more corporation-friendly state. Shareholders holding less than five percent of the outstanding shares must post a security bond for the possible award of litigation expenses, including attorney's fees that may be incurred by the corporation. Previously, if the value of a minority shareholder's shares was greater than $25,000 the shareholder could avoid posting a bond. That value has been raised to $250,000, the first such change since 1968, to be more in line with the Model Business Corporation Act. In updating this value, the Legislature has again imposed a more reasonable standard on the interested shareholder.[14]

The Shareholder's Protection Act was also amended to change the definition of "resident domestic corporation." The definition now includes all corporations incorporated in New Jersey regardless of the location of operation, provided both the corporation's principal office was in New Jersey and significant business was conducted in the state at the time of incorporation.[15]

Additionally, the act now allows corporations to engage in a business combination with an interested stockholder if the board approves the transaction. An interested stockholder is an owner of 10 percent or more of the outstanding voting stock. Pursuant to the new statute, business combinations are allowed within five years if approved by the board of directors, or a committee of the board not associated with the interested stockholder, *and* a vote of the majority of the voting stock not owned by the interested stockholder.[16] The purpose is to promote a more open and free exchange.

Amendments to the New Jersey Business Corporation Act were also made to ease the ability of shareholders to participate in meetings. Pursuant to the new language, shareholders can now participate in shareholder meetings and vote remotely.

Finally, the remedy for a dissenting shareholder, or a shareholder refusing to consent to a merger or other business combination, is to demand fair market value for his or her shares. Shareholders may only bring an action if the corporation has not complied with the amended rules, or if the corporation has engaged in fraud or material misrepresentation. Thus, shareholders' remedies are limited, empowering the corporation to engage in business decisions without the fear of superfluous litigation from shareholders.[17]

Conclusion

The long-awaited amendments to New Jersey's corporate laws are a strong nod to the state's existing corporations, which must revise their certificate of incorporation in order to elect these new statutory guidelines. Equally important, the Legislature has opened the door to corporations that previously shied away from New Jersey due to less favorable corporate laws.

Beyond the specific amendments, the overhaul to the corporate laws creates a more equitable environment for corporations and shareholders alike. These changes champion collaboration and cooperation. They establish a critical balance of power through reasonable thresholds, which is good for the business community, public policy and judicial efficiency. ⚖

Endnotes

1. The New Jersey shareholder derivative action statute, N.J.S.A. 14A:3-6, had previously been amended once in 1973.
2. Governor Chris Christie signed three laws on April 1, 2013, to make New Jersey's corporate governance more business-friendly: P.L. 2013, c.40, c.41, and c.42, subsequently codified at N.J.S.A. 14A:10A-1, *et seq.*; N.J.S.A. 14A:11-1, *et seq.*; and N.J.S.A. 14A:3-6.1 to 6.9.
3. *In re PSE&G Shareholder Litigation*, 173 N.J. 258, 277-78 (2002); *Kamen v. Kemper Financial Svcs., Inc.*, 500 U.S. 90, 95 (1991).
4. *See*, N.J.S.A. 14A:3-6.
5. *See*, N.J.S.A. 14A:3-6.1, *et seq*.
6. *See*, N.J.S.A. 14A:3-6.2.
7. N.J.S.A. 14A:3-6.3.
8. Model Business Corporation Act Section 7.40-7.4.
9. N.J.S.A. 14A:3-6.5.
10. N.J.S.A. 14A: 3-6.5.
11. N.J.S.A. 14A:3-6.5(7).
12. N.J.S.A. 14A:3-6.5.
13. N.J.S.A. 14A:3-6.5(b)(3).
14. N.J.S.A. 14A:3-6.8.
15. N.J.S.A. 14A:10A-1, *et seq*.
16. N.J.S.A. 14A:10A-5.
17. N.J.S.A. 14A:11-1 *et seq*.

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