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Nelson v. Patrick: More Problems for Professional Corporations

In recent years physicians and attorneys in North Carolina have become concerned about malpractice liability. Not only can professionals be held liable for their own negligent acts,[1] professionals in a partnership can be held jointly and severally liable for the acts of their partners.[2] If professionals incorporate, however, the extent of their liability is unclear. Under North Carolina corporate law the liability of shareholders is limited to the amount of capital they have invested in the corporation. Furthermore, shareholders cannot be held personally liable for negligent acts of the corporation or for negligent acts of other shareholders.[3] The question arises whether professionals who incorporate in North Carolina obtain the limited liability afforded corporate shareholders.[4]

In *Nelson v. Patrick*[5] the North Carolina Court of Appeals answered this question by holding that members of a professional corporation could be held jointly and severally liable for the negligence of other members.[6] Prior to *Nelson* many professionals had reason to believe that incorporation offered them limited liability.[7] Although the North Carolina Professional Corporation Act permits professionals to form corporations,[8] it does not specify whether a member of such a corporation can be held personally liable for the acts of the corporation or for the acts of fellow members. This Note analyzes the North Carolina Professional Corporation Act[9] and examines the court of appeals' interpretation of the Act in *Nelson*. It also analyzes interpretations of similar statutes by other jurisdictions. The Note concludes that the court of appeals in *Nelson* ignored the intent of the general assembly and misinterpreted the language of the Act.

Prior to the adoption of professional corporation statutes in the 1960s, doctors and lawyers were not permitted to incorporate.[10] The noncorporate status

1. N.C. GEN. STAT. § 55B-9 (1982).
2. *Id.* §§ 59-43, -45.
3. *See id.* § 55-53(e).
4. A "professional corporation" is defined as "a corporation which is engaged in rendering the professional services as herein specified and defined . . . and which has as its shareholders only those individuals permitted by G.S. § 55B-6 of this Chapter to be shareholders." *Id.* § 55B-2(5). Although the term "professional service" refers to "any type of personal or professional service of the public which requires as a condition precedent to the rendering of such service the obtaining of a license from a licensing board," *id.* § 55B-2(6), this Note discusses only professional corporations of physicians and professional corporations of attorneys.

A professional corporation may issue shares of its capital stock only to a person "who is duly licensed by the appropriate licensing board to render the same professional services" that will be rendered by the professional corporation. *Id.* §§ 55B-2(2), -6. Shareholders may transfer their shares only to another licensee. *Id.* § 55B-6.

5. 73 N.C. App. 1, 326 S.E.2d 45 (1985).
6. *Id.* at 8-9, 326 S.E.2d at 50.
7. *See* Shores, *Professional Corporations*, 10 WAKE FOREST L. REV. 691 (1974). Most professional corporation statutes do not change the rule that a shareholder generally has no personal liability for the obligations of the corporation. *Id.* at 712.
8. N.C. GEN. STAT. §§ 55B-1 to -15 (1982).
9. The North Carolina Professional Corporation Act became effective on January 1, 1970. The Professional Corporation Act, ch. 718, § 23, 1969 N.C. Sess. Laws 718, 722 (codified at N.C. GEN. STAT. §§ 55B-1 to -15 (1982)).
10. *E.g.*, Act of March 21, 1931, ch. 157, §§ 1-2, 1931 N.C. Pub. Laws 219, 219-20 (prohibiting

of the professional was considered necessary to preserve to the patient or client "the benefits of a highly confidential relationship based upon personal confidence, ability, and integrity."[11] Unlike other businesspersons, professionals were viewed primarily as public service providers.[12] Many states feared that professionals, if allowed to incorporate, would emphasize the business aspect of their professions rather than the service aspect, and clients would suffer as a result.[13] Denied the option to incorporate, many professionals formed "associations" with other professionals.[14]

Historically, the Internal Revenue Service (IRS) has treated professional associations as partnerships for tax purposes.[15] Thus, professionals could not obtain any of the employee fringe benefits of corporations because professionals were taxed as though they were self-employed.[16] In 1935, however, the United States Supreme Court in *Morrisey v. Commissioner*[17] established a resemblance test to determine when an unincorporated business could be taxed as a corporation.[18] Under the *Morrisey* test an unincorporated business can be taxed as a corporation if the business exhibits a preponderance of corporate characteristics.[19] These include: (1) limited liability;[20] (2) centralized management;[21]

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the practice of law by a corporation), *amended by* The Professional Corporation Act, ch. 718, § 20, 1969 N.C. Sess. Laws 718, 720 (amended as part of the Act authorizing attorneys and other professionals to incorporate) (codified as amended at N.C. GEN. STAT. § 84-5 (1985)). Most other states had similar prohibitions. *See, e.g., In re* Fla. Bar, 133 So. 2d 554 (Fla. 1961); *In re* Bar Ass'n of Hawaii, 55 Hawaii 121, 516 P.2d 1267 (1973); *In re* N.H. Bar Ass'n, 110 N.H. 356, 266 A.2d 853 (1970); *In re* R.I. Bar Ass'n, 106 R.I. 752, 263 A.2d 692 (1970).

11. *In re* Fla. Bar, 133 So. 2d 554, 556 (Fla. 1961).

12. *See* First Bank & Trust v. Zagoria, 250 Ga. 844, 302 S.E.2d 674 (1983). The Georgia Supreme Court stated that

> [t]he diligence of this court has been directed toward the assurance that the law practice will be a professional service and not simply a commercial enterprise. The primary distinction is that a profession is a calling which demands adherence to the public interest as the foremost obligation of the practitioner.

Id. at 845, 302 S.E.2d at 675. Significantly, the North Carolina Professional Corporation Act defines "professional corporation" as "a corporation which is engaged in rendering . . . professional *services*." N.C. GEN. STAT. § 55B-2(5) (1982) (emphasis added).

13. *See* First Bank & Trust v. Zagoria, 250 Ga. 844, 846, 302 S.E.2d 674, 675 (1983).

14. *See* Phillips, *Origins of Tax Law: The History of the Professional Service Corporation*, 40 WASH. & LEE L. REV. 433, 439 (1983).

15. *Id.*

16. Arnold, *Professional Corporations in Oklahoma*, 17 TULSA L.J. 1, 3 n.10 (1981). Being self-employed, the professionals were unable to take advantage of provisions in the Internal Revenue Code that permit employees to exclude from gross income certain benefits provided by their employer. *Id.*

17. 296 U.S. 344 (1935).

18. *Id.* at 357-59. The Court did not specifically label the test the "resemblance test." Other commentators, however, have referred to it as the "resemblance test," Phillips, *supra* note 14, at 440, the " 'attributes' or 'characteristics' test," *see* Shores, *supra* note 7, at 692, and the "corporate resemblance" test, Note, *Professional Corporations, Shareholder Liability in Ohio: Confounding Attorneys and Others*, 17 AKRON L. REV. 143, 145 (1983).

19. *Morrisey*, 296 U.S. at 356-60.

20. *Id.* at 359. Limited liability was not necessarily a prerequisite to achieving corporate status under the *Morrisey* resemblance test. It was simply one of the factors to be considered. Birt v. St. Mary Mercy Hosp., 175 Ind. App. 32, 38, 370 N.E.2d 379, 382 (1978).

21. *Morrisey*, 296 U.S. at 359. Management is centralized in a professional corporation. Bowman, *The Professional Corporation—Has the Death Knell Been Sounded?*, 10 PEPPERDINE L. REV. 515, 521 (1983). In a general partnership every partner has a right to participate in the management

(3) transferability of ownership;[22] and (4) continuity of life.[23] To gain the tax benefits of a corporation, many professionals began to organize their businesses to exhibit these corporate characteristics.[24]

In 1960 the IRS adopted regulations, known as the Kintner regulations,[25] that addressed the tax treatment of professional associations.[26] Under the Kintner regulations the corporate characteristcs of the resemblance test were to be assessed under state law.[27] Because the common law of most states prohibited doctors and lawyers from incorporating, however, it was unlikely that a professional association could exhibit a majority of these corporate characteristics.[28] Thus, the effect of the Kintner regulations was to preclude partnerships and unincorporated businesses from being taxed as corporations.[29] In response, professionals in many states pressured legislatures to enact statutes that would authorize professionals to form corporations.[30] By 1970 forty-nine states had statutes authorizing the incorporation of professional associations.[31] Finally, in 1970 the IRS announced that professional groups organized under state professional corporation statutes would be treated as corporations for federal income tax purposes.[32]

Given this history, it is apparent that professional corporation statutes were not enacted primarily for the purpose of limiting the liability of professionals. Rather, these statutes were enacted primarily to extend corporate tax treatment to professional associations.[33] Because the professional is considered an em-

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of the business. *Id.*; *see also* N.C. GEN. STAT. § 59-39 (1982) (every partner is an agent of the partnership). As the partnership grows, however, decision-making becomes increasingly difficult. This problem is resolved by incorporation. The election of a board of directors and officers permits a small number of individuals to manage the business. Bowman, *supra*, at 521.

22. *Morrisey*, 296 U.S. at 359. Partners are prohibited from transferring their complete partnership rights to another person without the consent of all partners. N.C. GEN. STAT. § 59-57(a) (1982); Bowman, *supra* note 21, at 522-23. In general, a shareholder of a corporation has no such restriction on the right to transfer his or her interest in the corporation. *Id.*

23. *Morrisey*, 296 U.S. at 359. Although a partnership is dissolved by the death or withdrawal of a partner, N.C. GEN. STAT. § 59-61 (1982), a corporation has a continuous life, regardless of the death or resignation of a shareholder, *Id.* § 55-17(a)(1); Bowman, *supra* note 21, at 522.

24. Note, *supra* note 18, at 145. These efforts apparently were successful. In United States v. Kintner, 216 F.2d 418 (9th Cir. 1954), the United States Court of Appeals for the Ninth Circuit held that an association of physicians was taxable as a corporation despite a state common-law prohibition against the incorporation of physicians. *Id.* at 428.

25. "Kintner" refers to United States v. Kintner, 216 F.2d 418 (9th Cir. 1954); *see supra* note 24.

26. Treas. Reg. §§ 301.7701-1 to -11 (1960).

27. *Id.* § 301.7701-1(c).

28. Note, *supra* note 18, at 146.

29. Phillips, *supra* note 14, at 441.

30. Note, *supra* note 18, at 145-46.

31. Phillips, *supra* note 14, at 441. Today, all states and the District of Columbia have statutes authorizing the incorporation of professional associations. *Id.*

32. Rev. Rul. 101, 1970-1 C.B. 278.

33. *See In re* Fla. Bar, 133 So. 2d 554, 556 (Fla. 1961) (purpose of statute to place professionals "on an equal footing with other taxpayers"); *In re* Bar Ass'n of Hawaii, 55 Hawaii 121, 121, 516 P.2d 1267, 1268 (1973) (purpose of statute "to place professional persons on parity with persons in other business corporations who are favored with tax benefits"); *In re* R.I. Bar Ass'n, 106 R.I. 752, 758, 263 A.2d 692, 695 (1970) (purpose of statute to enable "members of the covered professions, not previously allowed to incorporate, to form corporations, thus putting such members on an equal footing with other taxpayers").

ployee of the corporation, he or she is eligible for the tax-favored fringe benefits of the corporation,[34] consisting primarily of retirement plans and insurance coverage.[35] However, because the major tax benefits of incorporation were effectively eliminated in 1982 by the Tax and Equity Fiscal Responsibility Act (TEFRA),[36] the nontax benefits of incorporation have become the significant factors in a professional's decision to incorporate.[37]

The primary nontax benefit of incorporation is the shareholder's limited liability potential. Under North Carolina statutory law a professional corporation may issue shares of stock only to a person who is licensed to render the same services as the professional corporation.[38] In all jurisdictions a professional can be held personally liable for his or her negligent acts despite the concurrent liability of the corporation.[39] There is disagreement among the jurisdictions, however, whether the professional corporation statute shields a shareholder from personal liability for the negligent acts of other shareholders.[40]

State statutes take three approaches in establishing the liability of professional shareholders. First, many jurisdictions limit the personal liability of shareholders to their own negligent or wrongful acts and to the negligent acts of those persons under their direct supervision and control.[41] Second, a few statutes provide that shareholders will be jointly and severally liable for the negligence of fellow shareholders in providing professional services.[42] Third, a substantial number of jurisdictions including North Carolina have statutes that do not explicitly establish a shareholder's liability for the negligence of another

34. Arnold, *supra* note 16, at 2. According to Professor Arnold, the other benefits of incorporation are either minimal or can be obtained without incorporating. Limited liability for torts can be obtained "as a practical matter" by insurance. Centralized management may be accomplished through a well-drafted partnership agreement. The benefit of freely transferable interests may be eliminated by the lack of a ready market for shares in a professional corporation. *Id.* Finally, the professional corporation may be so dependent on one person that for all practical purposes it dissolves upon his or her death. *Id.* at 3.

35. Retirement plans include deferred compensation plans, qualified pension plans, and profit-sharing plans. *See* Note, *Tax and Corporate Aspects of Professional Incorporation in North Carolina*, 48 N.C.L. REV. 573, 576-78 (1970). Insurance benefits include life, health, medical, and disability. Bowman, *supra* note 21, at 528-30. Retirement plans provide the most significant tax advantage of incorporation and until recently provided greater tax benefits than similar plans for partnerships. *Id.* at 528.

36. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).

37. Phillips, *supra* note 14, at 455. The parity and nondiscrimination provisions of TEFRA in 1982 elevated the unincorporated retirement plan and lowered the corporate retirement plan to levels of near equality. Bowman, *supra* note 21, at 543. According to one commentator, "By virtue of the reduced marginal benefits available to incorporated-service providers, the enactment of TEFRA will likely decrease the number of PSC's [Professional Service Corporations] incorporated in the future." Phillips, *supra* note 14, at 455. Another commentator speculates that "with the new IRS allocation powers provided by TEFRA, the professional corporation may well have been dealt the final blow." Bowman, *supra* note 21, at 543.

38. N.C. GEN. STAT. § 55B-6 (1982).

39. Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1, 9 (1961). A professional employee of a professional corporation would be subject to this liability even in the absence of a statute providing for it. *Id.*

40. Note, *Professional Legal Corporations: Limited or Unlimited Liability for Shareholders in Missouri after* First Bank & Trust v. Zagoria?, 28 ST. LOUIS U.L.J. 297, 300-01 (1984).

41. *Id.* at 300.

42. *See, e.g.*, ALASKA STAT. § 10.45-140 (1985); ARIZ. REV. STAT. ANN. § 10-905 (1977); ME. REV. STAT. ANN. tit. 13, § 708 (1981); OR. REV. STAT. § 58.185 (1983).

shareholder in providing professional services.[43] Judicial interpretation of the statutory language determines liability in most jurisdictions.[44]

In *Nelson* the North Carolina Court of Appeals interpreted the North Carolina Professional Corporation Act. *Nelson* involved a medical malpractice action against two radiologists, Dr. Patrick and Dr. Flournoy, and the professional corporation of which they were members.[45] Plaintiff had undergone a complete abdominal hysterectomy and was advised by her gynecologist to undergo radiation therapy to reduce the risk of cancer.[46] As a result of radiation treatments administered by defendant Patrick, plaintiff suffered severe damage to her intestines.[47] Plaintiff alleged negligence on the part of Dr. Patrick for failure to obtain her informed consent to the radiation therapy.[48] The trial court held that defendant Patrick was negligent in failing to inform plaintiff about the therapy and its attendant risks.[49] The trial court also found Dr. Flournoy jointly and severally liable for the negligence of Dr. Patrick.[50]

The court of appeals affirmed the trial court's holding that defendant Patrick was negligent in failing to obtain the plaintiff's informed consent.[51] The appellate court also affirmed the trial court's holding that, although there was no negligence on the part of defendant Flournoy, "any negligence or damages for which Dr. Patrick is liable as a matter of law . . . Flournoy [also] will be liable as a matter of law jointly and severally."[52] The court of appeals cited section 55B-9 of the North Carolina Professional Corporation Act[53] and *Zimmerman v. Hogg & Allen*[54] for the proposition that a professional corporation is liable as if it were a partnership.[55] The court then applied the general rules of partnership

43. *See e.g.*, ARK. STAT. ANN. § 64-2015 (1980); KAN. STAT. ANN. § 17-2715 (1983); MO. REV. STAT. § 356.150 (1985); OHIO REV. CODE ANN. § 1785.04 (Page 1985).

44. *See, e.g.*, O'Neill v. United States, 281 F. Supp. 359 (N.D. Ohio 1968), *aff'd*, 410 F.2d 888 (6th Cir. 1969); Birt v. St. Mary Mercy Hosp., 175 Ind. App. 32, 370 N.E.2d 379 (1978).

45. *Nelson*, 73 N.C. App. at 1, 326 S.E.2d at 45.

46. *Id.* at 3, 326 S.E.2d at 47. Plaintiff's gynecologist referred her to defendants for therapy. *Id.*

47. *Id.* at 3, 326 S.E.2d at 47-48.

48. *Id.* at 4, 326 S.E.2d at 48.

49. *Id.*

50. *Id.* at 8-9, 326 S.E.2d at 51.

51. *Id.* at 9, 326 S.E.2d at 51. An important issue in the case was the modern law of informed consent in North Carolina. The court acknowledged that at common law a physician could be shielded from liability when the physician failed to inform the patient of certain risks if the physician determined that the patient's need to know the risks was outweighed by the anxiety that disclosure might cause the patient. *Id.* at 10-12, 326 S.E.2d at 51-52. The court stated that under the modern law of informed consent in North Carolina, the physician will be liable for nondisclosure if the information customarily would be provided by other physicians or if a reasonable person would need to be informed of those risks to have a general understanding of the procedure and its inherent hazards. *Id.*

52. *Id.* at 8, 326 S.E.2d at 50.

53. N.C. GEN. STAT. § 55B-9 (1982).

54. 22 N.C. App. 544, 207 S.E.2d 267, *rev'd on other grounds*, 286 N.C. 24, 209 S.E.2d 795 (1974).

55. *Nelson*, 73 N.C. App. at 8, 326 S.E.2d at 50. N.C. GEN. STAT. § 59-43 (1983) provides that

> [w]here by any wrongful act or omission of any partner acting in the ordinary course of business of the partnership or with the authority of his copartners loss or injury is caused to any person, not being a partner in the partnership, or any penalty is incurred, the partnership is liable to the same extent as the partner so acting or omitting to act.

liability and stated that members of a professional corporation could be held jointly and severally liable for any negligence of a member that occurred during the course of the corporation's business.[56]

The court in *Nelson* did not explain its interpretation of section 55B-9, nor did it provide an analysis of prior case law to support its holding. The court merely quoted its prior statement in *Zimmerman* that under section 55B-9 "a professional corporation is liable to the same extent as if it were a partnership."[57] The issue of the joint and several liability of members of a professional corporation, however, was not at issue in *Zimmerman*. Rather, *Zimmerman* dealt excusively with whether a professional corporation itself could be held liable for the acts of an attorney shareholder who had misappropriated funds.[58] Because the other members of the corporation were not named as defendants,[59] the court did not address whether they could be held liable. Thus, although *Zimmerman* supports the court's statement in *Nelson* that the professional corporation could be held liable for the negligence of Dr. Patrick, it provides no support for holding that Dr. Flournoy was jointly and severally liable as a shareholder for Dr. Patrick's negligence.

The court of appeals in *Nelson* also cited section 55B-9[60] to support its holding.[61] In analyzing the North Carolina Professional Corporation Act, however, section 55B-9 must be read in conjunction with section 55B-3. Section 55B-3 provides that professional corporations will be subject to the same liabili-

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Supplementing this, N.C. GEN. STAT. § 59-45 (1983) states that "[a]ll partners are jointly and severally liable for the acts and obligations of the partnership."

Joint and several liability is consistent with the common law rule of partnership liability. *See* Hardy and Newsome, Inc. v. Whedbee, 244 N.C. 682, 94 S.E.2d 837 (1956); Johnson v. Gill, 235 N.C. 40, 68 S.E.2d 788 (1949). There is little North Carolina law on a partner's liability in a general partnership engaged in a professional service. The North Carolina Supreme Court has acknowledged that "we find very little authority even as to a partner's liability in a general partnership engaged in the practice of law." Zimmerman v. Hogg & Allen, 286 N.C. 24, 30, 209 S.E.2d 795, 798 (1974). Although no North Carolina case directly deals with the issue, there is no indication that professional service partnerships would be treated any differently from other partnerships in terms of liability. *See* Nash v. Royster, 189 N.C. 408, 412, 127 S.E. 356, 359 (1925). A number of cases in other jurisdictions have held that a physician or surgeon is responsible for negligent acts of his or her partner. *See, e.g.*, Stephens v. Williams, 226 Ala. 534, 147 So. 608 (1933); Whittaker v. Collins, 34 Minn. 229, 25 N.W. 632 (1885); Simons v. Northern R.R. Co., 94 Mont. 355, 22 P.2d 609 (1933).

56. *Nelson*, 73 N.C. App. at 9, 326 S.E.2d at 50.

57. *Id.* at 8, 326 S.E.2d at 50 (quoting *Zimmerman*, 22 N.C. App. at 546, 207 S.E.2d at 269).

58. *Zimmerman*, 22 N.C. App. at 546, 207 S.E.2d at 269. Resolution of this issue depended on the apparent authority that the professional corporation had conferred upon defendant Greene, the attorney who misappropriated the funds. *Zimmerman*, 286 N.C. at 34, 209 S.E.2d at 801. The professional corporation of which Greene was a member represented Holly Farms as labor counsel. *Id.* at 25, 209 S.E.2d at 796. Defendant Greene, allegedly acting as agent for the corporation, entered into a contract with plaintiff, an officer of Holly Farms, to obtain, sell, transfer, and deliver to plaintiff three thousand shares of the common stock of Kentucky Fried Chicken, Inc. *Id.* at 26, 209 S.E.2d at 797. The court of appeals held that the conduct of Greene was not a part of his professional affairs and granted summary judgment in favor of the professional corporation. *Zimmerman*, 22 N.C. App. at 547, 207 S.E.2d at 269. The North Carolina Supreme Court reversed, finding that plaintiff's evidence was sufficient to justify a reasonable belief by plaintiff that the professional corporation had conferred authority on Greene to acquire the funds for investment. *Zimmerman*, 286 N.C. at 39-40, 209 S.E.2d at 804-05.

59. *Zimmerman*, 286 N.C. at 25, 209 S.E.2d at 796.

60. N.C. GEN. STAT. § 55B-9 (1982).

61. *Nelson*, 73 N.C. App. at 8, 326 S.E.2d at 50.

ties as other corporations "except insofar as the same may be limited or enlarged by this Chapter."[62] Section 55B-3 further provides that "[i]f any provision of this chapter conflicts with the provisions of the Business Corporations Act, the provisions of this chapter shall prevail."[63]

Under section 55-53(e) of the Business Corporation Act shareholders of a corporation have limited liability.[64] Thus, absent a provision in the Professional Corporation Act that limits, enlarges, or conflicts with section 55-53(e), shareholders of a professional corporation should be entitled to limited liability. If there is a conflicting provision it can be found only in section 55B-9.

Section 55B-9 is the only part of the Act that addresses explicitly the liability of a professional corporation's shareholders. It provides:

> Nothing in this Chapter shall be interpreted to abolish, restrict, limit, or alter the law in this State applicable to the professional relationship and liabilities between the person furnishing the professional service, or the standards of professional conduct applicable to the rendering therein of such services.[65]

Professional corporation acts in a number of jurisdictions contain almost identical provisions,[66] and courts and commentators interpreting those provisions have agreed that such statutory language is subject to various interpretations.[67]

Looking solely at the language of the Professional Corporation Act, it is unclear whether a shareholder of a professional corporation can be liable for the negligence of other shareholders. *Zimmerman* and *Nelson* are the only decisions interpreting the North Carolina statute. One commentator, however, has interpreted section 55B-9 as limiting personal liability of professional shareholders to their own negligence and to negligence of others under their supervision.[68] Important to this interpretation is the fact the statutory language refers only to "the person furnishing professional services and the person receiving the professional service";[69] the statute is silent on vicarious liability. Another commentator, however, has interpreted a similar statute as holding all members of a

62. N.C. GEN. STAT. § 55B-3 (1982).

63. *Id.*

64. "[S]hareholders shall be subject to no assessment of liability other than that arising from the unpaid balance, if any, of the agreed consideration." *Id.* § 55-53(e).

65. *Id.* § 55B-9.

66. *See* ARK. STAT. ANN. § 64-2015 (1980); KAN. STAT. ANN. § 17-2715 (1983); MO. REV. STAT. § 356.150 (1985); OHIO REV. CODE ANN. § 1785.04 (Page 1985).

67. *See* Note, *Professional Corporations and Associations*, 75 HARV. L. REV. 776 (1962). There are three possible statutory interpretations: (1) the statute retains only a professional's vicarious liability for the negligence of those under his control and the professional's contract liability for failure to produce a promised result; (2) the statute retains the mutual liability imposed on all members of a partnership; or (3) the statute retains mutual liability on the part of all members who participate in furnishing the services out of which the tort arises, regardless of individual fault. *Id.* at 780-81. Under all three interpretations the professional is still liable for the torts he or she commits. *Id.* at 781.

68. Shores, *supra* note 7, at 712. Shores concludes that the North Carolina statute is in the majority of professional corporation statutes that do not alter the general rule that a shareholder generally has no personal liability for the obligations of the corporation but does have personal liability for his or her own malpractice and for the negligence of those under his or her supervision. *Id.*

69. N.C. GEN. STAT. § 55B-9 (1982).

professional corporation personally liable for the negligence of another member because each is "a person furnishing professional services" within the meaning of the statute.[70]

Although a number of jurisdictions have professional corporation statutes containing language almost identical to section 55B-9,[71] *Nelson* is apparently the first case in which this language has been interpreted to impose joint and several liability on shareholders for the negligent acts of other shareholders in the professional corporation. A number of courts have interpreted such language to provide for limited liability.[72] In *Birt v. St. Mary Mercy Hospital*,[73] for example, the Indiana Court of Appeals held that no vicarious liability could be imposed on a member of a professional corporation for the negligence of another member under a statute that retained the relationship between "a person furnishing" and "a person receiving" professional medical services.[74] Similarly, the United States Court of Appeals for the Sixth Circuit in *O'Neil v. United States*[75] held that an Ohio statute containing provisions almost identical to sections 55B-3 and 55B-9 "merely preserves the personal liability of the professional man in his professional dealings with patients" and confers limited liability on the shareholders of a professional corporation.[76] The court based the holding on its conclusion that the professional corporation act did not alter the corporate rule of limited liability of shareholders.[77]

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70. Bittker, *supra* note 39, at 10-11. In 1961 Professor Bittker stated, "[A] limitation of the phrase 'person furnishing professional service' . . . to the precise members of an association who personally participated in the transaction out of which the liability arose is one of the consequences I should have to see in a judicial opinion to believe." *Id.* at 11. In 1968 such a limitation was made in O'Neill v. United States, 281 F. Supp 359 (N.D. Ohio 1968), *aff'd*, 410 F.2d 888 (6th Cir. 1969), in which the United States Court of Appeals for the Sixth Circuit interpreted similar language in the Ohio statute to limit the liability of shareholders of a professional corporation. *O'Neill*, 410 F.2d at 898. Bittker, however, asserted that he was still skeptical of such an interpretation. Bittker, *Professional Service Organizations: A Critique of the Literature*, 23 TAX L. REV. 429, 430 (1968).

71. *See, e.g.*, ARK. STAT. ANN. § 64-2015 (1980); GA. CODE ANN. § 14-10-7(b) (1982); KAN. STAT. ANN. § 17-2715 (1983); MO. REV. STAT. § 356.150 (1985); OHIO REV. CODE ANN. § 1785.04 (Page 1985).

72. *See, e.g.*, O'Neill v. United States, 281 F. Supp. 359 (N.D. Ohio 1968), *aff'd*, 410 F.2d 888 (6th Cir. 1969); Birt v. St. Mary Mercy Hosp., 175 Ind. App. 32, 370 N.E.2d 379 (1978).

73. 175 Ind. App. 32, 370 N.E.2d 379 (1978).

74. *Id.* at 43, 370 N.E.2d at 385. The court stated that "in view of the provision that general corporation law applies except where contrary to the provisions or purpose of the [Indiana Medical Professional Corporation Act], vicarious liability due solely to association would appear to be beyond the purview of the explicit terms of [the Act], which retains relationship and liability between 'a person furnishing' and 'a person recieving' professional medical service." *Id.* at 39-40, 370 N.E.2d at 383.

75. 410 F.2d 888 (6th Cir. 1969).

76. *Id.* at 898.

77. *Id.* The Professional Association Act incorporates by reference those provisions of the Ohio business corporation law that do not conflict with any provision of the Professional Association Act. OHIO REV. CODE ANN. § 1785.08 (1985). The statute provides that nothing in the Ohio Professional Association Act modifies "any law applicable to the relationship between the person furnishing professional services and a person receiving such services including liability arising out of such professional service." *Id.* § 1785.04. The lower court in *O'Neill* concurred with two Ohio commentators who concluded that "on the basis of the plain language of the statute and on the basis of the probable legislative intent, . . . [section 1785.04] does not alter the corporate rule of limited liability of shareholders." *O'Neill*, 281 F. Supp. at 362.

The Ohio Supreme Court in South High Dev. v. Weiner, 4 Ohio St. 3d 1, 2, 445 N.E.2d 1106, 1107 (1983), held an attorney shareholder of a professional corporation personally liable for the

In *First Bank and Trust v. Zagoria*,[78] however, the Georgia Supreme Court held the defendant personally liable for insufficiently funded corporate checks issued by another member of the corporation even though the defendant was not a party to the transaction in question.[79] Although the Georgia professional corporation statute provides for limited liability,[80] the court ignored that statute and stated that the facts required the court to exercise its authority to regulate the practice of law.[81]

Historically, three policy reasons have been offered in support of joint and several liability for members of a professional corporation.[82] The first is that limited liability would drastically alter the relationship between the professional corporation and its clients;[83] vicarious liability is needed to protect a patient's expectations that the entire corporation will be engaged in his or her behalf.[84] The court in *Zagoria* expressed this concern when it stated "a client seeking the services of a lawyer . . . has the right to expect the fidelity of other members of the firm."[85]

Patients and clients do expect that the services of all members of the professional corporation will be available. Limited liability, however, would not prevent professional corporations from meeting this expectation. Because the professional corporation itself can be held liable for the negligence of a member,[86] the corporation has great incentive to use any and all professionals necessary to render effective services. Furthermore, although a patient may expect to have the entire services of the professional corporation available, "experience dictates that the physician-patient relationship is generally intensely personal rather than collective."[87] The North Carolina Professional Corporation Act does not alter the law applicable to the relationship between the person furnish-

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corporation's breach of its lease of office space. Because *Weiner* did not overrule *O'Neill*, a professional in Ohio apparently may be liable for the debts of the corporation, but may not be held jointly and severally liable for the torts of other shareholders.

78. 250 Ga. 844, 302 S.E.2d 674 (1983).

79. *Id.* at 846, 302 S.E.2d at 676.

80. The Georgia Code is almost identical to § 55B-9 of the North Carolina General Statutes. Although § 55B-9 does not explicitly state the extent of liability of the shareholder, the Georgia Code provides that "subject to subsection (a) of this Code section, the members or shareholders of any professional association organized pursuant to this chapter shall not be individually liable for the debts of, or claims against, the professional association unless such member or shareholder has personally participated in the transaction for which the debt or claim is made or out of which it arises." GA. CODE ANN. § 14-10-7(b) (1982).

81. *Zagoria*, 250 Ga. at 845, 302 S.E.2d 675. Conceivably, North Carolina courts could apply the *Zagoria* rationale to cases involving a professional corporation of attorneys. The North Carolina General Statutes provide that a court has the inherent power to regulate and discipline attorneys practicing before it. N.C. GEN. STAT. §§ 84-28, -36 (1983); *see* Swenson v. Thibaut, 39 N.C. App. 77, 109, 250 S.E.2d 279, 299 (1978) (interpreting and applying the statute), *appeal dismissed*, 296 N.C. 740, 254 S.E.2d 183 (1979). The North Carolina courts, however, do not have a similar power to regulate the practice of medicine.

82. *Birt*, 175 Ind. App. at 40, 370 N.E.2d at 383-84.

83. Bittker, *supra* note 70, at 430 n.1.

84. *See Birt*, 175 Ind. App. at 40, 370 N.E.2d at 383.

85. *Zagoria*, 250 Ga. at 846, 302 S.E.2d at 675.

86. *See Zimmerman*, 22 N.C. App. 544, 207 S.E.2d 267.

87. *Birt*, 175 Ind. App. at 40, 370 N.E.2d at 383. The same is true of the attorney-client relationship.

ing the professional services and the person receiving those services.[88] The standard of conduct applicable to the rendering of such services also remains unaltered.[89] Limited liability, therefore, would not drastically alter the relationship between the professional corporation and its clients.

A second policy reason advanced in opposition to limited liability is that the practice of medicine and the practice of law are professional services and not commercial businesses.[90] Unlike a commercial business, the practitioner's primary obligation is concern for the public interest.[91] Limited liability would make "an inroad upon traditionally rigorous notions of legal or medical responsibility."[92] The presumption is that imposing vicarious liability on associated professionals is necessary to ensure that professional corporations provide high quality services.[93]

The presence or absence of vicarious liability, however, should not affect the quality of services rendered because the person providing the service can be held liable for his or her own negligence under section 55B-9.[94] Nor should the presence or absence of vicarious liability affect the quality of service provided by the corporation because the corporation itself can be held liable for the negligence of any of its members.[95] In addition, the penalties for violating professional ethics further deter negligence of the professional corporation.[96]

The third policy reason advanced in support of joint and several liability is that limited liability would not provide adequate protection to a client with claims against the corporation.[97] Professional service providers are perceived as having a greater responsibility than members of a business corporation to pro-

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88. N.C. GEN. STAT. § 55B-9 (1982).

89. *Id.*

90. *Zagoria*, 250 Ga. at 845, 302 S.E.2d at 675.

91. *Id.*

92. Note, *supra* note 67, at 789.

93. *Birt*, 175 Ind. App. at 40, 370 N.E.2d at 384.

94. N.C. GEN. STAT. § 55B-9 (1982).

95. *See Zimmerman*, 22 N.C. App. 544, 207 S.E.2d 267.

96. *Birt*, 175 Ind. App. at 40, 370 N.E.2d at 384. The court in *Birt* stated that the

> continuing supervision of professional status under the act . . . and the penalties available for violations of professional ethics take most of the force from this argument [that vicarious liability among associating professionals is necessary to ensure the proper quality of services provided by the corporation]. Even if broad forms of liability are desirable a rule other than vicarious liability should be adequate.

Id.

The North Carolina State Bar, which has established a Code of Professional Responsibility to which its members are required to conform, is empowered by N.C. GEN. STAT. § 84-28 (1982) to discipline attorneys and regulate their conduct. *See* Swenson v. Thibaut, 39 N.C. App. 77, 109, 250 S.E.2d 279, 299 (1978), *appeal dismissed*, 296 N.C. 740, 254 S.E.2d 183 (1979).

97. *In re* Bar Ass'n of Hawaii, 55 Hawaii 121, 122, 516 P.2d 1267, 1268 (1973). The Hawaii Bar Association requested the Hawaii Supreme Court to approve incorporation of attorneys as authorized by the legislature. *Id.* at 121, 516 P.2d at 1267-68. The supreme court adopted the Professional Corporation Act but emphasized that incorporated attorneys would not have limited liability. *Id.* at 122, 516 P.2d at 1268. The court stated that limited liability "would not provide adequate protection to a client's claims against a law corporation." *Id.* The Hawaii Act, however, expressly provided for limited liability of shareholders of a professional corporation. HAWAII REV. STAT. § 416-153 (1984).

tect the interests of their clients and patients.[98] Thus, "the promulgation of any rule allowing incorporation should not be in derogation of the attorney-client relationship to the detriment of the client,"[99] and incorporation should not adversely affect the injured patient's or client's ability to collect a damage award from the provider of the professional service.[100] Applying this rationale, the court in *Zagoria* stated that "[i]t is inappropriate for the lawyers to be able to play hide and seek in the shadows and folds of the corporate veil and thus escape the responsibilities of professionalism."[101]

With limited liability, a court may not hold the members of a professional corporation personally liable for the negligence of their associates. It can, however, hold the negligent professional personally liable to the extent of his or her personal assets.[102] Furthermore, the corporation will be liable for the malpractice committed by any of its members.[103] The liability of the corporation effectively replaces the vicarious liability of the partners. Not only will the corporation be liable to the extent of its assets, it is likely that the professional and the corporation will have sufficient malpractice insurance to enable the patient or client to recover fully.[104]

The North Carolina Court of Appeals in *Nelson* should have addressed all of these policy concerns and analyzed the language of the Professional Corporation Act. Instead, the court simply cited *Zimmerman* and section 55B-9 to support its holding. Because the Professional Corporation Act refers only to the liability of the person providing the service[105] and by reference incorporates the Business Corporation Act,[106] the express statutory language indicates that the members of a professional corporation have the protection of limited liability. If the general assembly had intended to deny members of a professional corporation the protection of limited liability, it could have done so explicitly, as legislatures in other jurisdictions have done.[107]

The general assembly should amend the North Carolina Professional Corporation Act to specify whether members of a professional corporation have limited or unlimited liability. The strongest argument against limited liability is that it reduces the ability of an injured client to collect a damage award. This can easily be resolved, however, by amending the statute to provide that liability will be limited only if the corporation maintains a specified amount of profes-

98. *See Zagoria*, 250 Ga. at 845, 302 S.E.2d at 675.

99. *In re* Bar Ass'n of Hawaii, 55 Hawaii 121, 122, 516 P.2d 1267, 1268 (1973).

100. *See Birt*, 175 Ind. App. at 40, 370 N.E.2d at 384; *In re* R.I. Bar Ass'n, 106 R.I. 752, 760-61, 233 A.2d 692, 697 (1970).

101. *Zagoria*, 250 Ga. at 846, 302 S.E.2d at 675.

102. *See* N.C. GEN. STAT. § 55B-9 (1982).

103. *See Zimmerman*, 22 N.C. App. 544, 207 S.E.2d 267.

104. *See Birt*, 175 Ind. App. at 40, 370 N.E.2d at 383.

105. N.C. GEN. STAT. § 55B-9 (1982).

106. *Id.* § 55B-3.

107. *See* ALASKA STAT. § 10.45-140 (1985); ARIZ. REV. STAT. ANN. § 10-905 (1977); ME. REV. STAT. ANN. tit. 13, § 708 (1981); OR. REV. STAT. § 58.185 (1983).

sional liability insurance.[108] Whether or not the statute is amended, however, the North Carolina Supreme Court should carefully analyze the Professional Corporation Act and the corresponding policy considerations before following the court of appeals' decision in *Nelson*. As the Florida Supreme Court stated, "if a means can be devised which preserves to the client and the public generally all of the traditional obligations and responsibilities of the [professional] and at the same time enables the . . . profession to obtain a benefit not otherwise available to it, we can find no objection to that proposal."[109]

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108. Rhode Island's Professional Services Corporation Act contains such a requirement. The Act requires that

> Every Professional service corporation shall maintain insurance against liability imposed by law upon the corporation or its employees arising out of the performance of such professional services. . . . Such insurance shall be . . . with respect to each claim, in the aggregate amount of fifty thousand dollars ($50,000) multiplied by the number of professional employees of the corporation as of the policy anniversary date; provided, however, that in no case shall the coverage basis be less than one hundred thousand dollars ($100,000) and not more than five hundred thousand dollars ($500,000).

R.I. GEN. LAWS § 7-5.1-8 (1985). The Rhode Island Supreme Court stated that "because of the requirement of mandatory liability insurance the clients served by the corporation and the members of the public who otherwise deal with the corporation will not suffer by reason of such limited liability." *In re* R.I. Bar Ass'n, 106 R.I. 752, 760-61, 263 A.2d 692, 697 (1970).

109. *In re* Florida Bar, 133 So. 2d 554, 556 (Fla. 1970).

Alford v. Shaw: North Carolina Adopts a Prophylactic Rule to Prevent Termination of Shareholders' Derivative Suits Through Special Litigation Committees

The shareholders' derivative suit[1] is an exception to the corporate norm. As a general rule, boards of directors exercise wide discretion in the management of corporate affairs,[2] and the business judgment rule[3] protects their good faith business decisions. The shareholders' derivative suit thus poses a significant check on the otherwise unfettered authority of directors to manage the cor-

1. A shareholders' derivative suit is an action brought by one or more shareholders of a corporation to enforce a corporate cause of action against officers, directors, or third parties. *See* Ross v. Bernhard, 396 U.S. 531, 534 (1970). Although a nominal defendant in such an action, the corporation is the real party in interest. *See* Koster v. (Am.) Lumbermen's Mut. Casualty Co., 330 U.S. 518, 522-23 (1947); H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 358, at 1035 (3d ed. 1983); *see also* Keenan v. Eshleman, 22 Del. Ch. 82, 88-91, 2 A.2d 904, 912-13 (1938) (any recovery in a derivative action goes to the corporation). Typically, minority shareholders rather than controlling shareholders bring derivative suits because controlling shareholders can usually influence the corporation itself to institute a direct action to enforce a claim. *See* 13 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATION § 5941.1, at 18 (rev. perm. ed. 1984). For general background information on shareholders' derivative suits, see *id.* §§ 5939-5942; H. HENN & J. ALEXANDER, *supra*, §§ 358-360; R. ROBINSON, NORTH CAROLINA CORPORATION LAW AND PRACTICE §§ 14-1 to -17 (3d ed. 1983).

N.C. GEN. STAT. § 55-55 (1982) authorizes derivative suits and sets out the rules governing their conduct. Prior to the enactment of § 55-55 in 1973, North Carolina common law governed derivative suits. For a general discussion and comparison of the common law and § 55-55, see Note, *Corporations—Shareholders' Derivative Actions*—N.C. GEN. STAT. § 55-55, 11 WAKE FOREST L. REV. 307 (1975). For a further discussion of § 55-55 and a comparison of its requirements to those of other jurisdictions, see *infra* notes 18-28 and accompanying text.

2. Directors manage the business and affairs of a corporation. *See* H. HENN & J. ALEXANDER, *supra* note 1, § 203, at 550-51. State statutes normally convey this authority; these statutes typically follow the letter or the spirit of the Model Business Corporation Act, which provides that "[a]ll corporate powers shall be exercised by or under authority of, and the business and affairs of a corporation shall be managed under the direction of, a board of directors." MODEL BUSINESS CORP. ACT § 35 (1979). The Model Act reflects a recent concept that the business and affairs are managed "under the direction of" rather than "by" the directors. *Id.*

N.C. GEN. STAT. § 55-24(a) (1982) provides that "the business and affairs of a corporation shall be managed by a board of directors." According to North Carolina case law, directors establish corporate policies and supervise the carrying out of these policies through their duly elected and authorized officers. *See* Burlington Indus., Inc. v. Foil, 284 N.C. 740, 758, 202 S.E.2d 591, 603 (1974); R. ROBINSON, *supra* note 1, § 10-1.

3. The business judgment rule requires that courts honor principles of corporate self-governance and, thus, must not interfere with a good faith decision made by directors in the exercise of their business judgment. Directors cannot be held liable for mere errors of judgment. *See* Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 518 (10th Cir.) (per curiam) (discussing rationale of the "business judgment" rule), *cert. denied*, 414 U.S. 874 (1973); H. HENN & J. ALEXANDER, *supra* note 1, § 242, at 661-63. For a brief summary of the underlying rationale of the business judgment rule and a list of situations to which it does not apply, see Joy v. North, 692 F.2d 880, 885-86 (2d Cir. 1982), *cert. denied*, 469 U.S. 1051 (1983).

The North Carolina Supreme Court has adopted and confirmed the "business judgment" rule on many occasions. *See* Security Nat'l Bank v. Bridgers, 207 N.C. 91, 96, 176 S.E. 295, 297 (1934) (bank directors not liable for alleged negligent mismanagement); Gordon v. Pendleton, 202 N.C. 241, 243, 162 S.E. 546, 546-47 (1932) (directors not liable for mere errors of judgment in management of bank); North Carolina Corp. Comm'n v. Harnett County Trust Co., 192 N.C. 246, 248, 134 S.E. 656, 657 (1926) (bank directors liable for wilful failure to perform their duties but not liable for mere errors of judgment); Braswell v. Pamlico Ins. & Banking Co., 159 N.C. 628, 631, 75 S.E. 813, 814 (1912) (bank directors are not liable as insurers or guarantors of corporate success); R. ROBINSON, *supra* note 1, § 12-6, at 178-80.

poration. The derivative suit enables shareholders to bring a cause of action on behalf of a corporation when their directors threaten or engage in misconduct. In North Carolina, however, as in many other jurisdictions, shareholders must exhaust intracorporate measures before they can proceed with a derivative suit. They first must make a demand on the directors to remedy the alleged wrongdoings.[4] If the directors in good faith decide on the corporation's behalf that litigation would not advance the best interests of the corporation, then the directors may terminate the suit, and the business judgment rule will insulate that decision from judicial scrutiny.[5]

When a shareholder-derivative plaintiff alleges with particularity wrongdoings by a majority of the corporation's directors, however, the board cannot rely on the business judgment rule. Their decision to terminate the suit would lack good faith and independent judgment, two factors that precondition any application of the rule.[6] Moreover, in this situation shareholders need not make a demand on the directors to take remedial actions because such a demand would be deemed futile.[7] To restore their ability to terminate derivative suits under these circumstances, directors have employed the device of a special litigation com-

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4. The universal rule that a shareholder must exhaust intracorporate remedies before bringing a derivative action is most often cited to Hawes v. City of Oakland, 104 U.S. 450, 460-62 (1882). The rationale for the demand requirement derives from a recognition of corporate managers' and directors' authority to bring a corporation's cause of action and from goals of judicial economy because many claims may be settled within the corporate structure. *See, e.g.*, Barr v. Wackman, 36 N.Y.2d 371, 378, 329 N.E.2d 180, 185-86, 368 N.Y.S.2d 497, 504-05 (1975) (board of directors can often correct alleged abuses without resort to the courts).

As in many other jurisdictions, North Carolina specifically requires that shareholders make a demand on their directors to take action on behalf of the corporation before they can institute a derivative action. Prior to 1973 many North Carolina Supreme Court cases upheld this rule as a matter of common law. *See, e.g.*, Goodwin v. Whitener, 262 N.C. 582, 583, 138 S.E.2d 232, 233 (1964) (before a stockholder may sue those guilty of mismanagement, he or she must show a demand on the corporation to bring suit and management's refusal to do so); Parrish v. Brantley, 256 N.C. 541, 544, 124 S.E.2d 533, 536 (1962) (in the absence of any showing that corporate action has been demanded and refused, the demurrer must be sustained). N.C. GEN. STAT. § 55-55(b) (1982) now codifies the common-law rule: the statute requires that in the complaint derivative plaintiffs allege with particularity the efforts, if any, to obtain the action desired from directors of comparable authority, as well as the reasons for plaintiffs' failure to obtain the action or, in the alternative, for not making the effort. For an application of the statute, see Swenson v. Thibaut, 39 N.C. App. 77, 101-02, 250 S.E.2d 279, 295 (1978) (plaintiff must show that he or she has exhausted intracorporate remedies), *disc. rev. denied*, 296 N.C. 740, 254 S.E.2d 181 (1979).

5. *See* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917). Justice Brandeis pronounced a general rule that the decision whether a corporation will seek to enforce a cause of action for damages, like any other business question, should be left to the discretion of the directors. *Id.* at 263-64.

6. *See id.* In *Amalgamated Copper* the court implicitly carved out an exception to the general rule, which would require an application of the business judgment rule in cases in which directors face allegations of fraud or other breaches of fiduciary duties. Because the rule is premised on good faith and the ability of directors to use their disinterested judgment, it simply does not apply in such situations. *See id.*

7. *See generally* 13 W. FLETCHER, *supra* note 1, § 5963, at 111-23; R. ROBINSON, *supra* note 1, § 14-16, at 219. Two recent Delaware Supreme Court cases have examined the question when a demand may be excused. *See* Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Pognostin v. Rice, 480 A.2d 619 (Del. 1984). In *Aronson* the court stated that both prongs of the following test must be met for demand to be excused: First, there must be a reasonable doubt as to the disinterestedness and independence of the directors; second, the challenged transaction must not otherwise be the product of a valid business judgment. *Aronson*, 473 A.2d at 814. Merely naming a director as a defendant will not taint that director with interest, because otherwise a plaintiff could readily circumvent the

mittee (SLC),[8] which is composed of disinterested directors appointed by the board and given the power to act for the board with respect to any of the plaintiffs' claims.

A debate currently rages among the jurisdictions as to whether and under what circumstances courts should respect an SLC's decision to terminate a shareholders' derivative suit. In *Alford v. Shaw*[9] the North Carolina Court of Appeals entered into this debate. Rather than apply the business judgment rule to an SLC's decision to terminate a suit, the *Alford* court adopted a prophylactic rule that "directors of North Carolina corporations who are parties to a derivative action may not confer upon a special committee of the board of directors the power to bind the corporation as to its conduct of the litigation."[10]

This Note examines the controversy surrounding SLCs, evaluates the three major approaches adopted by courts that have ruled on these committees, and concludes that in *Alford* the court of appeals correctly prescribed a prophylactic rule, although this rule needs further clarification and expansion.

In *Alford* a group of shareholders of All American Assurance Company, an insurance company incorporated in North Carolina, instituted a derivative action against the company's directors and alleged that defendants had looted assets of the corporation and that this fraudulent and self-dealing misconduct violated defendants' fiduciary duties.[11] The shareholders demanded that the

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demand requirement by naming all board members as defendants. *See* Lewis v. Graves, 701 F.2d 245, 248-49 (2d Cir. 1983).

In Swenson v. Thibaut, 39 N.C. App. 77, 250 S.E.2d 279 (1978), *disc. rev. denied*, 296 N.C. 740, 254 S.E.2d 181 (1979), the North Carolina Court of Appeals held that "where the directors who are in control of the corporation are the same ones . . . as were initially responsible for the breaches of duty complained of, the demand of a shareholder upon directors to sue themselves or their principals would be futile, and as such is not required as a prerequisite for the maintenance of the action." *Swenson*, 39 N.C. App. at 102, 250 S.E.2d at 295.

8. The first reported use of a litigation committee to terminate a derivative suit appeared in Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976). In *Gall* a litigation committee was appointed to investigate allegations of illegal payments in the form of bribes and political donations by Exxon's Italian subsidiary to political parties in Italy. The committee found that such payments had been made, but decided that a derivative suit would prove detrimental to the corporation. The court granted summary judgment for the defendants based on the committee's decision. For a discussion of special litigation committees, see Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of* Zapata *and the ALI Project*, 1982 DUKE L.J. 959, 970-72.

9. 72 N.C. App. 537, 324 S.E.2d 878, *disc. review allowed*, 314 N.C. 114, 332 S.E.2d 478 (1985).

10. *Id.* at 547, 324 S.E.2d at 886.

11. The *Alford* court referred to individual defendants Robert T. Shaw and C. Fred Rice and corporate defendants, American Commonwealth Financial Corporation (ACFC), Great Commonwealth Life Insurance Corporation (GCL), and ICH Corporation (ICH) as the "Shaw Group." *Alford*, 72 N.C. App. at 537, 324 S.E.2d at 880. The Shaw Group collectively constituted the majority and controlling shareholder of All American. Simply stated, at the time of the alleged wrongdoings the control dynamics of the group operated as follows: "Shaw and Rice controlled ICH; ICH controlled ACFC; ACFC controlled GCL; and GCL controlled All American . . . ." Plaintiffs-Appellees New Brief at 2, Alford v. Shaw, 72 N.C. App. 537, 324 S.E.2d 898 (1985). The remaining individual defendants, Charles E. Black, S. J. Campisi, Roy J. Broussard, Touman D. Cox, Fred M. Hurst, and Peggy P. Wiley, had been elected directors of All American by the Shaw Group. *Id.* at 2.

In a letter dated October 1981 and addressed to the Board of Directors of All American, plaintiff shareholders accused the board of mismanagement. In May 1982 plaintiffs threatened suit and demanded that the board assert claims on behalf of the corporation. In early November 1982 plaintiffs filed a complaint that charged the Shaw Group with having engaged in self-dealing and "intentionally defrauding and wrongfully diverting funds of All American for their benefit," and the

corporation recover defendants' ill-gotten gains. In response the directors of All American elected two new directors and designated them as members of a Special Investigative Committee that possessed investigative powers and binding authority to take any action regarding plaintiffs' claims.[12] In its final report the committee announced that only two of plaintiffs' claims warranted further action, and the committee negotiated a tentative settlement of both claims on behalf of the corporation.[13] Based on the committee's decision, All American and all but two of the individual defendants moved in court for summary judgment on the remaining claims.[14]

The trial court held that the business judgment rule insulated the committee's decision to terminate the suit, and thus granted defendants' motion for summary judgment and approved the proposed settlement plan.[15] Its decision rested on fact findings regarding two issues, namely, whether the committee consisted of disinterested, independent directors who had acted in good faith and whether the scope of their investigation and the procedures followed were appropriate.[16]

The North Carolina Court of Appeals, however, vacated the trial court's grant of summary judgment on the ground that because defendants served as members of the board that selected the committee, they could not delegate the authority to terminate plaintiffs' derivative suit.[17] The *Alford* court adopted a prophylactic rule that prevents directors from appointing an SLC when they are

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complaint charged the remaining individual defendants with breaches of fiduciary duty and acquiescence. *Id.* at 2; *see* Defendant-Appellants New Brief at 2-4, *Alford.*

At least in part, plaintiffs' complaints seem to have been spurred by a proposed merger or series of mergers of All American that involved the elimination of minority shareholders of the corporation. On November 15, 1982, the trial court denied plaintiffs' motion for a preliminary injunction restraining the merger. In the same month, the mergers were consummated, and the shares of minority shareholders of All American were exchanged for shares of ICH. *Id.* at 4.

12. On the recommendation of its legal counsel, the Board of Directors of All American elected Marion G. Follin, a retired insurance executive, and Frank M. Parker, a former judge of the North Carolina Court of Appeals, as members of the Special Investigative Committee. *Alford,* 72 N.C. App. at 537-38, 324 S.E.2d at 880. The board took this action in May 1982. Selection of the committee followed plaintiffs' threat of suit but preceded the filing of the complaint in November 1982. Plaintiffs-Appellees New Brief at 2; Defendant-Appellants New Brief at 3.

13. In its report of July 29, 1983, the committee concluded that only two claims should be asserted by the corporation: (1) failure of GCL to offer All American the opportunity to purchase shares of All American stock, which resulted in lost profits of $259,000; and (2) unauthorized actions by officers of All American, who had made investments in ACFC Ltd. that exceeded the board's authorization by approximately $114,000. The committee settled these two actions with GCL for $250,000. *See* Defendant-Appellants New Brief, at 5.

14. *Alford,* 72 N.C. at 538, 324 S.E.2d at 880.

N.C.R. Civ. P. 56 provides that "a party against whom a claim . . . is asserted . . . may, at any time, move with or without supporting affidavits for a summary judgment in his favor as to all or any part thereof." Courts may grant summary judgment when the moving party has proved that there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law. *See* Gore v. Hill, 52 N.C. App. 620, 621-22, 279 S.E.2d 102, 104 (1981).

15. *Alford,* 72 N.C. App. at 538, 324 S.E.2d at 880.

16. *Id.* at 538, 324 S.E.2d at 880. The trial court apparently applied a test developed by the New York Court of Appeals in Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). For a thorough discussion of this test, see *infra* notes 46-52 and accompanying text.

17. *Alford,* 72 N.C. App. at 547, 324 S.E.2d at 886.

named defendants in a derivative suit. The court articulated several policy reasons to support its decision.

At several points in its decision, the court noted that North Carolina public policy favors derivative actions. This policy is derived from the relatively liberal provisions of North Carolina General Statutes section 55-55,[18] which authorizes and governs derivative actions in state courts.[19] Although section 55-55 imposes a contemporaneous ownership rule[20] on putative plaintiffs and authorizes the courts to assess a defendant's fee expenses against an unsuccessful plaintiff,[21] the statute does not contain some of the more restrictive provisions that other jurisdictions have adopted. Specifically, section 55-55 does not require that derivative plaintiffs provide security for expenses,[22] that plaintiffs make a prior demand on shareholders as well as on the board of directors,[23] and that plaintiffs show adequate representation.[24] Moreover, the statute authorizes mere benefi-

18. N.C. GEN. STAT. § 55-55 (1982).

19. *Alford*, 72 N.C. App. at 539, 541, 324 S.E.2d at 881, 882.

20. N.C. GEN. STAT. § 55-55(a) (1982). Under § 55-55 the contemporaneous ownership rule requires plaintiffs in a derivative suit to have been a shareholder or a holder of a beneficial interest in shares of the corporation at the time of the transaction that the complaint addresses. This rule precludes a potential plaintiff from purchasing an interest in shares after a corporate action merely to bring a derivative suit. *See* R. ROBINSON, *supra* note 1, § 14-7, at 220-21 (discussing the requirement of share ownership).

21. N.C. GEN. STAT. § 55-55(e) (1982). If, upon its final judgment, a court finds that the plaintiff brought an action without reasonable cause, it may require the plaintiff to pay defendants for reasonable expenses incurred by them in their defense, including attorneys' fees. *See* R. ROBINSON, *supra* note 1, § 14-41, at 231 (discussing the award of litigation expenses).

22. A security-for-expense provision in a statute authorizes a court to require plaintiffs in a derivative action to furnish a bond or other security for payment of any expenses of the defendants that plaintiffs ultimately may be ordered to pay. Some states, such as New York, require advance security for expenses if the plaintiffs own less than a minimum percentage of the corporate defendant's stock. *See* N.Y. BUS. CORP. LAW § 627 (McKinney Supp. 1986).

The original draft of § 55-55 gave trial courts the discretion to order plaintiffs to pay an expense security when necessary to protect the defendant. S. 283 (2d ed.) N.C. Gen. Assembly § 12 (1973). The North Carolina Senate Judiciary Committee, however, deleted this provision because it viewed the potential risks of strike suits as less ominous than the threat of unsympathetic trial judges who might prematurely end meritorious derivative actions. S. 283 (2d ed.) N.C. Gen. Assembly § 12 (1973); *see* R. ROBINSON, *supra* note 1, § 14-41, at 230-32.

23. The law in many jurisdictions requires plaintiffs to make a demand on shareholders as well as directors to exhaust intracorporate remedies. *See generally* Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746 (1960) (discussing the sufficiency of demands). At the federal level plaintiffs in a derivative action must make a demand on the shareholders if, considering all of the surrounding circumstances, it would be reasonable to require such a demand. FED. R. CIV. P. 23.1; *see* Howes v. City of Oakland, 104 U.S. 450 (1882).

Dictum in a 1906 case suggested that North Carolina would follow this rule. In Merrimon v. Southern Paving & Constr. Co., 142 N.C. 539, 55 S.E. 366 (1906), the court stated that plaintiff "'must apply to the managing officers to take action in the corporate name, and, if he fails with them, he must, if the matter will admit of the delay, seek to obtain action by the stockholders as a body, unless for some reason such attempt would be useless.'" *Id.* at 551, 55 S.E. at 369-70 (citing Brewer v. Boston Theatre, 104 Mass. 378 (1870)). However, the Drafting Committee and members of the Senate Judiciary Committee deleted a provision identical to FED. R. CIV P. 23.1 when they drafted § 55-55(b), because they viewed the federal rule as overly vague, burdensome, and nonbeneficial. This omission indicates the legislative intent that shareholder plaintiffs need not make a demand on the corporation's shareholders before they bring a derivative action. *See* R. ROBINSON, *supra* note 1, § 14-5.

24. FED. R. CIV. P. 23.1 provides that a derivative action may fail if the plaintiff, in seeking to enforce rights on behalf of the corporation, does not fairly and adequately represent the interests of similarly situated shareholders. North Carolina courts have not applied such an adequate representation requirement in derivative suits. Robinson, however, suggests that a trial judge could possibly

cial owners not of record to bring suit,[25] allows plaintiffs to recover expenses beyond monetary recovery,[26] and contains liberal provisions for the service of process on nonresident parties.[27] The *Alford* court declared that, on balance, the provisions of section 55-55 favor shareholders' derivative suits more than the statutes in other jurisidictions.[28] Noting the threat that SLCs pose to the continued effectiveness of derivative suits,[29] the court adopted a prophylactic rule to further North Carolina's legislative policy.[30] The court reasoned that in large, publicly held corporations such as All American, when director misconduct has undermined the value of corporate securities, the derivative action may represent the only effective means to guard against or remedy the destructive acts of wrongdoing directors.[31]

In addition, the *Alford* court noted that directors have a fiduciary relationship with the corporation and its shareholders. This relationship imposes a strict duty on directors to avoid impropriety and to protect the corporation.[32] The court stated that in cases such as *Alford*, directors bear a heavy burden of

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bar a derivative lawsuit on such grounds by virtue of N.C. GEN. STAT. § 55-55(c) (1982), which vests control over dismissal or settlement of claims in trial courts: "[s]uch action shall not be discontinued, dismissed, compromised or settled without approval of the court." *See* R. ROBINSON, *supra* note 1, § 14-8.

25. N.C. GEN. STAT. 55-55(a) (1982) provides: "An action may be brought . . . by a shareholder of a beneficial interest in shares . . . ." Thus, any type of share ownership, whether legal, equitable, or otherwise, will qualify a plaintiff to bring a derivative action. *See* R. ROBINSON, *supra* note 1, § 14-7.

26. N.C. GEN. STAT. § 55-55(d) (1982) reads: "If the action on behalf of the corporation is successful, in whole or part, whether by means of a compromise and settlement or by judgment, the court may award the plaintiff the reasonable expenses of maintaining the action, including reasonable attorneys' fees, and shall direct the plaintiff to account to the corporation for the remainder of any proceeds of the action."

The original draft of § 55-55 provided that courts could award expenses to plaintiffs solely from the proceeds or monetary funds recovered in the litigation. The bill was revised to permit an award of expenses even if the award is nonpecuniary. *See* R. ROBINSON, *supra* note 1, § 14-14.

27. Under the long-arm provisions contained in the Business Corporation Act, directors of North Carolina corporations are subject to the jurisdiction of North Carolina courts in any action against them arising out of their conduct while they serve in office. N.C. GEN. STAT. § 55-33 (1982). A general jurisdictional statute also provides for this result. *Id.* § 1-75.4(8). *See* R. ROBINSON, *supra* note 1, § 12-10, at 183 & § 13-14, at 208.

28. "The North Carolina statute contains liberal provisions favoring, by contrast with laws of other jurisdictions, suits by minority shareholders." *Alford*, 72 N.C. App. at 539, 324 S.E.2d at 881.

29. "Commentators have expressed concern over the continued vitality of the derivative suit in light of the development of special committees." *Id.* at 546, 324 S.E.2d at 885. The court discussed this concern and cited three articles—Brown, *Shareholder Derivative Litigation and the Special Litigation Committee*, 43 U. PITT. L. REV. 601 (1982); Cox, *supra* note 8; Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U.L. REV. 96 (1980). *Id.*

30. *Alford*, 72 N.C. App. at 547, 324 S.E.2d at 886 (stating the "rule").

31. *Id.* at 539, 324 S.E.2d at 881.

32. The court twice noted that directors owe a strict fiduciary duty to the corporation. *Alford*, 72 N.C. App. at 541-42, 547, 324 S.E.2d at 882, 886 (citing Meiselman v. Meiselman, 309 N.C. 279, 307 S.E.2d 551 (1983)).

See also N.C. GEN. STAT. § 55-35 (1982). Section 55-35 provides: "Officers and directors shall be deemed to stand in a fiduciary relation to the corporation and to its shareholders and shall discharge the duties of their respective positions in good faith, and with that diligence and care which ordinarily prudent men would exercise under similar circumstances in like positions." For a further discussion of this duty, see Note, *Corporations—Interested Directors—Fiduciary Duty and the Business Judgment Rule*, 45 N.C.L. REV. 755 (1967).

proof when they seek to dispose summarily of a derivative suit that alleges they have breached that duty, particularly because such litigation involves questions of subjective intent.[33] Furthermore, the court noted that the rule followed by the trial court in *Alford* would shift the burden from defendants to shareholder plaintiffs, who then would have to show that the SLC did not exercise its independent judgment. This allegation would be difficult to prove given that shareholders lack access to corporate records and information, and in light of the "many levels of financial, social, occupational, and psychological pressures" that the corporation's board could exert.[34]

In the *Alford* case the problem of structural bias was the key factor in the court's decision. The court defined structural bias as personal, financial, or moral influences that flow to litigation committee members from the directors who appoint them.[35] The *Alford* court also recognized the structural deficiencies that permeate SLCs and stated that such committees may stifle shareholders' derivative suits.[36] After reviewing reported case law on the subject, the *Alford* court noted that in no case had a litigation committee chosen to pursue a plaintiff's derivative claim.[37] The court's concerns regarding structural bias motivated it to adopt the prophylactic rule that theoretically precludes the appointment of SLCs that might be affected by structural bias and promotes the state's public policy favoring derivative actions.[38]

As a further consideration, the *Alford* court noted that the SLC operates as an offensive procedural device and thus represents an unconventional use of the business judgment rule. The court stressed that traditionally the rule has operated as a defense on the merits[39] and as an evidentiary statement that defendants

33. *Alford*, 72 N.C. App. at 547, 324 S.E.2d at 886 (citing Johnson v. Insurance Co., 300 N.C. 247, 266 S.E.2d 610 (1980)).

34. *Alford*, 72 N.C. App. at 548, 324 S.E.2d at 886.

35. *Id.* at 545, 324 S.E.2d at 884 (quoting and implicitly adopting the definition of "structural bias" suggested in Miller v. Register and Tribune Syndicate, Inc., 336 N.W.2d 709, 716 (Iowa 1983)). For a description of the way structural bias flows from interested directors to the litigation committees they appoint, see Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 275-85 (1981); Cox, *supra* note 8, at 962-64; Dent, *supra* note 29, at 111-17; Gevurtz, *Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Suits*, 46 U. PITT. L. REV. 265, 277-87 (1985); Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 619-26 (1980).

36. *See Alford*, 72 N.C. App. at 546, 324 S.E.2d at 885. The court cited Dent, *supra* note 29, as a particularly strong critic of structural bias and the courts' inattentiveness to the pressures exerted over seemingly disinterested directors who serve on litigation committees.

37. *Alford*, 72 N.C. App. at 548, 324 S.E.2d at 886. The court acknowledged that some courts have recognized the existence of valid claims, but noted that these claims represent a minor portion of the overall claims by plaintiffs and arguably have been settled prematurely as in *Alford*. *See supra* note 13 (discussing the facts in *Alford*). For example, in Joy v. North, 519 F. Supp. 1312 (D. Conn. 1981), *aff'd*, 692 F.2d 880 (2d Cir. 1982), *cert. denied sub nom.*, Citytrust v. Joy, 460 U.S. 1051 (1983), the litigation committee recommended dismissal of the derivative suit as to 23 of the officers and directors, but as to 7 officers and directors the committee recommended suit and later negotiated a settlement plan. *Id.* at 1314-16.

38. *See Alford*, 72 N.C. App. at 547, 324 S.E.2d at 886 (adopting the *Miller* rule).

39. *Id.* at 540, 548, 324 S.E.2d at 882, 886. The *Alford* court contrasted the traditional defensive use of the rule as a "shield to liability" with its more recent offensive use as a "sword" to thwart derivative suits. *Id.* Directors may use the business judgment rule defensively to avoid potential liability by showing that they "erred," if at all, in good faith while exercising reasonable care and

could use in court to test the sufficiency of facts offered by plaintiffs, particularly in cases of fraud.[40] The *Alford* court reasoned that any analysis that focuses exclusively on the disinterestedness of and procedures followed by an SLC would remove the facts and circumstances of cases from judicial scrutiny, effectively bypassing the courts.[41] The court refused to allow the business judgment rule to insulate the SLC's decision as a matter of law.

A final rationale advanced by the *Alford* court pertained to the question of what role courts should play when they review SLC decisions. The court stated that undue judicial intervention into a committee's decision to terminate a suit would present too many complications and might erroneously extend litigation.[42] Furthermore, as stated above, the court suggested that a sweeping application of the business judgment rule to SLC decisions would eliminate any meaningful judicial review.[43] The court concluded that a simple prophylactic rule would better serve the courts in these types of cases.[44]

To understand thoroughly the *Alford* decision, it is necessary to review prior case law. In 1979 the United States Supreme Court declared in *Burke v. Lasker*[45] that state law governs the question whether SLCs can terminate a derivative action as a matter of law. Immediately following the *Burke* decision, the New York Court of Appeals became the first state court to apply the business judgment rule to an SLC's decision to discontinue a derivative suit. In the landmark case of *Auerbach v. Bennett*[46] a shareholder of General Telephone and Telegraph filed a derivative action alleging that, from 1971 to 1975, the company's directors had paid eleven million dollars in bribes and kickbacks to political parties and public officials abroad and to domestic officers of the corporation.[47] An SLC, appointed by the board of directors of the corporation,

while using their business judgment. This showing involves an examination of actions by the directors in the particular case. Used offensively, however, an implicated board may strategically employ the device of the SLC: implicated directors may appoint new outside directors to whose decisions the business judgment rule will apply, thereby procedurally ending a derivative suit without any judicial inquiry into their own actions. *See id.*

40. *Id.* at 548, 324 S.E.2d at 886.

41. *Id.* The court seemed to suggest that, when defendant directors raise a summary judgment motion, the courts should play an active role in business judgment cases. The court strongly implied that courts must examine the facts and circumstances of a particular case to determine whether directors made their decision while exercising their good faith business judgment. According to the court, merely examining the SLC's independence and investigative procedure rather than the facts of the case would not meet this standard of scrutiny.

42. *Alford*, 72 N.C. App. at 547, 324 S.E.2d at 886. The *Alford* court apparently was referring to the judicial inquiry advocated by Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981), discussed *infra* notes 53-60 and accompanying text. The court implied that courts, exercising their own "business judgment" as advocated by the *Zapata* decision, could continue derivative suits that would not benefit the corporation.

43. *See supra* notes 39-41 and accompanying text.

44. *Alford*, 72 N.C. App. at 547, 342 S.E.2d at 886. To apply the prophylactic rule courts need only determine whether any parties to the litigation appointed the committee. This rule seems relatively simple compared to the alternatives: administering business judgment evaluations or examining the independence of and procedures followed by SLCs.

45. 441 U.S. 471 (1979). "[F]ederal courts should apply state law governing the authority of independent directors to discontinue derivative suits . . . ." *Id.* at 486.

46. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

47. *Id.* at 624, 393 N.E.2d at 996-97, 419 N.Y.S.2d at 922-23.

decided to terminate the shareholders' action.[48] The *Auerbach* court granted summary judgment to the corporation, declaring that the business judgment rule insulated substantive aspects of the committee's decision from judicial scrutiny.[49] To apply the rule in the SLC context, the court restricted its review to only two questions—namely, whether the committee was made up of disinterested, independent members and whether the committee's investigative procedures were appropriate.[50] In support of its decision, the *Auerbach* court stated at least two reasons why, absent fraud or bad faith, courts should respect the business decisions of SLCs: courts generally are ill equipped to evaluate business decisions,[51] and, more importantly, decisions involving derivative claims fall within the province of corporate management and the claim itself belongs to the corporation.[52]

In 1981 the Delaware Supreme Court developed a more probing two-step approach in assessing an SLC's decision. This approach reflected a greater skepticism of the propriety of applying the business judgment rule in cases involving SLCs. In *Zapata Corp. v. Maldonado*[53] the same ten directors who faced breach of fiduciary duty allegations had also appointed the SLC that would decide whether those defendants had wrongly accelerated the date on which some of the directors could exercise certain stock options.[54] The *Zapata* court established a two-step test to be used by courts when reviewing a committee's decision to discontinue a shareholders' suit. First, the court "should inquire into the independence and good faith of the committee and the basis supporting its conclusions."[55] Second, the court "should determine, applying its own independent business judgment, whether the motion should be granted."[56] By adopting this two-step test, the *Zapata* court superimposed judicial review over the decisions of SLCs; this test theoretically would achieve a "balancing point" between the shareholder's power to bring derivative suits and the corporation's power to rid

48. *Id.* at 625-26, 393 N.E.2d at 997, 419 N.Y.S.2d at 923-24.

49. *Id.* at 628-32, 393 N.E.2d at 999-1001, 419 N.Y.S.2d at 925-27.

50. *Id.* at 663-64, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926.

Several other courts have followed the test adopted in *Auerbach. See, e.g.*, Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979) (applying Delaware state law), *cert. denied*, 444 U.S. 1017 (1980); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979) (applying California law while citing *Auerbach*), *cert. denied*, 449 U.S. 869 (1980); Genzer v. Cunningham, 498 F. Supp. 682 (E.D. Mich. 1980) (applying Michigan law while citing *Auerbach*); Roberts v. Alabama Power Co., 404 So. 2d 629 (Ala. 1981) (applying Alabama law).

51. *Auerbach*, 47 N.Y.2d at 630, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926. The court also stated that "[t]he authority and responsibilities vested in corporate directors . . . proceed on the assumption that inescapably there can be no available objective standard by which the correctness of every corporate decision may be measured, by the courts or otherwise." *Id.*

52. "[B]y definition the responsibility for business judgments must rest with the corporate directors; their individual capabilities and experience peculiarly qualify them for the discharge of that responsibility." *Id.* at 631, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926-27.

53. 430 A.2d 779 (Del. 1981).

54. *Id.* at 780-81. These facts appear in Maldonado v. Flynn, 413 A.2d 1251, 1254-55 (Del. Ch. 1980), *rev'd sub nom*, Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

55. *Zapata*, 430 A.2d at 788.

56. *Id.* at 789. The *Zapata* court limited its two-step approach to cases in which demand on the directors is excused. *See id.* at 785. Several courts have followed the *Zapata* approach. *See, e.g.*, Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied sub nom.*, Citytrust v. Joy, 460 U.S. 1051 (1983); Rosengarten v. Buckley, 613 F. Supp. 1493 (D.C. Md. 1985).

itself of detrimental litigation.[57] The court acknowledged its reluctance to apply the business judgment rule after the first step of the test, largely because of risks associated with the SLC's inherent structural biases.[58] According to the court, the second step would ensure that SLC actions meet the spirit as well as the criteria of the first step, and it would eliminate instances when a committee's decision prematurely terminates a stockholder's grievance that merits future consideration.[59] In addition to concerns for the corporation's interests, the court stated that, when appropriate, matters of law and public policy should be considered in the judicial decisions.[60]

In 1983 the Iowa Supreme Court decided *Miller v. Register and Tribune Syndicate, Inc.*,[61] in which it adopted a third approach to SLCs: a simple prophylactic rule. In *Miller* plaintiffs brought a derivative action alleging that four members of the board of directors of the corporation had sold the corporation's stock to key employees at fraudulently low prices.[62] In considering an SLC's decision to discontinue the derivative suit, the *Miller* court adopted a strict prophylactic rule: directors who are parties to a derivative action may not confer to an SLC the power to bind the corporation as to the conduct of its litigation.[63] The court further specified that when a majority of a corporation's board are named as defendants in a derivative suit, the corporation may apply to the court and request the appointment of a special panel with plenary board powers.[64] The court in *Miller* reiterated the *Zapata* court's suspicion of the structural bias that potentially permeates a litigation committee and then adopted the prophy-

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57. The court stated the need for a balance between shareholders' rights and directors' powers as follows:

> If, on the one hand, corporations can consistently wrest bona fide derivative actions away from well-meaning derivative plaintiffs through the use of the committee mechanism, the derivative suit will lose much, if not all, of its generally-recognized effectiveness as an intra-corporate means of policing boards of directors . . . . If, on the other hand, corporations are unable to rid themselves of meritless or harmful litigation and strike suits, the derivative action, created to benefit the corporation, will produce the opposite, unintended result.

Zapata, 430 A.2d at 786-87.

58. "[W]e must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members." *Id.* at 787.

59. The court emphasized the impact of the second step of judicial review when it specified that courts may deny a corporation's motion for summary judgment even if a SLC can establish its independence and show sound bases for good faith decisions. *Id.* at 789.

60. *Id.*

61. 336 N.W.2d 709 (Iowa 1983).

62. *Id.* at 710. The Iowa Supreme Court confronted a certified question from the United States District Court for the Southern District of Iowa in *Miller*. *Id.* at 709-10.

63. *Id.* at 718. In Clark v. Lomas & Nettleton Fin. Corp., 625 F.2d 49 (5th Cir. 1980), *cert. denied*, 450 U.S. 1029 (1981), a shareholder brought a derivative action against the corporation's president, who also was its largest shareholder. The shareholder attacked a merger of the corporation's predecessors and the sale of a predecessor's assets to that shareholder. The corporation, through its board of directors, did not pursue the derivative action. The court found that because each of the directors who voted to terminate the derivative claim had been elected by the defendant shareholder, they would be deemed adversely interested and incompetent to take such action. By disallowing directors "controlled" by defendant from terminating a derivative suit, this approach resembles the *Miller* prophylactic rule. *See id.* at 52-54.

64. *Miller*, 336 N.W.2d at 718.

lactic rule to ensure that such bias would not affect an SLC's decision.[65]

In addition to the three approaches adopted by state courts, the American Law Institute (ALI) also has addressed the question whether and under what circumstances SLCs should determine the conduct of derivative actions.[66] The ALI has proposed that courts inquire into a committee's decision using an approach similar to that developed in *Zapata*.[67] The ALI has stated the issue in terms of standing: when should a shareholder be entitled to bring an action that a disinterested SLC committee has rejected?[68] The ALI proposals would broaden the *Zapata* approach by requiring judicial inquiry into all contended decisions of the SLC, because the ALI reasoned that courts should not be confined to the mechanical approach of the business judgment rule.[69]

In *Alford* the court of appeals confronted a question of first impression in North Carolina. Section 55-31[70] of the North Carolina General Statutes authorizes boards of directors of North Carolina corporations to appoint committees from among their members who then may exercise full board authority,[71] so long as a majority of the directors then in office[72] has approved the committee members and the committee consists of two or more directors.[73] Without this statutory authority, an SLC's decision to terminate a derivative suit would be

65. "We believe that the potential for structural bias on the part of a litigation committee appointed by directors who are parties to derivative actions is sufficiently great and sufficiently difficult of precise proof in an individual case to require the adoption of a prophylactic rule. We conclude that we should prevent the potential for structural bias in some cases by effectively limiting the powers of such directors in all cases." *Id.* at 718 *cited in Alford*, 72 N.C. App. at 545, 324 S.E.2d at 884.

66. *See* PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Tent. Draft No. 1, 1982) [hereinafter cited as 1982 DRAFT]; PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Discussion Draft No. 1, 1985) [hereinafter cited as 1985 DRAFT]. Both drafts have been circulated to members of the American Law Institute for their consideration. As such they do not represent the position of the Institute.

67. *See* 1982 DRAFT, *supra* note 66, § 7.03, at 304. "Thus, § 7.03 steers a middle course, recognizing both the right of the corporation to seek termination of an action for business reasons and the need for careful judicial review of the adequacy of the reasons so offered. In so doing, § 7.03 essentially adopts the rule of the Delaware Supreme Court in *Zapata* . . . . Section 7.08 takes a position intermediate between *Zapata*, on the one hand, and *Miller* and *Alford*, on the other. Essentially, it is in basic accord with the *Zapata* court's recognition of the need for judicial review . . . ." 1985 DRAFT, *supra* note 66, § 7.08, at 98.

68. *Id.* § 7.02-.03.

69. The judicial intervention advocated in *Zapata*, *supra* notes 53-60 and accompanying text, would apply only in cases in which demand on the directors was excused. The ALI advocated a mandatory judicial inquiry into all cases, rather than the discretionary approach taken in *Zapata*. The ALI draft proposal also argued that judicial inquiry should involve more than the mechanical, procedural inquiry that the *Auerbach* approach advocated. *See supra* notes 46-52 and accompanying text; 1985 DRAFT, *supra* notes 66, at § 7.08, at 98-99.

70. N.C. GEN. STAT. § 55-31 (1982).

71. The relevant part of the statute reads:

> Unless otherwise provided in the charter or a bylaw adopted by the shareholders, the board of directors, by resolution adopted by a majority of the number of directors then in office may designate from among its members an executive committee and one or more other committees, each consisting of two or more directors, and each of which, to the extent provided in the resolution or in the charter or in the bylaws of the corporation, shall have and may exercise all of the authority of the board of directors . . . .

Id.

72. *Id.*

73. *Id.*

merely advisory and would require final action by the full board. The issue in *Alford* would not have arisen under such an arrangement, because the business judgment rule does not apply to a mere recommendation by a committee.

In 1978 the North Carolina Court of Appeals faced such a situation in *Swenson v. Thibaut,*[74] a case in which minority shareholders of All American Assurance Company had filed a derivative suit.[75] In *Swenson* the directors of All American had appointed a litigation committee to evaluate plaintiffs' claims that defendants had mishandled corporate funds, but the board of directors did not grant the SLC plenary board powers.[76] The *Swenson* court held the business judgment rule inapplicable because the committee's decision to terminate the derivative action did not result from a good faith, independent determination by truly disinterested directors.[77] Although the *Swenson* court did not reach the issue raised in *Alford,* defendants in *Alford* argued that North Carolina should follow the *Auerbach* approach in light of *Swenson* dicta that "where the business judgment question is presented to a court as a ground for dismissal, the sole issue for determination is whether the decision was made in good faith."[78] The *Alford* court, however, expressly refused to follow this dicta.[79]

Alford and other cases that have reviewed SLC attempts to terminate a derivative suit have focused on four main areas of controversy. First, how should courts balance the goal of maintaining corporate management by directors against the goal of assuring shareholder enforcement of fiduciary duties owed by directors? Second, should SLCs take advantage of the business judgment rule given the structural bias inherent in such committees? Third, do the underlying policy goals of the business judgment rule truly apply to litigation committees? And last, what role should the courts play with respect to litigation committees?

The crux of the controversy surrounding the role of SLCs revolves around the inherent tensions between the conflicting goals of directors and shareholders.[80] On the one hand, corporate directors assert their statutory right to govern the business and affairs of the corporation, including the decision whether to bring a lawsuit on behalf of the corporation.[81] In defense of their position, directors also hold out the experience and superior knowledge that they bring to such a corporate decision. Because litigation may result in a myriad of costs to

74. 39 N.C. App. 77, 250 S.E.2d 279 (1978), *disc. rev. denied,* 296 N.C. 740, 254 S.E.2d 181 (1979).

75. *Id.* at 82, 250 S.E.2d at 283-84. That suit against All American was brought derivatively by 33 minority shareholders alleging breach of fiduciary duties owed to All American by past and present officers and directors. These actions led to All American being placed in involuntary rehabilitation in 1975. *Id.* at 84-85, 250 S.E.2d at 285.

76. *Id.* at 87-88, 250 S.E.2d at 287.

77. *Id.* at 107-08, 250 S.E.2d at 298.

78. *Id.* at 107, 250 S.E.2d at 298. In support of this proposition, the court cited Swanson v. Traer, 249 F.2d 854 (7th Cir. 1957).

79. *Alford,* 72 N.C. App. at 548, 324 S.E.2d at 886.

80. The *Zapata* court discussed these tensions. *See Zapata,* 430 A.2d at 786-87; *supra* note 57.

81. *See supra* note 2 (noting the derivation of directorial authority to manage the affairs of the corporation).

the corporation,[82] directors urge that the corporation must have a voice in any decision regarding derivative claims, even if a majority of the directors have been accused of wrongdoing. Directors argue that the SLC provides this voice in such situations, because SLCs can and do render independent good faith business decisions.

On the other hand, although shareholders acknowledge the role of directors as managers of the corporation, they assert their statutory right to use the derivative suit as a means to enforce the fiduciary duties that directors owe to the corporation and its owners.[83] Many courts have extolled the role that derivative suits play in protecting corporations and shareholders from directors' wrongdoing. Derivative actions have been described as "intra-corporate means of policing boards of directors,"[84] "important weapons for remedying abuses of corporate management,"[85] and as "the chief regulator of corporate management."[86] The derivative suit also has been characterized as the principal remedy by which shareholders can rehabilitate their corporation in the aftermath of directorial mismanagement.[87]

The SLC context almost always involves a derivative suit alleging wrongdoings on the part of a majority of the board of directors. If a majority were not implicated, the board would not need a committee to terminate the suit and could instead terminate the litigation by a majority vote of disinterested directors.[88] Without a committee the implicated majority has no avenue to stop the litigation, which leaves the corporate management voiceless in any litigation decision. Based on this situation, directors warn of the potential for strike suits,[89] which shareholders may bring for their nuisance value or to obtain a favorable settlement. Compared to plaintiffs in typical direct actions, however, derivative-plaintiffs have few incentives to bring a strike suit because any recovery goes to the corporation rather than individual plaintiffs, and also because statutes bar an out-of-court settlement.[90] In addition, a court may order a losing plaintiff to

82. *See* Brown, *supra* note 29, at 617-18. Brown identifies the following types of adverse consequences and costs that may befall a corporation when it pursues derivative litigation: time and energy expended by the officers and directors, expensive and time consuming discovery, disruption of corporate business activities, undermining of employee morale, adverse effects on business relationships with others, and damage to the corporation's reputation and standing in the business community. *Id.*; *see also* Dent, *supra* note 29, at 142-44. Dent contends that even meritorious suits may be detrimental to the corporation. He cites the out-of-pocket costs of litigation, the interruption of corporate business, and the undermining of personnel morale as possible corporate expenses. *Id.* at 144.

83. *See supra* note 1 (describing the nature of a shareholders' derivative suit).

84. *Zapata*, 430 A.2d at 786.

85. Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

86. Cohen v. Beneficial Loan Corp., 337 U.S. 541, 548 (1949).

87. *See* Abbey v. Control Data Corp., 603 F.2d 724, 731 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980).

88. *See* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917) (business judgment rule protects decision by disinterested directors to terminate derivative suit).

89. A strike suit is a vexatious lawsuit brought to extract an exorbitant attorney's fee or a private settlement that benefits only the shareholder plaintiff. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 741-43 (1975) (discussing the ill effects of strike suits).

90. *See* Dent, *supra* note 29, at 137-40. The requirement that courts approve any settlements of

pay defendants' costs in a derivative action.[91]

In the final analysis, little potential exists for strike suits in the derivative context.[92] Although directors do possess the power and discretion to manage corporations, their authority is not absolute. Derivative suits represent a valuable check on the management powers of directors, a point that the North Carolina General Assembly has recognized through liberal statutory provisions favoring shareholders suits.[93]

Although the courts should recognize this public policy, they should not lose sight of the intended focus of derivative suits—the corporation and its best interests. Courts should adopt a rule regarding SLCs that will achieve the desired result: derivative actions that will ultimately benefit a corporation should be pursued and strike suits and other suits not in the best interests of the corporation should be terminated at an early stage.

The track record of SLCs clearly reflects a propensity toward categorical termination of derivative claims.[94] An application of the business judgment rule to SLCs, an approach advocated in *Auerbach*, would surely undermine North Carolina public policy that favors derivative actions and would deny North Carolina corporations the beneficial effects of such actions.[95] Although the *Zapata* approach correctly seeks to balance the discretion of directors against the rights of shareholders, its prescription for reaching this balance requires courts to evaluate a corporation's best interests, and requires an overly complicated and undefined analysis.[96] The prophylactic rule adopted in *Miller* and *Alford* may be criticized for disallowing a corporation its voice in the form of an SLC, but this rule furthers the legislative intent that shareholders obtain a fair hearing through derivative suits so that they may protect their corporation. The rule recognizes that under normal conditions shareholders should not second-guess their directors' authority, but when a derivative suit alleges wrongdoing or self-dealing by directors, the action represents a necessary vehicle to protect the best interests of the corporation.

Structural bias constitutes the second problem that arises in SLC cases. Critics generally contend that an SLC's independence may be more apparent than real,[97] even if limited by a test such as the one created in *Auerbach*.[98] The primary source of bias arises from the fact defendants in a derivative suit may

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derivative suits prohibits private settlements, which otherwise would provide an incentive for strike suits. This requirement derives from FED. R. CIV. P. 23.1; N.C. GEN. STAT. § 55-55(a) (1984). A court would not approve the settlement of a groundless suit, which only benefits the plaintiff and constitutes a loss to the corporation. Dent argues that other obstacles to derivative suits, *see supra* notes 20-26 and accompanying text, also prevent strike suits. *See* Dent, *supra* note 29, at 138-39; *see also* H. HENN, *supra* note 1, § 374, at 1101-02 ("[T]here remains little opportunity to derive personal gain from a derivative action, thus seriously curbing strike-suits.' ").

91. *See supra* note 21.

92. *See supra* note 1 (regarding the nature of a shareholders' derivative suit).

93. *See supra* notes 20-27 and accompanying text.

94. *See supra* note 37 and accompanying text.

95. *See supra* notes 20-27 & 84-87 and accompanying text.

96. *See infra* notes 105-07 and accompanying text.

97. *See supra* note 35.

98. *See supra* notes 46-52 and accompanying text.

have formed the SLC and the SLC members serve as co-directors with the defendants. Thus, a "there but for the grace of God go I"[99] attitude may play a role in the committee's decision whether to bring an action against their fellow directors.

In choosing individuals to serve as new directors and committee members, defendant directors may select persons from whom they expect sympathetic treatment.[100] Defendants may look to persons who have similar social and professional backgrounds and who share similar attitudes regarding corporate management and derivative suits generally. In effect, the defendants may choose their "own judge and jury."[101]

Any committee that potentially places the interests of individual defendants above the interests of the corporation should be barred from terminating a derivative suit. In *Auerbach* the court developed a test that seeks to identify the potential for structural bias on a case-by-case basis, scrutinizing tangible features of the SLC and its investigative procedures.[102] Yet no matter how much evidence the parties produce in a given case to validate a committee's independence, in the final analysis the extent and effect of bias remains unascertainable.[103] Thus, such an objective test will not go far enough in assuring the "good faith" prerequisite of the business judgment rule. The track record of litigation committees bears out this point because SLCs in every recorded case have sided with defendant directors.[104]

The *Zapata* court chose to deal with the structural bias problem by authorizing the courts to second-guess a litigation committee's decision.[105] In effect, the *Zapata* rule provides that if structural bias leads an SLC to make a decision inconsistent with the best interests of the corporation, then the courts can correct that decision and substitute their own business judgment for that of the committee. This approach fails for several reasons. If structural bias permeates SLCs, as the *Zapata* court[106] contended, then the courts should not allow defendant directors to form such committees and seek business judgment immu-

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99. *Zapata*, 430 A.2d at 787.

100. *See* Cox, *supra* note 8, at 962. "Also, when the committee is formed after the instigation of the derivative suit, the situation is rife with opportunities for the defendants to select for committee membership those directors most sympathetic to their position." *Id.*; *see also* Dent, *supra* note 29, at 11-12 ("The selection of outside directors is usually controlled by the senior management of the corporation, which seeks to name individuals who will not rock the boat.' "); Gevurtz, *supra* note 35, at 278 ("Naturally, individuals are chosen whose support can be counted on. In addition, the power to select often gives the power to remove.").

101. Gevurtz, *supra* note 35, at 280.

102. *See supra* notes 46-52 and accompanying text.

103. *See* Gevurtz, *supra* note 35, at 281-89. In this section of his article, Gevurtz discusses "the impracticality of searching for independence" in nondefendant directors. He points out the extensive evidence and costs that would be required to determine a committee's independence and predicts that in the end such a finding would be inconclusive. Given the alternatives, when courts must choose between disallowing a director to have a say when a fellow director is implicated or ignoring structural bias and limiting the meaning of independence to the lack of any blatant self-interest, Gevurtz notes that courts generally have chosen the latter.

104. *See supra* note 37 and accompanying text.

105. *See supra* notes 53-60 and accompanying text.

106. *See supra* note 58 and accompanying text.

nity in the off-chance that they may reach a fair and independent decision. Furthermore, by placing the determination of a corporation's best interests in the hands of the courts, the *Zapata* approach becomes problematic and raises serious questions of possible intrusion into and erosion of principles of independent corporate governance.[107]

The *Miller* and *Alford* courts attempted to cure the ill effects of structural bias with a prophylactic rule that would prevent directors who are named as defendants from appointing SLCs.[108] This rule seeks to combat structural bias by identifying types of litigation committees prone to such bias and then forbidding their formation. This approach is preferable because it looks to the source rather than the symptoms of structural bias. Rather than attempt to identify structural bias in each particular committee, as proposed in *Auerbach*,[109] or in a given committee's decision, as proposed in *Zapata*,[110] the *Miller* and *Alford* approach seeks to preclude bias by preventing potentially biased persons from appointing an SLC.

The third area of controversy in this area involves the business judgment rule and whether that rule should apply to an SLC's decision to terminate a derivative suit. The business judgment rule insulates from judicial scrutiny any good faith decisions made by disinterested corporate directors in the exercise of their business judgment.[111] Given that directors should not serve as guarantors or insurers of business success, the rule serves as a defensive device to shield directors from liability for mere errors of judgment.

Apart from any structural bias concerns and in contrast with normal business decisions, when an SLC decides to end a derivative suit the underlying policy rationales of the business judgment rule simply do not apply. Policy justifications for the rule fall into two categories. First, the rule recognizes that directors have superior competency because they are intimately acquainted with the corporation's affairs, whereas the courts have a limited ability to deal with such concerns.[112] Second, the rule limits the personal liability of directors and encourages entrepreneurial risk taking by alleviating the fears of those who contemplate serving as corporate directors.[113]

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107. *See infra* notes 121-22 and accompanying text.

108. *See supra* notes 17-44 & 61-65 and accompanying text.

109. *See supra* notes 46-52 and accompanying text.

110. *See supra* note 53-60 and accompanying text.

111. *See supra* note 3.

112. *See* Brown, *supra* note 29, at 608, 636-38. In discussing the rationales for the business judgment rule, Brown makes the following observation:

> [T]he business judgment rule accords recognition and deference to the business expertise and acumen which directors are able to develop under its aegis. The business judgment rule has also been perceived as a prudent rule of judicial self-restraint which recognizes the institutional inadequacy of courts to exercise judicial power effectively in matters involving business judgment. Courts lack the training and expertise necessary for directly reviewing the manifold decisions made by directors. Given the highly discretionary nature of most business decisions, no objective criteria exist for a court to measure the correctness of a given business decision. *Id.* at 608.

113. *See* Brown, *supra* note 29, at 608. Brown argues that the rule is intended to encourage "the development of entrepreneurial expertise" and to encourage directors "to exercise their managerial powers in a creative and innovative fashion." *Id*; *see also* Dent, *supra* note 29, at 135-36. Dent

However, neither of these policy justifications applies when an SLC decides to terminate a shareholders' derivative suit. First, as newly appointed directors, committee members usually have no previous exposure to the workings of the corporation, and the SLC exists solely to make the litigation decision.[114] Such directors do not possess sufficient knowledge of the corporation to warrant deferential treatment by the courts. Second, because members of the SLC are not named defendants to any suit, they face little if any threat of personal liability.[115] Entrepreneurial risk taking simply does not become an issue in the litigation committee context and therefore should not serve as a basis for applying the rule.

Thus, the business judgment rule should not provide blanket immunity for SLC decisions to terminate derivative suits. Given that the rule is expressly designed to protect the legitimate business decisions of directors, it would be anomalous to apply the rule to an SLC's decision that benefits only the defendant directors who do not deserve the rule's protection. Because the generally accepted policy justifications for the rule do not apply in the SLC context, the *Auerbach* deference to such committees is unwarranted. The derivative suit should continue through the judicial process based on its merits.

In the dispute over litigation committees, the fourth and final issue focuses on the courts and their unsettled relationship with litigation committees. As reasoned above, courts should not defer to SLCs to the extent of granting business judgment rule immunity. The *Zapata* court suggested that courts should exercise their own independent business judgment and decide whether to terminate a derivative suit.[116] Yet the *Zapata* balancing approach has thrust the courts into an uneasy and undelineated business decision-making role that creates as many problems as it solves.

Although advocating that courts exercise "independent business judgment," the *Zapata* court unfortunately left that term undefined. The major consideration in a court's decision should be the best interests of the corporation,

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asserts that the purpose of the rule is not to ensure a correct result but to insulate from liability directors who have caused losses to the corporation by mistakes of judgment. In addressing the public policy behind this rule, Dent comments that "if directors were held liable for reasonable decisions that proved unsuccessful, competent persons would either refuse to be directors or would become inordinately cautious in managing the corporation . . . ." *Id.* at 135; *see* 1985 DRAFT, *supra* note 66, § 7.08, at 99. The Draft states that the business judgment rule is "founded on a recognition of both the limited competence of courts in dealing with issues of business risk-taking and the counter-productive impact of the threat of personal liability on corporate directors, which threat might make directors unduly risk averse or less willing to serve." *Id.* at 99.

114. Furthermore, unless the committee members were truly outsiders to the corporation, the committee probably would not even pass the threshold independence test of *Auerbach*. *See supra* notes 46-52 and accompanying text (discussing various aspects of the *Auerbach* test).

115. *See* Coffee & Schwartz, *supra* note 35, at 280-84. These authors contend that the "decision [by an SLC] not to sue typically occurs in a very different context from that of the normal business judgment." *Id.* at 281. Among several distinctions, the authors note that SLC members face little risk of liability because they are not defendants to the very suit they may terminate. Commentators also argue that, even if plaintiffs subsequently sued the SLC members for their decision to dismiss the action, the business judgment rule would apply to that decision. *Id.* at 281-82; *see* 1985 DRAFT, *supra* note 66, § 7.08, at 99. The proposal also states that directors serving on SLCs "have little or no exposure to liability for their decision to reject the action." *Id.*

116. *See supra* notes 53-60 and accompanying text.

although the *Zapata* court also injected "matter of law" and "public policies" as factors a court should consider.[117] By failing to prescribe a more definite formula in such cases, the *Zapata* approach gives trial courts an ambiguous standard that could lead to inconsistent results.[118]

More importantly, the *Zapata* court makes a tenuous assumption that trial courts can ascertain the best interests of a corporation with respect to a derivative claim. Judicial inquiry into the question whether plaintiff has brought a meritorious claim will not achieve a proper result because not all meritorious derivative claims necessarily advance the best interests of the corporation.[119] Courts simply lack the time and expertise to evaluate such business decisions.[120]

An equally disturbing aspect of the *Zapata* approach involves the question whether courts should intrude into the private decision-making territory of corporations.[121] Under the *Zapata* approach, courts, in effect, substitute their business judgment for that of the directors. In considering such factors as "public policy" in their decisions, the courts may miscalculate the corporation's best interests and may subrogate its interests to other outside factors.[122] Given that the sole focus of a derivative action should be the corporation, this approach is unacceptable.

The *Alford* court suggested that a prophylactic rule would be easier to apply and that courts would continue to review the merits of derivative claims.[123] Moreover, a prophylactic rule should promote judicial economy—courts should not have to undertake the time consuming and complicated task of assessing the corporation's best interests or, alternatively, of evaluating the independence and investigative procedures of SLCs. The rule automatically takes effect whenever parties to a derivative suit appoint the members of an SLC.

Although a prophylactic rule leaves the corporation without a means to terminate the suit, the *Alford* court suggested that the corporation may still use

117. *Zapata*, 430 A.2d 779. "The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests." *Id.* at 789.

118. The court did not specify what factors courts should take into account to determine a corporation's best interests, nor did it specify which situations warrant considerations of "law" and "public policy." *Id.* at 789; *see* Brown, *supra* note 29 at 642-48. Brown argues that little or no guidance exists for courts to apply the second step of *Zapata*. Brown also contends that the *Zapata* court probably intended to give courts flexibility but that undefined flexibility can lead to inconsistent results. *Id.* at 642.

119. *See* Brown, *supra* note 29, at 617-18 (cost of conducting litigation may outweigh any potential recovery in a meritorious suit).

120. *See Auerbach*, 47 N.Y.2d at 630, 393 N.E.2d at 1000, 419 N.Y.S. 2d at 926; *see also* Coffee & Schwartz, *supra* note 35, at 329 (expressing suspicion that courts, even if given the authority, will continue to defer to SLCs); Cox, *supra* note 8, at 986 (expressing view that courts have limited ability to calculate such factors as the impact of suits on employee morale and other factors peculiar to the corporation).

121. *See* Brown, *supra* note 29, at 643 ("Delaware has chosen to substitute public decision-making by a court for private decision-making by directors . . . .").

122. *See* Cox, *supra* note 8, at 986 (stating that even if dismissal is in corporation's best interest, that interest may have to give way to broader social concerns); *see also* Coffee & Schwartz, *supra* note 35, at 329 (stating that there can be a transcending importance to the concept of corporate accountability, over and above the narrow interests of a particular corporation).

123. *Alford*, 72 N.C. App. at 547-49, 324 S.E.2d at 886.

the summary judgment motion as a means to defeat strike suits on the merits.[124] Such a rule allows the courts to review suits and rule on matters of law as they are intended and equipped to do, rather than tread tentatively into the less familiar area of business decisions.

Furthermore, by allowing derivative claims to proceed on their merits, the best interests of shareholders should prevail through the adversarial process. The shareholders' interests would not be adequately or zealously represented if the courts or SLCs made the decision whether to pursue a derivative claim.[125] The adversarial nature of litigation ultimately will provide a more conducive forum to hear shareholders' claims on behalf of their corporations.

In the final analysis, the prophylactic rule created in *Miller* and adopted by the *Alford* court is preferable to the *Auerbach* and *Zapata* approaches. Special litigation committees represent an imaginative attempt by management to preserve the voice of corporations in derivative litigation decisions when a majority of the board of directors has been implicated in wrongdoings. Despite arguments that a litigation decision is a business decision that the directors should make,[126] the special characteristics of an SLC render the business judgment rule inapplicable. Because SLC members neither possess superior knowledge of the corporation nor risk personal liability,[127] the *Auerbach* result is untenable.

The genuine problem of structural bias further undermines application of the business judgment rule to SLCs. Given the intangible nature of such bias,[128] the *Auerbach* test, which requires that courts scrutinize each SLC decision on its own, fails in its attempt to assure the independence of such committees. The prophylactic rule adopted by the *Alford* court recognizes that the effects of structural bias inherently attach to certain types of directors, and the rule attempts to eliminate any chance of such bias by prohibiting defendant directors from appointing SLC members. Thus, the *Alford* court adopted a rule that attacks structural bias at its source.

To resolve problems of structural bias, the *Zapata* court added a second step to the *Auerbach* approach, which allows courts to exercise their own "business judgment" to determine whether a derivative suit should be pursued.[129]

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124. *Id.*

125. *See* Dent, *supra* note 29, at 118. Dent makes the following comments regarding derivative suits in the court system:

> [T]he Anglo-American legal system features adversary proceedings in which key roles are played by persons who clearly are not disinterested—the parties to the dispute and their attorneys. It is believed that the truth is more likely to emerge if each party, aided by skilled counsel, is free to advance his own case and to attack his opponent's case vigorously. In theory, and to a large extent in practice, shareholders receive the benefits of an adversary proceeding in a derivative suit. Although the interest of the nominal plaintiff in the outcome is usually minimal, the interest of his attorney in receiving a generous court award of attorneys' fees . . . assures shareholders of vigorous and competent representation.

Id.

126. *See, e.g.*, Auerbach, 47 N.Y.2d at 631, 393 N.E.2d at 1000, 419 N.Y.S. 2d at 927 (decision whether to prosecute a derivative claim falls within judgment and control of board of directors, as with any other business decision).

127. *See supra* notes 112-15 and accompanying text.

128. *See supra* note 103 and accompanying text.

129. *See supra* notes 53-60 and accompanying text.

The *Zapata* decision allows SLCs to make recommendations while vesting the courts with veto power over a committee's decision to terminate suit. This approach fails for several reasons. First, it forces courts to undertake an overly complicated analysis, given the number of intracorporate factors that must be weighed as well as public policy and legal considerations.[130] Courts are most accustomed to making legal rather than private business decisions. Second, even if courts could make such decisions, arguably they should not: when courts attempt to make a private business decision in a public forum, they violate principles of corporate privacy and self governance.[131] Last, the courts' exercise of business judgment requires them to make time consuming and burdensome investigations into the business matters of corporations. The North Carolina Court of Appeals was therefore correct in refusing to adopt this approach in *Alford*.

In light of deficiencies evident in the *Auerbach* and *Zapata* approaches, the *Miller* approach stands out as the best of the three major judicial treatments of SLCs. North Carolina public policy favors derivative actions,[132] and judicial deference to SLCs would severely undermine this policy given their propensity to terminate such suits. The prophylactic rule allows derivative suits to proceed on their own merits through the judicial system. Critics may contend that a plaintiff could easily name a majority of the directors as defendants and thus paralyze the corporation. Yet strike suits should not arise often because the cause of action is derivative and therefore belongs to the corporation.[133] Moreover, even if defendants cannot invoke the business judgment rule, trial courts still may terminate strike suits on their merits if and when defendants raise a summary judgment motion.[134]

The prophylactic rule preserves the integrity of the business judgment rule by restricting its application to times when its underlying goals are served. As the *Alford* court noted, management traditionally has used the rule as a defensive device or shield rather than as a sword.[135] If courts applied the business judgment rule to SLC decisions, the rule anomalously would benefit defendant directors rather than SLC members who make the decision.

In its discretionary review the North Carolina Supreme Court should follow the court of appeals' choice of a prophylactic rule, but should clarify some points and address sources of structural bias other than defendant directors. The North Carolina Court of Appeals expressly held that *Miller* controlled the outcome in *Alford*.[136] Yet *Alford* neglected to discuss one aspect of *Miller*: The court in *Miller* stated that even when a shareholders' derivative suit names a

130. *See supra* notes 117-18 and accompanying text.

131. *See supra* note 121 and accompanying text.

132. *See supra* notes 19-28 and accompanying text.

133. *See supra* note 90 and accompanying text.

134. *See Alford*, 72 N.C. App. at 548-49, 324 S.E.2d at 886 ("Summary judgment will remain an appropriate device where plaintiffs bring suits of little or no merit, . . . [S]uch summary judgment must however be on the merits of the decision, not on the adequacy of intracorporate procedures used to determine those merits.").

135. *See id.* at 540, 548, 324 S.E.2d at 882, 886.

136. *Id.* at 547, 324 S.E.2d at 886.

majority of the board of directors as defendants, the corporation could apply to the courts for the appointment of an SLC.[137] It remains an open question whether North Carolina courts will adopt this proposal. Theoretically, such an alternative would accomodate the corporation's need to have derivative suits evaluated quickly and efficiently, and, at the same time, derivative plaintiffs would receive a more objective consideration of their claims than would otherwise be the case.

Yet in this context court appointed SLCs suffer from some of the same problems and deficiencies as board appointed SLCs so that traditional business judgment rule rationales prove unjustified. In either case the SLC members lack superior knowledge of the corporation[138] and do not risk personal liability,[139] use of the rule would not promote legitimate entrepreneurial risk taking,[140] and the SLC may become an offensive procedural device rather than a defensive measure designed to protect legitimate business decisions.[141] Furthermore, as occurs with the *Zapata* approach, the judiciary may invade traditional areas of private corporate governance.[142] Nonetheless, the benefits that could accrue from such a disinterested SLC cured of its most crippling ailment, structural bias, warrant adoption of this approach by the supreme court.[143]

The *Alford* court stated that its ruling does not abolish the committee device altogether.[144] Specifically, the court mentioned derivative suits against third parties as a context in which the SLC may be used.[145] Yet this situation rarely arises because, even when a shareholders' derivative suit names a majority of the board of directors as defendants, the board can act on claims against third parties. The supreme court should define the scope of the prophylactic rule to eliminate the use of board appointed SLCs in this context or in any situation in which they may be useful to an implicated board of directors.

Although the prophylactic rule adopted in *Alford* represents a step in the right direction, the decision does not address all sources of structural bias effectively. The *Alford* court correctly identified directors named as defendants in a derivative suit as one source of structural bias, and the decision eliminates their ability to appoint SLCs. Under this rule, however, any nonparty directors who may have participated in the alleged wrongdoings still may appoint SLC mem-

137. *Miller*, 336 N.W.2d at 718.

138. *See supra* notes 112-15 and accompanying text.

139. *See supra* notes 112-15 and accompanying text.

140. *See supra* notes 112-15 and accompanying text.

141. *See supra* notes 39-41 and accompanying text.

142. *See supra* notes 107 & 121 and accompanying text. Although in effect a court may impinge on corporate autonomy, the appointment of an SLC would not be drastically different from the appointment of provisional directors by a court in the case of a deadlocked board. *See* N.C. GEN. STAT. § 55-39 (1984); *see also* Gevurtz, *supra* note 35, at 322-23 (identifying incompetent persons and bankrupt or deadlocked corporations as situations in which courts appoint individuals to determine and protect the interests of parties unable to do so for themselves).

143. Gevurtz advocates such an approach and addresses the consequent issues concerning the manner of appointment, compensation, and duties of these court appointed SLC members. *See* Gevurtz, *supra* note 35, at 321-34.

144. *Alford*, 72 N.C. App. at 548, 324 S.E.2d at 886.

145. *Id.*

bers. A more accurate approach to structural bias would raise the following questions: Did the director participate in the alleged action? Did the director vote to approve the action at issue? Did the director serve on the board at the time of the alleged wrongdoing? Has the director since or prior to the action served on the board with those who participated in the action?

To eradicate structural bias, the supreme court should bar all potentially biased persons from appointing an SLC. The directorial bias could infect SLC members and lead the committee to place the interests of the implicated directors over those of the corporation. The supreme court would further eliminate structural bias by adopting a rule that directors of North Carolina corporations who are parties to a derivative action or who have participated in or voted for the alleged misconduct may not confer on an SLC the power to bind the corporation. The court should also include within the scope of the prophylactic rule directors who have served on the board with the alleged wrongdoers. By including those directors, however, the court might preclude directors from appointing a committee that might otherwise have the business judgment rule applied to their own decisions.

By adopting this approach the North Carolina Supreme Court would address the structural bias issue in full, offering predictability for other courts and avoiding an ad hoc determination of the sources of bias. This approach also would guide corporations and courts in their handling of derivative suits and would finally establish North Carolina's position on the issue of SLCs. The business judgment rule's theoretical underpinnings do not apply to malfeasant boards of directors, and the use of SLCs as an offensive procedural device designed to insulate defendant directors from liability must end.

CHARLES MARK HOLT

ADDENDUM

While this Note was in the final publication stages, the North Carolina Supreme Court decided *Alford v. Shaw*, No. 132PA85 (N.C. Oct. 7, 1986). A sharply divided court adopted a modified version of the business judgment rule approach to SLCs as enunciated in *Auerbach*. *Id.*, slip op. at 28. This holding allows directors accused of wrongdoing to appoint an SLC and limits judicial review of the SLC's decision to terminate a shareholders' derivative suit to whether the SLC was made up of "disinterested, independent directors who acted in good faith, following appropriate investigative procedures." *Id.* The majority opinion, written by Chief Justice Billings, further stated that a court would presume that the SLC members acted in good faith if the defendant established the other elements of the *Auerbach* test. *Id.* at 31.

Justice Frye concurred in allowing defendant directors to appoint SLCs, but in dissent advocated additional judicial scrutiny of an SLC's decision by way of the *Zapata* approach. *Id.* at 1 (Frye, J., concurring in part and dissenting in part). In dissent, Justice Martin declared that "[t]he Court today has placed the corporate fox in charge of the shareholders' hen house" and sought affirmance of the prophylactic rule. *Id.* at 1 (Martin, J., dissenting).

The court's widely divergent opinions suggest that the law in North Carolina pertaining to SLCs remains controversial if not unsettled. It is hoped that this Note's analysis of the three judicial approaches to SLCs will aid practitioners in dealing with this area of the law and encourage the court to reconsider this crippling blow that it has dealt to the rights of minority shareholders and to their ability to protect the interests of North Carolina corporations.

Skinner v. E.F. Hutton & Co.: North Carolina's Caveat Tipper Exception to the *In Pari Delicto* Doctrine

The equitable doctrine *in pari delicto* bars the claim of any party found to be equally at fault with his or her adversary.[1] North Carolina traditionally has recognized the doctrine and its inherent limitations in a variety of contexts.[2] However, the North Carolina Supreme Court in *Skinner v. E.F. Hutton & Co.*[3] recently concluded that the doctrine "should not be recognized as a defense to claims under state law concerning securities transactions involving the transfer of purported inside information . . . to plaintiffs who have acted upon such information for their own gain and suffered damages as a result."[4] Thus, apparently for the first time, a state court has decided the issue whether *in pari delicto* constitutes a defense available to "tippers"[5] who defraud their willing "tippees."[6]

Skinner is significant in several respects. The decision carves out a new public policy exception to the traditional *in pari delicto* doctrine.[7] Moreover, it rejects a test recently adopted by the United States Supreme Court in *Bateman Eichler, Hill Richards, Inc. v. Berner*,[8] a case involving a tippee's Securities and Exchange Commission Rule 10b-5 claim.[9] The *Skinner* decision may indicate that the North Carolina courts will now play a more active role in insider trading cases,[10] an area primarily governed by federal law.[11]

This Note analyzes the logic underlying the court's conclusion, discusses the implications of the decision, and examines an alternative solution to the general issue presented in *Skinner*. Although the *Skinner* decision avoids inherent difficulties posed by the *in pari delicto* doctrine, it also sacrifices judicial discretion and policy goals in favor of a per se rule—*caveat tipper*.

The controversy in *Skinner* arose between the Skinners, private investors,

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1. *See infra* notes 27-37 and accompanying text. *See generally* Grodecki, *In Pari Delicto Potior Est Conditio Defendentis*, 71 LAW Q. REV. 254 (1955) (discussing the history and rationale behind the equitable doctrine).

2. *See infra* notes 38-43 and accompanying text.

3. 314 N.C. 267, 333 S.E.2d 236 (1985).

4. *Id.* at 273, 333 S.E.2d at 240.

5. A "tipper" is defined as one "who gives a tip." 3 A. BROMBERG, SECURITIES FRAUD & COMMODITIES FRAUD § 7.5(521), at 7:243 (1984). The act of tipping involves "the selective disclosure of [material, nonpublic information] for trading or other personal purposes." *Id.* Federal and state laws prohibit self-dealing in inside information.

6. A "tippee" is defined as one who receives a tip. *Id.*

7. *See infra* notes 27-37 and accompanying text.

8. 105 S. Ct. 2622 (1985).

9. 17 C.F.R. § 240.10b-5 (1985). Rule 10b-5 was promulgated under § 10b of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982). Since the seminal case of Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969), holding that the doctrine barred recovery, the federal courts had split over the question whether *in pari delicto* should be recognized as an equitable defense to rule 10b-5 claims. *See, e.g., Bateman Eichler*, 105 S. Ct. at 2626 n.10. *Bateman Eichler* settled the dispute by upholding the doctrine under limited circumstances. *See infra* notes 79-84 and accompanying text.

10. *See infra* notes 110-12 and accompanying text.

11. *See infra* text accompanying notes 45-63.

and their two securities brokers, employees of E.F. Hutton and Company. The Skinners alleged that in early 1981 their brokers encouraged them to "load up" on securities in two companies the brokers represented as take-over candidates.[12] Based on inside information they claimed to possess, the brokers assured the Skinners that takeovers would "shortly drive up the price" of the target companies' stock.[13] The Skinners accordingly invested 191,334 dollars in 7,950 shares of the companies' stock through their margin accounts with E.F. Hutton.[14]

When the takeovers never materialized,[15] the Skinners waited and then unloaded their holdings in October, November, and December 1981. As a result, they suffered losses of at least 47,526.84 dollars in market losses, brokers' commissions, margin interest, and a margin call.[16]

The Skinners sued E. F. Hutton for fraud, constructive fraud, and negligent misrepresentation,[17] seeking both compensatory and punitive damages. They

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12. *Skinner*, 314 N.C. at 268, 333 S.E.2d at 237. The two "target" companies were Washington National Corporation (WNT) and Academy Insurance Group (ACIG). Both corporations had stock available either through an exchange or over-the-counter. *Id.*

13. *Id.*

14. *Id.* The Skinners purchased 3,850 shares of WNT for $109,850 and 4,100 shares of ACIG for $81,484. *Id.*

15. *Id.* Because the trial court partially dismissed the Skinners' claims on defendant's motion to dismiss, a full account of the facts remains undetermined. Nevertheless, from the pleadings it appears that the Skinners approached the brokers on at least three separate occasions, and each time they were assured that a takeover was imminent. In fact, the brokers specified dates on which the takeovers were to occur. *Id.*

16. *Id.* "Market losses" are measured in terms of the out-of-pocket standard or the benefit of the bargain standard. Either standard may be fraught with difficulties. *See* T. HAZEN, THE LAW OF SECURITIES REGULATION § 13.7 (1985) (discussing the measure of damages appropriate in a rule 10b-5 action). Brokers charge "commissions" and earn "interest" thereon as a percentage of their clients' account transactions. Purchasing "on margin" occurs when a "customer purchases a specified amount of stock from securities firms by advancing only a portion of purchase price . . . ." BLACK'S LAW DICTIONARY 871 (rev. 5th ed. 1979). The firms maintain such stock as collateral for this credit arrangement. "Margin calls" occur upon a "demand by a broker to put up money or securities upon purchase of a stock, or if the stock is already owned on margin, to increase the money or securities in the event the price of the stock has fallen since purchase." *Id.*

17. *Skinner*, 314 N.C. at 269, 333 S.E.2d at 238. Some jurisdictions have extended common-law fraud to negligent and even innocent misrepresentations. *See, e.g.*, Link v. Link, 278 N.C. 181, 192, 179 S.E.2d 697, 704 (1971) (recognizing constructive fraud); Howell v. Fisher, 49 N.C. App. 488, 494-95, 272 S.E.2d 19, 24 (1980) (recognizing negligent misrepresentation as a cause of action); PROSSER AND KEETON ON THE LAW OF TORTS § 107, at 745-49 (W. Keeton 5th ed. 1984) [hereinafter cited as PROSSER & KEETON] (discussing strict liability for innocent misrepresentation); RESTATEMENT (SECOND) OF TORTS § 552 (1977) (discussing negligent misrepresentation). Most jurisdictions, however, traditionally require that the plaintiff prove the following elements of deceit:

> 1. A false representation made by the defendant. In the ordinary case, this representation must be one of fact.
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> 2. Knowledge or belief on the part of the defendant that the representation is false—or, what is regarded as equivalent, that he has not a sufficient basis of information to make it. This element often is given the technical name of "scienter."
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> 3. An intention to induce the plaintiff to act or to refrain from action in reliance upon the misrepresentation.
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> 4. Justifiable reliance upon the representation on the part of the plaintiff, in taking action or refraining from it.
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> 5. Damage to the plaintiff, resulting from such reliance.

PROSSER & KEETON, *supra*, § 105, at 728 (footnotes omitted). The fact misstated must be a material one. *Id.* § 108, at 753; *see, e.g.*, Johnson v. Phoenix Mut. Life Ins. Co., 300 N.C. 247, 253, 266 S.E.2d 610, 615 (1980).

claimed that their brokers never had any bona fide inside information.[18] They also sued under statutory provisions prohibiting unfair or deceptive acts or practices.[19]

E.F. Hutton interposed a motion to dismiss. The trial court upheld the motion in part and stated that " 'plaintiffs' purported claims are barred as a matter of law by the doctrine of *in pari delicto*, except as to commissions and margin interest received by Defendants.' "[20] A divided North Carolina Court of Appeals partially affirmed, holding that the "*in pari delicto* defense must work as a bar against all . . . claims for relief."[21] In a unanimous decision overturning the lower courts' holdings, the North Carolina Supreme Court concluded that the defense should no longer be recognized in the broker/tipper-investor/tippee context under state law.[22]

The *Skinner* court examined the recent United States Supreme Court decision in *Bateman Eichler*, and then offered three arguments to support its decision not to recognize the defense. First, the culpability of fraudulent stockbrokers presumptively exceeds that of investors trading on inside information.[23] Second, as a matter of policy, allowing tippees to recover from their tippers aids securities enforcement efforts.[24] Last, again as a matter of policy, the court's desire for uniformity and its disdain for any doctrine so "difficult and impractical to apply" requires that it not recognize the defense in this context.[25] The opinion avoided an analysis of the *in pari delicto* doctrine itself, simply stating

18. Plaintiff-Appellant's New Brief at 1, 3, *Skinner*. By "tipping" clients with false inside information, a fraudulent broker may generate higher commissions on his or her clients' margin accounts. This practice of encouraging excessive trading is commonly referred to as "churning." T. HAZEN, *supra* note 16, § 10.10, at 282. The question whether disclosing false "inside information" even constitutes a "tip" has never been resolved by the courts. *See, e.g., Bateman Eichler*, 105 S. Ct. at 2629 n.21 (court expressed no views on the issue and proceeded on the assumption "that the [plaintiffs'] activities rendered them *in delicto*"). The North Carolina Supreme Court in *Skinner* passed over the question entirely, assuming "*arguendo* . . . that the plaintiffs were 'tippees' and in violation of all pertinent provisions in North Carolina and federal law prohibiting trading in securities on inside information." *Skinner*, 314 N.C. at 270, 333 S.E.2d at 238-39 (footnotes omitted). Of course, the logical consequences of such a presumption bear directly on the question whether parties may truly be deemed *in pari delicto*. *See infra* note 90.

19. The Skinners sought treble damages under N.C. GEN. STAT. § 75-16 (1985) and reasonable attorney's fees under N.C. GEN. STAT. § 75-16.1 (1985), North Carolina's unfair trade practices act. The North Carolina Supreme Court summarily dismissed these claims, holding that "securities transactions are beyond the scope of N.C.G.S. 75-1.1." *Skinner*, 314 N.C. at 275, 333 S.E.2d at 241. N.C. GEN. STAT. § 75-1.1 (1985) declares unfair methods of competition affecting commerce unlawful.

20. *Skinner*, 314 N.C. at 269, 333 S.E.2d at 238.

21. Skinner v. E.F. Hutton & Co., 70 N.C. App. 517, 522-23, 320 S.E.2d 424, 428 (1984) (2-1 decision), *rev'd*, 314 N.C. 267, 333 S.E.2d 236 (1985). Judge Becton dissented on grounds that the North Carolina Supreme Court explored more fully: First, the fraudulent tipper (broker) should not profit by his or her ill-gotten gains; second, the *in pari delicto* defense discourages private enforcement efforts; last, the tippee is not equally culpable. *Id.* at 523 (Becton, J., dissenting). The dissenting opinion portentously cited Berner v. Lazzaro, 730 F.2d 1319 (9th Cir. 1984) (holding that securities professionals may not invoke the *in pari delicto* doctrine as a bar to tippee's claim under rule 10b-5), *aff'd sub nom.* Bateman Eichler, Hill Richards, Inc. v. Berner, 105 S. Ct. 2622 (1985).

22. *Skinner*, 314 N.C. at 273-74, 333 S.E.2d at 240.

23. *Id.* at 272-73, 333 S.E.2d at 240; *see Bateman Eichler*, 105 S. Ct. at 2630-31.

24. *Skinner*, 314 N.C. at 273, 333 S.E.2d at 240; *see Bateman Eichler*, 105 S. Ct. at 2631-32.

25. *Skinner*, 314 N.C. at 273, 333 S.E.2d at 240.

that "we reject the defense entirely in the present case."[26]

The equitable doctrine *in pari delicto potior est condito possidentis [defendentis]* originated at common law.[27] Loosely translated, the maxim means "In a case of equal or mutual fault [between two parties] the condition of the party in possession [or defending] is the better one."[28] Its effect is to bar a cause of action brought by an injured party who is substantially culpable *vis-a-vis* transactions that form the basis of his or her claim.

Several reasons have traditionally justified application of the doctrine in a particular case. First, in its inception the doctrine was intended to preserve the integrity of the court. As explained by one commentator, "there is present a feeling that the court must not be humiliated by an inquiry into base and shameful bargains."[29] A second and related reason springs from the court's reluctance to allow culpable parties to profit by their unlawful conduct.[30] Finally, the doctrine is grounded on the premise that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality.[31] Its intended effect is to aid enforcement efforts and safeguard policy goals.

The scope of the doctrine is circumscribed by several "limitations"[32] or "exceptions."[33] One limitation is that any party asserting the doctrine as an

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26. *Id.* at 271, 333 S.E.2d at 239. The North Carolina Supreme Court defined the doctrine and noted its place in history. *Id.* at 270-71, 333 S.E.2d at 239. Nevertheless, the court failed to analyze the doctrine on its own terms: *in pari delicto* traditionally allows equitable considerations to limit or circumscribe its scope. *See infra* notes 32-37 and accompanying text. Rather than continuing to recognize the doctrine and its inherent limitations or exceptions, the *Skinner* court created a per se rule—*caveat tipper.*

27. The defense and the maxim describing it are products of Roman law. *See* Grodecki, *supra* note 1, at 254-56. After centuries of neglect, the English rediscovered the doctrine in the mid-eighteenth century. *Id.* at 256-58. The United States in general, and North Carolina in particular, have adopted the doctrine. *See, e.g.*, Lexington Insulation Co. v. Davidson County, 243 N.C. 252, 90 S.E.2d 496 (1955); Bledsoe v. Coxe Lumber Co, 229 N.C. 128, 48 S.E.2d 50 (1948); Bean v. Home Detective Co., 206 N.C. 125, 173 S.E. 5 (1934); Lloyd v. North Carolina R.R., 151 N.C. 536, 66 S.E. 604 (1909); Kim v. Professional Business Brokers Ltd., 74 N.C. App. 48, 328 S.E.2d 296 (1985); Curry v. Staley, 6 N.C. App. 165, 169 S.E.2d 522 (1969); *see* 30 C.J.S. *Equity* § 94 (1974).

28. BLACK'S LAW DICTIONARY 711 (rev. 5th ed. 1979).

29. Grodecki, *supra* note 1, at 265. Former Chief Justice Stacy had this principle in mind when the North Carolina Supreme Court denied plaintiff recovery in Bean v. Home Detective Co., 206 N.C. 125, 173 S.E. 5 (1934):

> The allegations of the complaint are discreditable to both parties. They blacken the character of the plaintiff as well as soil the reputation of the defendant. As between them, the law refuses to lend a helping hand. The policy of the civil courts is not to paddle in muddy water, but to remit the parties, when *in pari delicto*, to their own folly. So, in the instant case, the plaintiff must fail in his suit.

Id. at 126, 173 S.E. at 6.

30. Grodecki, *supra* note 1, at 266; *see supra* note 29. In this respect, the *in pari delicto* doctrine mirrors the "unclean hands" doctrine, its corollary at equity. *See* 2 J. POMEROY, EQUITY JURISPRUDENCE § 397 (5th ed. 1941).

31. *Bateman Eichler*, 105 S. Ct. at 2626-27; *see also* Bledsoe v. Coxe Lumber Co., 229 N.C. 128, 134-35, 48 S.E.2d 50, 54-55 (1948) (doctrine bars buyer's action against seller because their agreement violated Emergency Price Control Act); Grodecki, *supra* note 1, at 268 (citing "respect for public policy" goals as a common justification of the *in pari delicto* doctrine); 1 C.J.S. *Actions* § 13 (1974) (application of doctrine based on public policy considerations).

32. *See, e.g.*, *Bateman Eichler*, 105 S. Ct. at 2627 ("[n]otwithstanding these traditional *limitations*") (emphasis added).

33. *See, e.g.*, Note, *Rule 10b-5—Application of the In Pari Delicto Defense in Suits Brought Against Securities Brokers by Customers Who Have Traded on Inside Information*, 37 VAND. L. REV.

equitable defense must prove causation, namely, that the plaintiff's alleged misconduct relates directly to the subject matter of the suit and to the defendant.[34] Fraud or duress may obviate the defense because a duped party cannot be *in pari delicto* with his or her adversary.[35] If the plaintiff is a member of a class specifically protected by statute, the defense fails by operation of law.[36] General policy concerns also limit the doctrine. When the courts believe that allowing a party's suit will support policy goals in a particular case, they may overlook the party's dirtied hands.[37]

Although the North Carolina courts clearly recognize *in pari delicto* as an equitable doctrine in North Carolina,[38] its use has diminished over the years. Originally a defense to contract claims,[39] the doctrine had been expanded by the courts to include claims based on fraud[40] or statutory rights,[41] as well as claims brought between co-conspirators[42] or joint tortfeasors.[43] A survey of recent

557, 561 (1984) ("[C]ourts have developed four *exceptions* that do not allow defendants to assert the defense.") (emphasis added). Use of the term "exception" may be a misnomer: "What are sometimes termed exceptions are merely illustrations of cases where the parties are not regarded as being *in pari delicto*." 1 C.J.S. *Actions* § 13(b), at 1000 (1974).

34. 1 C.J.S. *Actions* § 13(b), at 1000 (1974).

35. *See, e.g.*, Webb v. Fulchire, 25 N.C. (1 Ired.) 485 (1843). Webb suffered a gambling loss and sued when he discovered that the game was rigged. Even though gambling was admittedly illegal, the court allowed plaintiff's suit. "Surely, the artless fool, who seems to have been alike bereft of his senses and his money, is not to be deemed a partaker in the same crime, *in pari delicto*, with the juggling knave, who gulled and fleeced him." *Id.* at 487; *see also* 1 C.J.S. *Actions* § 13, at 1001 (1974) (*in pari delicto* not necessarily a defense when fraud, duress, or undue influence involved). *But see* Bean v. Home Detective Co., 206 N.C. 125, 173 S.E. 5 (1934) (party indicted for "knowingly" receiving stolen goods on behalf of his employer may not subsequently sue his employer for fraud).

36. *See* Note, *supra* note 33, at 563.

37. *See* Cauble v. Trexler, 227 N.C. 307, 42 S.E.2d 77 (1947); Note, *supra* note 33, at 564. The *Cauble* court stated, " 'Even where the contracting parties are *in pari delicto*, the courts may interfere from motives of public policy.... [E]quity may aid a party equally guilty with his opponent.' " *Cauble*, 227 N.C. at 313, 42 S.E.2d at 81 (quoting 3 J. POMEROY, EQUITY JURISPRUDENCE § 941, at 734 (5th ed. 1941)).

38. *See supra* note 27; *see, e.g.*, Cauble v. Trexler, 227 N.C. 307, 312, 42 S.E.2d 77, 81 (1947) (The *in pari delicto* "rule . . . is the policy of the law in this State."). The *Skinner* court did not purport to eradicate the doctrine in North Carolina. *See Skinner*, 314 N.C. at 270-73, 333 S.E.2d at 239-40. Rather, the court would characterize tippee suits as an outright exception to the doctrine.

39. *See, e.g.*, Grodecki, *supra* note 1, at 254.

40. *See, e.g.*, Bean v. Home Detective Co., 206 N.C. 125, 173 S.E. 5 (1934) (decision appears to uphold the doctrine's use despite plaintiff's fraud claim); Jordan v. E.F. Hutton & Co., 82-1511-CIV-5 (E.D.N.C. May 13, 1983). The facts in *Jordan* are similar to the facts in *Skinner*. Judge Fox, however, ruled that the *in pari delicto* defense may bar a common-law fraud claim in a suit brought by a defrauded tippee. *See id.*, slip op. at 9-10.

41. *See, e.g.*, Lloyd v. North Carolina R.R., 151 N.C. 536, 66 S.E. 604 (1909). The *Lloyd* case demonstrates the hardships that may befall a plaintiff when the doctrine is rigidly applied. Lloyd, a railroad company employee, "violated" Chapter 456 of the Public Laws of 1907 by working hours in excess of the statutory maximum. He was severely injured while attempting to disembark from a moving train. At that time he was under the direct supervision of a company engineer. Lloyd's suit charging the company with requiring him to work overtime in violation of the law was defeated on a motion to dismiss, because "an action never lies when a plaintiff must base his claim, in whole or part, on a violation by himself of the criminal or penal laws of the State." *Id.* at 540, 66 S.E. at 605-06. The *Skinner* court cited *Lloyd*, noting: "This Court and others, have not limited the defense to contract actions." *Skinner*, 314 N.C. at 271, 333 S.E.2d at 239.

42. *See, e.g.*, Curry v. Staley, 6 N.C. App. 165, 169 S.E.2d 522 (1969) (claim based on civil conspiracy).

43. *See, e.g.*, Huyck Corp. v. Magnum, Inc., 309 N.C. 788, 309 S.E.2d 183 (1983) (dicta noting that third party claim by contractor in a negligence case would be barred if contractor were found *in*

North Carolina case law, however, indicates that the doctrine arises infrequently today; its use is most prevalent in indemnity and contribution cases.

Notwithstanding this trend at the state level, federal law has resurrected the doctrine. Since the 1930s the federal courts have had to decide the propriety of common law and equitable doctrines in cases arising under federal statutes. The equitable doctrine *in pari delicto* is no exception.[44] Particularly in the realm of securities regulation, in which federal law developed largely as a response to the inadequacies of common law,[45] federal law continues to influence and interact dynamically with state law.

Congress originally enacted federal securities regulations to curb widespread market abuses that went unchecked by common law. The Securities Act of 1933 (1933 Act)[46] and the Securities Exchange Act of 1934 (1934 Act)[47] have provided the bases for much litigation in the federal courts.[48] The 1934 Act contains a general anti-fraud provision[49] which spawned rule 10b-5.[50] In con-

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pari delicto with third party defendant); Kim v. Professional Business Brokers Ltd., 74 N.C. App. 48, 328 S.E.2d 296 (1985) (holding that broker and agent cannot sue vendor for indemnity in fraud case involving sale of motel); *see also Bateman Eichler*, 105 S. Ct. at 2632 n.28 (comparing the common-law rule with federal law on subject).

44. *See, e.g., Bateman Eichler*, 105 S. Ct. 2622 (1985) (*in pari delicto* defense attempted against rule 10b-5 claim); Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968) (defense raised to antitrust claim); Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978) (defense raised to claim of violation of securities registration provisions); Chris-Craft Indus., Inc. v. Independent Stockholders Comm., 354 F. Supp. 895 (D. Del. 1973) (defense raised to claim of proxy violations).

45. *See* T. HAZEN, *supra* note 15, § 1.2, at 6-7.

46. 15 U.S.C. §§ 77a-77bbbb (1982).

47. *Id.* §§ 78a-78kk.

48. Each act implicitly allows plaintiffs to bring private causes of action. *See generally* Comment, *Implied Private Rights of Action: The Courts Search for Limitations in a Confused Area of the Law*, 13 CUM. L. REV. 569, 574 (1983) (discussing right to private action under federal statutes that grant no express right). Individuals suing under the 1933 Act may pursue their claims in either state or federal court, however, the 1934 Act vests exclusive jurisdiction in the federal courts. Of course, federal courts still have pendent jurisdiction over any state law claim. *See* Hazen, *Allocation of Jurisdiction Between the State and Federal Courts for Private Remedies under the Federal Securities Laws*, 60 N.C.L. REV. 707 (1982).

49. Section 10b-5 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1982), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

50. 17 C.F.R. § 240.10b-5 (1985) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any securtiy.

trast to the majority of state courts,[51] federal courts recognized a cause of action based on nondisclosure,[52] and, at least until 1976, they apparently required no proof of scienter.[53] Moreover, the wide range of practices and acts deemed "fraudulent" under rule 10b-5[54] has extended far beyond the reach of common law.[55] Recently, however, federal courts have imposed additional requirements on claims arising under rule 10b-5, so that today plaintiffs[56] must prove such elements as scienter and deception.[57]

A parallel development occurred in defining the duties and liabilities of inside traders. At common law insider trading directly with shareholders was often actionable, while insider trading in the open market generally was not actionable.[58] Most jurisdictions still follow this rule.[59] In the 1930s Congress in-

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51. *See supra* note 17.

52. In Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), the United States Supreme Court held that plaintiffs may recover damages from insiders who buy securities without public disclosure of the relevant facts: "Clearly, the Court of Appeals was right to the extent that it held that the two employees had violated Rule 10b-5; . . . the record reveals a misstatement of a material fact, within the proscription of Rule 10b-5(2)." *Id.* at 152. Most commentators now express the view that civil liability under subsection 2 of rule 10b-5 must arise from a face-to-face transaction, rather than from a purchase and sale in the open market. *See* T. HAZEN, *supra* note 16, § 13.9, at 482 n.10 (stating that "[i]t is questionable whether rule 10b-5(2) applies to insider trading in the context of a faceless market"). In SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969), however, the United States Court of Appeals for the Second Circuit held that a plaintiff may sue corporate insiders who have purchased stock on the open market without publicly disclosing a valuable mineral find. In the aftermath of *Texas Gulf Sulphur*, tippees have been subject to civil liability in addition to SEC sanctions for trading on material nonpublic information. "More recent Supreme Court decisions have been narrowing the scope of tippee liability. However, fraud on the market remains a basis for rule 10b-5 liability." T. HAZEN, *supra* note 16, § 13.9, at 483.

53. Note, *Securities—Underdevelopment of Securities Fraud in North Carolina Courts and the Potential Effect of the North Carolina Securities Act of 1975*, 53 N.C.L. REV. 1104, 1107-08 (1975).

54. *See* T. HAZEN, *supra* note 16, § 13.2, at 447.

55. *See* Note, *supra* note 53, at 1105-08. By the mid-1970s many commentators believed, "The doctrines enunciated by the federal courts in interpreting Federal Securities law are preferable to common-law doctrines in the area of securities fraud because they allow injured investors to recover more readily." *Id.* at 1107.

56. In Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), the United States Court of Appeals for the Second Circuit held that to attain standing, a rule 10b-5 plaintiff must have purchased or sold the securities that form the basis of a material omission, misstatement, or deceptive conduct. In 1975 the United States Supreme Court adopted this ruling. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). Today, however, the courts recognize numerous ways to achieve "purchaser/seller" status. Defendants, on the other hand, may violate rule 10b-5 regardless of their purchaser/seller status. *See* T. HAZEN, *supra* note 16, § 13.6, at 469-70 (discussing the "in connection with" requirement).

57. To establish a valid claim for damages under rule 10b-5, a plaintiff now must prove defendant acted with scienter. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); *see also* Aaron v. SEC, 446 U.S. 680 (1980) (extending the scienter requirement to SEC enforcement actions). Furthermore, particularly with regard to actions alleging corporate fraud and mismanagement, plaintiffs must prove the element of deceit. *See* Sante Fe Industries v. Green, 430 U.S. 462 (1977) (involving a shareholder's claim that the majority had frozen out minority interests pursuant to a short-form merger). *See* T. HAZEN, *supra* note 16, § 13.11, at 495-501 (discussing *Sante Fe* and subsequent cases on the issue of deception). Finally, the courts may require proof of reasonable reliance. *See id.* § 13.5, at 463-66 (discussing the reliance requirement). In the words of the United States Court of Appeals for the Fifth Circuit, "The 10b-5 action today requires all the essential elements of common law fraud except privity, . . . and [sometimes] reliance." Wood v. Combustion Eng'g, Inc., 643 F.2d 339, 345 (5th Cir. 1981). For further discussion of tippee and insider liability under rule 10b-5, see *infra* note 61.

58. 3 A. BROMBERG, *supra* note 5, § 7.4(111), at 7:102-:103. At common law, "[Early views

vestigated insider trading abuse,[60] and thereafter implemented federal measures designed to combat these abuses. The general anti-fraud provisions of rule 10b-5 serve as bases for SEC actions as well as private enforcement actions.[61] Rule 14e-3[62] explicitly prohibits trading on, and tipping, material nonpublic information about tender offers. Congress recently enacted the Insider Trading Sanctions Act, which further proscribes the use of inside information for personal gain.[63]

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coupled] *laissez-faire* philosophy with doubts about the materiality of the information and certainty about the limited fiduciary and disclosure duties in the open market." *Id.*

59. T. HAZEN, *supra* note 16, § 13.9, at 488. North Carolina courts have not conclusively resolved the question whether and to what extent insiders owe duties to the corporation and its shareholders. R. ROBINSON, NORTH CAROLINA CORPORATION LAW §§ 12-14 (3d ed. 1983). Passage of the North Carolina Securities Act in 1975, however, substantially broadened the "duties of disclosure that are imposed upon all sellers and buyers of securities." *Id.* at 189.

60. Commentators point to several egregious aspects of the practice: its use in manipulative or speculative pools, its use to take advantage of less informed investors, and its use to violate fiduciary obligations. *See* 3 A. BROMBERG, *supra* note 5, § 7.4(120), at 7:106 (discussing early congressional reaction to insider trading).

61. *See* 3 A. BROMBERG, *supra* note 5, § 7.40(120), at 7:110 (chart outlining the scope of rule 10b-5). Since the controversial decision in Chiarella v. United States, 445 U.S. 222 (1980), the United States Supreme Court has narrowed the scope of tipper-tippee liability. The *Chiarella* Court overturned defendant's criminal conviction because he owed no duty to disclose "market information" that he had gleaned while working at his employer's printing presses. The Court reasoned that the "disclose or abstain" rule first enunciated in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), only applied to persons—both insiders and others—who have a duty to disclose apart from the mere possession of material nonpublic information. *Chiarella*, 445 U.S. at 231. Thus, because defendant had no special relationship with the shareholders of a target company who had sold their stock on the market, defendant could not be held liable. In a later decision, the United States Supreme Court confirmed that plaintiffs alleging insider trading violations must prove two essential elements: a fiduciary relationship between the defendant and the parties with whom the defendant transacts, and fraudulent conduct by the defendant. *See* Dirks v. SEC, 463 U.S. 646, 661-64 (1983); Chiarella, 445 U.S. at 231-35.

Depite this narrowing trend, several significant post-*Chiarella* decisions have imposed liability on defendants who have profited from trading on confidential inside information. *See, e.g.*, United States v. Newman, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983) (holding that defendant broker/dealer violated rule 10b-5 when he conspired with investment bankers to misappropriate confidential information); United States v. Winans, 612 F. Supp. 827 (S.D.N.Y. 1985) (holding newspaper reporter liable for misappropriating confidential information from his employer).

62. 17 C.F.R. § 240.14e-3 (1985). This rule provides in pertinent part:

> (a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of § 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:
>
> (1) The offering person,
>
> (2) The issuer of the securities sought or to be sought by such tender offer, or
>
> (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities.

63. *See* §§ 2 and 3 of the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264-65 (1984) (codified as amended at 15 U.S.C.A. §§ 78u(d)(2), 78ff(a) (West Supp. 1986)), which impose severe civil sanctions on persons who illegally trade on inside information, as well as criminal fines of up to $100,000. The Act does not allow for private actions by individuals, who must resort to rule 10b-5, rule 14e-3, or other provisions under federal law. As explained by a student commentator:

> [The Insider Trading Sanctions Act (ITSA)] provides the Securities and Exchange Commission (SEC) with a treble civil penalty enforcement sanction to use against corporate

State lawmakers have reacted favorably to federal measures aimed at curbing securities market abuses. For example, the North Carolina General Assembly enacted section 78A-8 of the North Carolina General Statutes,[64] which essentially mirrors rule 10b-5. At the same time, some jurisdictions have revitalized and broadened common-law concepts of fraud and fiduciary duty to hold insider traders more accountable.[65] Nonetheless, state law still plays second fiddle to federal law in the regulation of the securities markets.[66]

With this background in mind, judges have found the task of striking a balance between federal securities law and traditionally nonfederal doctrines and remedies difficult. The *Bateman Eichler* decision, which upheld the right of a tippee to sue his fraudulent tipper, attempted to strike such a balance. *Bateman Eichler* stands for the proposition that courts may fashion an equitable remedy, apply it to individual cases arising under federal law, and still promote important policy goals.

Bateman Eichler settled a longstanding controversy between federal circuits over the applicability of the *in pari delicto* doctrine to rule 10b-5 cases. One line of cases had upheld the doctrine.[67] Decisions upholding the doctrine typically stressed that (1) tippees are willing participants in any scheme to capitalize on inside information;[68] (2) by trading on inside information, tippees seek to defraud the investing public—the class of people Congress intended to protect

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> insiders who trade securities in violation of rule 10b-5 .... The treble penalty supplements existing SEC sanctions and is designed to deter insider trading, thereby protecting investor confidence and the integrity of the securities market. Although ITSA bolsters the SEC enforcement sanctions, it does not alter the underlying substantive law of insider trading; accordingly, the courts, not ITSA, define what conduct constitutes a 10b-5 violation.

Comment, *Implications of the 1984 Insider Trading Sanctions Act: Collateral Estoppel and Double Jeopardy*, 64 N.C.L. REV. 117, 117-18 (1985).

64. North Carolina Securities Act, ch. 1380, 1973 N.C. Sess. Laws 742 (codified at N.C. GEN. STAT. § 78A-8 (1985)); *see* Jordan v. E.F. Hutton & Co., No. 82-1511-CIV-5 (E.D.N.C. May 13, 1983). The *Jordan* court "[interpreted] the North Carolina Statute to impose the same requirements as are established under federal law." *Id.* at 3-4 n.4.

65. *See, e.g.*, Cameron v. Outdoor Resorts of Am., Inc., 608 F.2d 187 (5th Cir. 1979) (allowing suit under Florida's common law when plaintiff's rule 10b-5 claim failed), *modified*, 611 F.2d 105 (5th Cir. 1980); Diamond v. Oreamuno, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969) (holding director and president liable to the corporation for ill-gotten gain). *See generally* Hazen, *Corporate Insider Trading: Reawakening the Common Law*, 39 WASH. & LEE L. REV. 845 (1982) (tracing the development of blue sky laws, federal securities law, and the common law). According to Professor Hazen, "recent federal decisions ... have cut back on the general thrust of the securities law and in particular the regulation of insider trading." *Id.* at 846. This trend may lead to more progressive statutes and judicial opinions at the state level proscribing insider trading and granting private right of action to injured parties.

66. The North Carolina courts recognize claims based on fraud, constructive fraud, and negligent misrepresentation. *See supra* note 17. The liabilities of insider-tippers, however, remain undetermined. *See supra* note 59. Furthermore, the express statutory provisions for civil liability under the North Carolina Securities Act, N.C. GEN. STAT. § 78A-56 (1985), would apparently rule out any implied private rights of action under § 78A-8 of the Act, which prohibits fraudulent practices in the sale or purchase of securities. N.C. GEN. STAT. § 78A-56(j) (1985), "provides ... that Section 78A-8 is not a basis for civil liability." Note, *supra* note 53, at 1112. "[T]he effect of the limitation is not to deprive the screwee of a private right of action, but rather to force him to go into federal court to assert it ... ." Ratner, *Federal and State Roles in the Regulation of Insider Trading*, 31 BUS. LAW. 947, 951 n.7 (1976) (discussing civil liability under the Uniform Securities Act, which North Carolina adopted with some modifications).

67. *See Bateman Eichler*, 105 S. Ct. at 2626 n.10.

68. *See, e.g.*, Kuehnert v. Texstar Corp., 412 F.2d 700, 703-04 (5th Cir. 1969).

by including the antifraud provision of section 10 in the 1934 Act;[69] (3) if allowed to sue under rule 10b-5, tippees would have an "enforceable warranty" against securities trading losses when trading on inside information;[70] (4) current sanctions already provide a strong disincentive to potential tippers;[71] (5) the difficulty of tracing tippees virtually ensures that they escape civil liability;[72] and (6) recalling an original premise of the *in pari delicto* doctrine itself, courts should not serve as a referee between guilty parties and, therefore, courts should deny a plaintiff's claim for losses.[73]

Another line of cases had declined to uphold the doctrine as a defense to a tippee's suit under rule 10b-5.[74] Decisions following this line emphasized that (1) federal law disfavors the use of *in pari delicto* and other rigid common law doctrines;[75] (2) the culpability of tippers presumptively exceeds that of tippees, because tippers pose a greater potential threat to the investing public;[76] and (3) recognition of the defense would weaken the threat of private suits under rule 10b-5 and thus would lessen the deterrent effect of such suits on potential tippers.[77]

The United States Supreme Court endorsed this second line of cases in *Bateman Eichler*. A securities broker employed by Bateman Eichler, Hill Richards, Inc. and an officer of a corporation fraudulently induced plaintiff to purchase stock in the corporation by divulging false and materially incomplete information about the corporation on the pretext that it was accurate inside information.[78] Defendants had collaborated to profit from manipulating the price of the corporation's stock.[79] When the tip proved false, plaintiff sued under rule 10b-5. Defendants interposed the *in pari delicto* defense.

In a unanimous decision written by Justice Brennan, the Supreme Court

69. *See id.*

70. *See id.* at 705. If the tippee profits from a tip, then he or she hypothetically would not report the broker's use of confidential inside information. If the tippee suffers market losses, in the absence of the *in pari delicto* doctrine, the tippee could sue to recover damages. In other words, the tippees in such circumstances would be in "the enviable position of 'heads-I-win tails you lose.'" Wolfson v. Baker, 623 F.2d 1074, 1082 (5th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981). *But see Bateman Eichler*, 105 S. Ct. at 2633 (discrediting this theory in the context of a rule 10b-5 action).

71. *See* Kuehnert v. Texstar Corp., 412 F.2d 700, 705 (5th Cir. 1969).

72. *See id.*

73. *See id.*

74. *See Bateman Eichler*, 105 S. Ct. at 2626 n.10. Many articles, comments, and notes have undertaken an analysis of the conflicting views held by the federal courts. *See, e.g.*, Note, *supra* note 33.

75. *See, e.g.*, Nathanson v. Weis, Voison, Cannon, Inc., 325 F. Supp. 50, 56 (S.D.N.Y. 1971). The *Nathanson* court relied heavily on a United States Supreme Court decision rendered in the antitrust context. *See* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968) (denying the *in pari delicto* defense in an action by a dealer against its supplier).

76. *See* Nathanson v. Weis, Voison, Cannon, Inc., 325 F. Supp. 50, 56 (S.D.N.Y. 1971). Because tippers are the source of inside information and disseminate this information to the public, their conduct may be deemed more egregious.

77. *See id.* at 57.

78. *Bateman Eichler*, 105 S. Ct. at 2624. The stockbroker made specific but false representations that the corporation had " 'options on thousands of acres in gold-producing regions of Surinam,' " unknown to the public, which would markedly inflate the value of the corporation's stock. *Id.* (footnotes omitted).

79. *Id.*

reversed the district court's decision to dismiss plaintiff's suit for failure to state a claim. The Court concluded that "the public interest will most frequently be advanced if defrauded tippees are permitted to bring suit and to expose illegal practices by corporate insiders and broker-dealers to full public view for appropriate sanctions."[80] Emphasizing the "duty of honesty and fair dealing" owed by brokers to their clients, the Court established the presumption that a tippee "[cannot] be characterized as being of substantially equal culpability as his tippers."[81]

Nonetheless, the Court recognized that "situations might well arise in which the relative culpabilities of the tippee and his insider source merit a different mix of deterrent incentives."[82] Accordingly, the decision established a two-prong test for determining when a tippee's suit may be barred on the grounds of his or her own culpability. The *in pari delicto* doctrine may be applicable when (1) as a direct result of his or her own actions, the plaintiff bears at least substantially equal responsibility for the violations he or she seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public.[83] In effect, the Supreme Court adopted a *caveat tipper* presumption from the second line of cases, while preserving the *in pari delicto* doctrine's inherent balancing test.[84]

The North Carolina Supreme Court decided *Skinner* shortly after the *Bateman Eichler* decision.[85] Curiously, *Skinner* involved a situation similar to many 10b-5 cases, including *Bateman Eichler*. The Skinners alleged that their brokers fraudulently induced them to purchase stock in a corporation by divulging false information about the corporation on the pretext that it was accurate inside

80. *Id.* at 2633.

81. *Id.* at 2630-31.

82. *Id.* at 2632. This statement and the test that follows bring *Bateman Eichler* in line with Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968) (recognizing *in pari delicto* as a defense to an antitrust claim under limited circumstances). *See Bateman Eichler*, 105 S. Ct. at 2627-28 (discussing *Perma Life*).

83. *Bateman Eichler*, 105 S. Ct. at 2629.

84. For a recent case discussing the *Bateman Eichler* doctrine, see Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985). The *Rothberg* court remanded the federal district court's decision, which had upheld defendant's assertion of the *in pari delicto* doctrine. In remanding the district court's decision, Judge Gibbons stated that "[i]n *Bateman Eichler* the Supreme Court appears to establish a new two-pronged standard for the use of the *in pari delicto* defense, . . . Accordingly, we feel it appropriate to remand this matter to the trial court to make factual findings." *Id.* at 824.

85. Prior to *Bateman Eichler* the United States Court of Appeals for the Fourth Circuit had decided Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978) (private action for damages under the 1933 Act for the sale of unregistered securities). The *Lawler* court, on the facts before it, disallowed the *in pari delicto* defense—a holding consistent with the majority approach to cases involving the sale of unregistered securities. *See* Note, *supra* note 33, at 568-69. Nonetheless, the court preserved the doctrine itself—a holding not inconsistent with the later *Bateman Eichler* decision. *Compare Bateman Eichler*, 105 S. Ct. at 2629 (arising under the 1934 Act) *with Lawler*, 569 F.2d at 1291 (arising under the 1933 Act). Two courts deciding rule 10b-5 cases decided after *Lawler* but prior to *Bateman Eichler* split over whether to apply the doctrine, based on the facts of each case. *Compare* Jordan v. E.F. Hutton & Co., No. 82-1511-CIV-5 (E.D.N.C. May 13, 1983) (disallowing tippee's suit under rule 10b-5 *and* under common law), *with* Haynes v. Anderson & Strudwick, Inc., 508 F. Supp. 1303 (E.D. Va. 1981) (allowing tippee's suit against tipper on a motion to dismiss). Both *Jordan* and *Haynes* expressly used the *Lawler* "test"—essentially the traditional *in pari delicto* doctrine—in reaching their respective decisions.

information.[86]

Rather than pursuing a claim under federal law, the Skinners resorted to the state's common law.[87] Their choice to forgo a rule 10b-5 claim disposed of one dilemma posed by the *in pari delicto* defense: Traditionally, federal courts have "eschewed rigid common-law barriers in construing the securities laws."[88] Logically, use of the doctrine as a defense to common-law fraud, constructive fraud, and negligent misrepresentation would appear more compelling; the *Skinner* court should have upheld the *in pari delicto* doctrine and analyzed the case on its own terms.[89] Instead, the North Carolina Supreme Court disallowed the defense and adopted a per se rule:

> [W]e hold that with regard to claims under North Carolina law, the fact that a plaintiff has dealt in securities for gain upon purported inside information will not give rise to the common law defense of *in pari delicto* in an action by such plaintiff against an insider or securities professional providing the information.[90]

A liberal reading of the holding indicates that the *Skinner* decision will apply to any potential claims under state common law or statute.

The *Skinner* court relied heavily on language from *Bateman Eichler*, and first reasoned that the culpability of fraudulent stockbrokers presumptively exceeds that of investors trading on inside information.[91] If the plaintiff is in fact a "tippee,"[92] however, it follows that he or she stands in violation of state and

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86. *See supra* notes 12-18 and accompanying text.

87. Exclusivity of jurisdiction forced the Skinners to choose between federal court and state court. *See supra* note 48. Their decision to sue in state court under the state's common law may be explained on several grounds. First, plaintiffs must prove scienter to establish a claim under rule 10b-5. *See supra* note 57. In contrast, the Skinners could win under a variety of claims at common law, without establishing scienter. *See supra* note 16. Second, when the Skinners filed their complaint, *Bateman Eichler* had not yet been decided; they could not rely on the strong *caveat tipper* presumption later adopted by the *Bateman Eichler* Court. *See supra* notes 80-84 and accompanying text. Last, the Skinners chose not to bring a claim under the North Carolina Securities Act, apparently because N.C. GEN. STAT. § 78A-8 (1985) does not vest a cause of action in private plaintiffs. *See supra* note 66.

88. *Bateman Eichler*, 105 S. Ct. at 2628. Federal courts have questioned the propriety of applying common-law doctrines in cases arising under federal law. Such doctrines may be deemed to interfere with congressional policies implicit in a regulatory scheme. *See, e.g.*, Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 138-39 (1968) (ruling against *in pari delicto* defense raised to defeat antitrust claim).

89. *See supra* note 26 and notes 27-37 and accompanying text. The *Skinner* court implicitly undertook an analysis of factors traditionally comprising the equitable doctrine—policy and the relative culpability of the parties. *Skinner*, 314 N.C. at 271-73, 333 S.E.2d at 240. The court then "[concluded] that the defense has *no* place in cases such as this." *Id.* (emphasis added). Alternatively, the court could have determined whether the facts warranted application of the defense. The Skinners' fraud claim apparently would not have sufficed to defeat the defense. *See Skinner*, 70 N.C. App. at 522, 320 S.E.2d at 427-28 (plaintiffs' willful violation of securities laws belies their own substantial culpability despite brokers' fraud); *accord* Jordan v. E.F. Hutton & Co., No. 82-1511-CIV-5 (E.D.N.C. May 13, 1983) (claim by defrauded tippee barred by *in pari delicto* doctrine). Further, it is questionable whether policy factors weigh more heavily in favor of the tipper or tippee in this context. *See infra* notes 102-05 and accompanying text. Nonetheless, broker-dealers obviously owe strict fiduciary duties to their clients. *See Bateman Eichler*, 105 S. Ct. at 2630-32.

90. *Skinner*, 314 N.C. at 273-74, 333 S.E.2d at 240.

91. *Skinner*, 314 N.C. at 272-73, 333 S.E.2d at 240.

92. Both the *Bateman Eichler* case and the *Skinner* case involved claims arising from false "tips." Commentators and the courts have questioned whether conveying false inside information

federal securities laws.[93] Plaintiff in *Bateman Eichler* committed "potential" violations of rule 10b-5 and Sections 2 and 3 of the Insider Trading Sanctions Act of 1984.[94] Because the plaintiffs in *Skinner* used purported inside information about impending corporate takeovers, they potentially committed additional violations of rule 14e-3[95] as well as section 78A-8 of the North Carolina Securities Act, which parallels rule 10b-5.[96] Neither the *Bateman Eichler* Court nor the *Skinner* court fully analyzed the plaintiffs' potential culpability under these laws. A presumption that tipper culpability exceeeds that of tippees may make sense in light of the brokers' fiduciary obligations,[97] but it should remain a presumption. A sophisticated investor who actively solicits inside information from a broker or inside source should not have an "enforceable warranty" that guarantees his or her success.[98]

The *Skinner* holding may produce undesirable consequences in cases in which parties' conduct warrants application of the doctrine. It is clear that the holding precludes assertion of the *in pari delicto* doctrine when a securities professional or insider *intentionally* gives a *false* tip. However, the *Skinner* decision leaves unresolved the issue whether a negligent misrepresentation is actionable.[99] Under *Skinner* a broker who negligently misstates material, nonpublic information might be held liable for any market losses incurred by the tippee, regardless of the tippee's sophistication or conduct. This result ignores the parties' relative culpabilities and undermines policy goals,[100] two factors underpinning the court's decision.[101] The court also failed to address whether a broker possessing *actual* inside information may be sued by a tippee if the tip leads to market losses.

Apart from its analysis of the parties' relative culpabilities, the *Skinner* court further reasoned that allowing tippees to recover from their tippers would aid securities enforcement efforts.[102] Since the late 1960s the federal courts have

constitutes a "tip." *See Bateman Eichler*, 105 S. Ct. at 2629 n.21. On the one hand, "tippees" argue that the theory of legal impossibility prevents them from being found equally culpable with their counterparts—in the absence of bona fide inside information, they would not even characterize themselves as being "tippees" in violation of the law. *Id.* On the other hand, "tippers" argue that plaintiffs are nevertheless guilty of at least an attempted violation of the securities laws. *Id.* Indeed, defendant in *Skinner* claimed that "in contrast to actual inside information . . . , a false tip generally injures only those who are unscrupulous enough to trade on purported inside information." Appellee's Reply to Brief of Amicus Curiae at 4, *Skinner*. Both the *Bateman Eichler* and *Skinner* courts, however, opted to treat plaintiffs as tippees, without resolving the dilemma posed by false tips.

93. *Skinner*, 314 N.C. at 270, 333 S.E.2d at 238-39; *see Bateman Eichler*, 105 S. Ct. at 2629-30 n.21.

94. *Bateman Eichler*, 105 S. Ct. at 2633 n.32.

95. *See supra* note 62.

96. *See supra* note 64.

97. *Bateman Eichler*, 105 S. Ct. at 2630-31.

98. *See supra* note 70 and accompanying text.

99. A recent North Carolina Court of Appeals decision upheld a claim based on negligent misrepresentation. Howell v. Fisher, 49 N.C. App. 488, 272 S.E.2d 19, *disc. review denied*, 302 N.C. 21, 277 S.E.2d 69 (1980). The Florida courts have extended liability for negligent misstatements that involve corporate finances. *See supra* note 65.

100. *See supra* notes 67-73 and accompanying text.

101. *Skinner*, 314 N.C. at 272-73, 333 S.E.2d at 240; *see Bateman Eichler*, 105 S. Ct. at 2630-31.

102. *Skinner*, 314 N.C. at 273, 333 S.E.2d at 240.

debated enforcement policy aspects of the *in pari delicto* doctrine without reaching a satisfactory answer to the problem.[103] Meanwhile, insider trading abuses have reached enormous proportions today,[104] and it is unlikely that suits at common law by defrauded tippees will stem the tide. Tippers already face a host of sanctions, including liability under rule 10b-5, rule 14e-3, the Insider Trading Sanctions Act, and state securities law,[105] as well as the loss of their brokerage licenses. Tippees also face sanctions, but this concession does not justify allowing them to recover their market losses.

Finally, perhaps the most important reason underlying the *Skinner* decision was a concern for consistency.[106] The court stressed that the *Bateman Eichler* rule "will be difficult and impractical to apply in actual cases," and that this would encourage unscrupulous brokers to swindle their clients.[107] Although it is true that the *in pari delicto* doctrine traditionally requires a difficult balancing of equitable factors, this balance may buttress policy goals. Courts mindful of the history behind the *in pari delicto* doctrine may consider its varying limitations and exceptions,[108] and use the doctrine to afford or deny relief based on the relative culpabilities of the parties.

The *Bateman Eichler* Court adopted this approach, and appropriately modified the doctrine to fashion a workable test. *Bateman Eichler* established a strong *caveat tipper* presumption, while preserving the *in pari delicto* doctrine itself. In so doing, the Court balanced common-law and equitable concerns with federal securities enforcement policy goals. Because the *Skinner* dispute centered on a common-law action, the application of such a judicial balance would appear compelling.[109]

The decision in *Skinner* may be explained in terms of the evolving role played by state courts in insider trading cases, an area primarily governed by federal law.[110] Some state courts now appear more willing to grant relief to parties injured by insider trading abuses.[111] This trend is understandable in light of recent federal measures proscribing insider trading, as well as a general concern that the federal courts are overburdened and enforcement agencies understaffed. The relative infrequency of the *in pari delicto* doctrine's use in North

103. *See supra* notes 67-77 and accompanying text. *Compare Skinner*, 314 N.C. at 273, 333 S.E.2d at 240 (stating that "any potential for the application of the defense . . . will give some encouragement to the few dishonest securities professionals to engage in such . . . conduct") *with Skinner*, 70 N.C. App. at 519-22, 320 S.E.2d at 427 (reasoning that public interest will be promoted by denying tippee's suit).

104. *See* 3 A. BROMBERG, *supra* note 5, § 7.4(144), at 7:125-:129. Professor Bromberg notes that "it is evident from the reported cases that tipping and tippee trading takes [sic] place with speed and proficiency among securities professionals and amateurs alike." *Id.* at § 7:129.

105. *See supra* notes 46-66 and accompanying text.

106. *See Skinner*, 314 N.C. 273, 333 S.E.2d at 240.

107. *Id.*

108. *See supra* notes 32-37 and accompanying text.

109. *See supra* notes 88-89 and accompanying text.

110. *See supra* notes 45-66 and accompanying text.

111. *See supra* note 65. This premise lacks support in North Carolina in the absence of any decisions amplifying the duties of insiders under state law. *See supra* note 59 and accompanying text.

Carolina may provide another explanation for the *Skinner* court's decision.[112]

Nonetheless, the issues framed by the *Skinner* court would have been resolved more satisfactorily by upholding the *in pari delicto* doctrine. Plaintiffs injured by false "tips" should be allowed to recover whatever compensation accrued to the tipper in the form of commissions. This would deprive fraudulent tippers of their ill-gotten gains. At the same time, the *Bateman Eichler* test could be used to determine whether defrauded plaintiffs may recover for market losses, margin interest, and missed margin calls.[113] Thus, defrauded tippees would be encouraged to sue and expose the *delicto,* without being assured an enforceable warranty against all losses. Allowing trial courts discretion in applying the *caveat tipper* presumption would be a desirable result of this alternative and would be consistent with the Supreme Court's approach in *Bateman Eichler.*

The holding in *Skinner* represents one state court's response to the serious abuses created by insider trading. Stressing the need for consistency in enforcement, and the blameworthiness of broker misconduct, the North Carolina Supreme Court adopted a per se rule disallowing the *in pari delicto* defense in insider trading cases. An alternative solution to the *Skinner* holding would have accomplished several objectives. First, it would have brought *Skinner* in line with common-law precedent. Second, it would have enabled trial courts to weigh equitable considerations contemplated by the *in pari delicto* doctrine. Last, it would have been consistent with the United States Supreme Court's decision in *Bateman Eichler.* Although the test and presumption set forth in *Bateman Eichler* serve as models for limiting future tippee suits brought under federal law, the decision in *Skinner* indicates an increased willingness in North Carolina to allow tippees' suits under common law.

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112. *See supra* notes 38-43 and accompanying text.

113. The *Bateman Eichler* Court declined to express any views on the measure of relief appropriate in suits by defrauded tippees. *See Bateman Eichler,* 105 S. Ct. at 2633 n.33.

Glenn v. Wagner: Instrumentality Rule versus the Balancing Test in Piercing the Corporate Veil

The concept of the corporation as a separate legal entity is a universally accepted legal fiction.[1] The corporation has become a popular form of business largely because limited liability insulates shareholders from risks beyond their initial contributions.[2] Limited liability encourages shareholder investment and thus stimulates economic growth and expansion.[3]

The concept of limited liability works against public policy, however, when it denies an individual who has dealt with a corporation compensation for resulting injuries.[4] Courts have therefore developed the equitable doctrine of corporate disregard:[5] they will disregard the corporate status in some instances and let a plaintiff recover against a shareholder, a parent corporation, or an affiliated corporation.[6] The doctrine is complicated by the tension that arises between the competing policies of allowing recovery for injured plaintiffs and respecting the

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1. *See* 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 25 (perm. ed. 1983); H. HENN, CORPORATIONS § 16 (2d ed. 1970); Douglas & Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L.J. 193, 193 (1929); Krendl & Krendl, *Piercing the Corporate Veil: Focusing the Inquiry*, 55 DEN. L.J. 1, 1 (1978); *see also* E. LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS § 7, at 5-40 (1936) (discussing the relevance of the entity concept); 13A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 6213 (perm. ed. 1984) (emphasizing that a corporation has limited liability because it is an entity separate from its owners). *See generally* 1 W. FLETCHER, *supra*, § 7 (discussing whether the corporation should be referred to as fact or fiction).

2. H. HENN, *supra* note 1, § 16, at 146; Horowitz, *Disregarding the Entity of Private Corporations*, 14 WASH. L. REV. 285, 285-86 (1939) (the greatest advantage of incorporation is limited liability); Note, *Disregard of the Corporate Entity*, 4 WM. MITCHELL L. REV. 333, 334-35 (1978).

3. Barber, *Piercing the Corporate Veil*, 17 WILLAMETTE L. REV. 371, 371 (1981) ("The purpose of limited liability is to promote commerce and industrial growth by encouraging shareholders to make capital contributions to corporations without subjecting all of their personal wealth to the risks of the business."); Douglas & Shanks, *supra* note 1, at 193 ("[Limited liability] is ingrained in our economic and legal systems. The social and economic order is arranged accordingly."); Note, *supra* note 2, at 335.

4. *See, e.g.*, E. LATTY, *supra* note 1, § 7, at 200 ("If a claimant is made to suffer a loss purely for the gain of some other individual or group of individuals, in the absence of some over-riding policy consideration, one readily understands that his loss is considered 'inequitable,' even though the limited liability principle be firmly established in the law."). Other instances in which limited corporate liability might contravene public policy include "when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime . . . ." 1 W. FLETCHER, *supra* note 1, § 41, at 389; *see also* E. LATTY, *supra* note 1, § 7, at 199, wherein Professor Latty argues that "up to a certain point [limited liability] does more good than harm; beyond that point the reverse may be true." Professor Latty suggests that sub-incorporation, or one corporation as controlling shareholder of another, might be where to draw the line.

5. "Corporate disregard" is the term often applied to the process by which a court denies a corporation its privileges and holds the shareholders or other related companies liable for the other entity's obligations. "A denial of limited liability is probably the most common consequence of 'disregarding the corporate entity' or 'piercing the corporate veil' . . . ." R. ROBINSON, NORTH CAROLINA CORPORATION LAW AND PRACTICE § 9-7, at 145 n.2 (3d ed. 1983). *See* 1 W. FLETCHER, *supra* note 1, § 41; Note, *Corporations—Shareholder Liability—Louisiana Adopts a Balancing Test for Piercing the Corporate Veil*, 58 TUL. L. REV. 1089, 1092 (1984).

6. This Note examines the concept of piercing the corporate veil in the context of affiliated corporations. Professor Latty defines an affiliated corporation as "a corporation in which the controlling interest is owned by the same person or persons (including corporate persons) who own the controlling interest in another corporation, the latter one being therefore also an affiliate." E.

corporate form.[7] When the injustice to the plaintiff outweighs the necessity to respect the corporate status, however, courts do not hesitate to disregard the corporate form to prevent such injustice.[8]

Since as early as 1899 North Carolina has explicitly recognized the concept of corporate disregard.[9] State courts have consistently emphasized that the doctrine is basically equitable in nature;[10] nevertheless, they have applied the structured "instrumentality"[11] rule of corporate disregard, which premises liability of a solvent entity on the degree of control it exercised over an insolvent corporation.[12] In *Glenn v. Wagner*[13] the North Carolina Supreme Court expanded this instrumentality theory to include a corporation that had exercised general control over an affiliated corporation,[14] even though it had not exercised control over the "particular transaction attacked."[15]

This Note examines the *Glenn* court's application of the instrumentality

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LATTY, *supra* note 1, § 7, at 3-4. In practice, courts and commentators often fail to distinguish between parent-subsidiary or affiliated organizations. *See id.* at 197.

The concept of corporate disregard, however, also applies in dominant shareholder situations, in which the status of a corporation is pierced to hold the shareholder responsible for the corporation's obligations, and in parent-subsidiary situations, in which a parent corporation is held responsible for its insolvent subsidiary's debts. *E.g.*, Huski-Bilt, Inc. v. First Citizens Bank & Trust Co., 271 N.C. 662, 157 S.E.2d 352 (1967) (action to impose liability on the parent bank of the insolvent sudsidiary insurance company); Fountain v. West Lumber Co., 161 N.C. 35, 76 S.E. 533 (1912) (action to impose liability on the dominant shareholder/president/secretary of two different companies); Air Traffic Conference of Am. v. Marina Travel, Inc., 69 N.C. App. 179, 316 S.E.2d 642 (1984) (action to impose liability on a shareholder who owned one hundred percent of the stock in an airline agency); Pilot Title Ins. Co. v. Northwestern Bank, 11 N.C App. 444, 181 S.E.2d 799 (1971) (action to impose liability on the parent-bank over the insolvent subsidiary); *see, e.g.*, Gillespie, *The Thin Corporate Line: Loss of Limited Liability Protection*, 45 N.D.L. REV. 363, 365 (1969).

7. Barber, *supra* note 3, at 373; Dobbyn, *A Practical Approach to Consistency in Veil-Piercing Cases*, 19 U. KAN. L. REV. 185, 185 (1971) ("The situation generally involves a triangle of interests—a plaintiff seeking to enforce a contract or tort obligation, a corporation that has signed the contract or committed the tort directly, and the controlling shareholder of the corporation."); Krendl & Krendl, *supra* note 1, at 7 ("[D]isregarding the corporate entity requires contradicting the strong public policy of limited liability . . . .").

Public policy supports the "performance of contracts, repayment of debts, and compensation for personal injury." Note, *supra* note 2, at 335-36. *See generally* 1 W. FLETCHER, *supra* note 1, § 41.30, at 429-30 (contracts and debts); PROSSER AND KEETON ON THE LAW OF TORTS § 4 (W. Keeton 5th ed. 1984) (personal injury).

8. "[C]ourts simply will not let interposition of corporate entity or action prevent a judgment otherwise required." *In re* Clark's Will, 204 Minn. 574, 578, 284 N.W. 876, 878 (1939); *see* H. HENN, *supra* note 1, § 16, at 250; Barber, *supra* note 3, at 372 ("When the incentive value of limited . . . liability is outweighed by the competing factor of basic fairness to parties dealing with the corporation . . . courts may 'pierce the corporate veil' and hold the shareholders personally liable for the obligations of the corporation.").

9. Commonwealth Mut. Fire Ins. Co. v. Edwards & Broughton, 124 N.C. 116, 32 S.E. 404 (1899) (undercapitalization, or "congenital insolvency," as a justification for non-recognition of a corporation).

10. *E.g.*, Mills .v. Mutual Bldg. & Loan Ass'n, 216 N.C. 664, 670, 6 S.E.2d 549, 553 (1940); Pilot Title Ins. Co. v. Northwestern Bank, 11 N.C. App. 444, 453-54, 181 S.E.2d 799, 805 (1971).

11. *See infra* notes 45-47 and accompanying text.

12. *E.g.*, Waff Bros., Inc. v. Bank of North Carolina, 289 N.C. 198, 221 S.E.2d 273 (1976); Henderson v. Security Mortgage & Fin. Co., 273 N.C. 253, 160 S.E.2d 39 (1968); Huski-Bilt, Inc. v. First Citizens Bank & Trust Co., 271 N.C. 662, 157 S.E.2d 352 (1967); B-W Acceptance Corp. v. Spencer, 268 N.C. 1, 149 S.E.2d 570 (1966).

13. 313 N.C. 450, 329 S.E.2d 326 (1985).

14. *See supra* note 6.

15. *Glenn*, 313 N.C. at 456, 329 S.E.2d at 331.

theory against the background of the corporate disregard doctrine. It concludes that although the result achieved by the court may have been justified, the court's reasoning merely adds to the confusion surrounding corporate disregard. The Note therefore advances a more flexible approach to reviewing such cases—a test that examines a number of factors and balances the equities behind the two opposing policies of respecting the corporate form and allowing recovery for injured plaintiffs.

The controversy in *Glenn* involved the degree of control B-Bom, Inc. (B-Bom) exercised over D&S Enterprises, Inc. (D&S). B-Bom was organized for the purpose of acquiring, leasing, and managing property.[16] David Wagner owned fifty percent of B-Bom[17] and acted as its president and registered agent.[18] David and his cousin, Smilie Wagner, organized D&S for the purpose of leasing Salem Manor, one of B-Bom's apartment rental properties.[19] David was president and treasurer of D&S; Smilie was vice president and secretary.[20] Smilie also was employed by D&S as property manager of the Salem Manor property.[21]

David Wagner originally owned one hundred percent of D&S,[22] but by 1980 he and Smilie each owned fifty percent of the corporation.[23] As manager of Salem Manor, Smilie oversaw the day to day operations of the rental property. David's role was merely to advise Smilie on occasion.[24] Even though David handled the details of incorporating D&S,[25] at trial he could not recall any organizational meeting, adoption of any by-laws, the initial board of directors, or any formal shareholder meetings.[26] The only asset of D&S was the lease executed with B-Bom,[27] and B-Bom determined the amount of rent to be charged Salem Manor residents. D&S paid B-Bom from the collection of these rents.[28]

During the fall of 1979 Richard Glenn and the Earl Hood family were locked out of their respective Salem Manor apartments by one of Smilie Wagner's employees for failure to pay rent.[29] Glenn's personal property was removed from his apartment and placed in storage, where it was damaged before he could retrieve it.[30] Glenn and Hood brought suit against Smilie Wagner,

16. *Id.* at 452, 329 S.E.2d at 328.

17. *Id.* at 451, 329 S.E.2d at 328.

18. *Id.*

19. Glenn v. Wagner, 67 N.C. App. 563, 568, 313 S.E.2d 830, 836 (1984), *rev'd*, 313 N.C. 450, 329 S.E.2d 326 (1985).

20. *Glenn*, 313 N.C. at 452, 329 S.E.2d at 329.

21. *Id.* at 452, 329 S.E.2d at 328-29.

22. *Glenn*, 67 N.C. App. at 568, 313 S.E.2d at 836.

23. *Id.* Even though David Wagner knew that he and Smilie shared ownership of D&S, he could not recall the exact number of shares issued. *Id.* Also, no evidence indicated that any shares were issued. *Id.*

24. *Glenn*, 313 N.C. at 452, 329 S.E.2d at 329.

25. *Glenn*, 67 N.C. App. at 568, 313 S.E.2d at 836.

26. *Glenn*, 313 N.C. at 452, 329 S.E.2d at 329.

27. *Id.*

28. *Id.*

29. *Glenn*, 67 N.C. App. at 566-67, 313 S.E.2d at 835.

30. *Id.* at 566-67, 313 S.E.2d at 835.

D&S Enterprises, Inc., and B-Bom, Inc., alleging trespass, breach of covenant of quiet enjoyment, and conversion.[31] D&S was insolvent,[32] and the trial court pierced D&S's corporate veil to hold B-Bom liable on the theory that B-Bom operated D&S as a "mere instrumentality to shield it from liability."[33] The North Carolina Court of Appeals dismissed the trial court's instructions on the traditional instrumentality theory[34] as inapplicable to B-Bom and D&S,[35] and instead held that the trial court's failure to instruct the jury regarding the single enterprise theory and the thin capitalization doctrine was prejudicial error.[36]

On review the North Carolina Supreme Court reversed the court of appeals,[37] finding that the trial court's instructions were not erroneous, but merely "surplusage."[38] After concluding that the instrumentality rule would apply to affiliated corporations as well as dominant individual shareholders and parent-subsidiary relationships,[39] the court indicated that B-Bom did indeed dominate D&S.[40] In reaching its conclusion, the *Glenn* court noted that when a corporation is operated as a "mere shell, created to perform a function for an affiliated corporation . . . an analysis of domination need [not] be narrowly limited to control over the *particular* transaction attacked . . . ."[41] Applying this theory and concluding that David Wagner had so much control over D&S that he, and through him B-Bom, was "deemed to have had notice" of the padlocking incident,[42] the court in effect established that constructive or imputed knowledge now satisfies the element of control in the traditional instrumentality rule analysis.

31. *Id.* at 564-65, 313 S.E.2d at 834.

32. *Id.* at 571, 313 S.E.2d at 838.

33. *Id.* at 565, 313 S.E.2d at 834-35.

34. *See infra* notes 45-47 and accompanying text.

35. *Glenn*, 67 N.C. App. at 580, 313 S.E.2d at 842. The court of appeals found that the evidence did not indicate control over Smilie Wagner, and through him D&S, by B-Bom "with regard to the acts in question" and that "the trial judge [therefore] erred in giving the jury an instruction on . . . [the instrumentality doctrine] because it related to a factual situation not properly supported by the evidence." *Id.* at 580-81, 313 S.E.2d at 893.

36. *Id.* at 590, 313 S.E.2d at 849. For a description of the single enterprise theory of liability, see *infra* note 53. The thin capitalization doctrine is used to pierce the corporate veil when corporate assets are grossly inadequate to meet creditor obligations. *Id.* at 587-88, 313 S.E.2d at 847. The question whether a corporation is inadequately capitalized is determined at the formation of the corporation. Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 986 (1971). The court of appeals found that the evidence tended to show that the lease of D&S, its sole asset, was inadequate protection for the "obligations arising out of the rental property." *Glenn*, 67 N.C. App. at 588, 313 S.E.2d at 848.

37. *Glenn*, 313 N.C. at 459, 329 S.E.2d at 333.

38. *Id.* at 457, 329 S.E.2d at 332.

39. *See id.* at 456-57, 329 S.E.2d at 331-32.

40. *Id.* The North Carolina Supreme Court apparently concluded that B-Bom did indeed dominate D&S on the basis that the "primary function of D&S was to collect rent for B-Bom," that David Wagner was "the president and one of the two directors for both [corporations]," and that he had such control that unilaterally he was able to dissolve the lease between the two. *Id.* at 456, 329 S.E.2d at 331.

41. *Id.* at 457, 329 S.E.2d at 331. The usual analysis of "domination" involves examining evidence of control and *then* determining whether one corporation is a mere shell or instrumentality of another. The reasoning of the *Glenn* court arguably is an example of a court manipulating a test to reach the "just results." *See infra* text accompanying note 57.

42. *Glenn*, 313 N.C. at 457, 329 S.E.2d at 331-32.

To understand the significance of the *Glenn* decision, it is necessary to consider briefly the background of corporate disregard. The doctrine is universally accepted,[43] but there is no universally accepted approach to cases arising under it.[44] The instrumentality theory of liability[45] is probably the most widely accepted approach to disregarding the corporate entity.[46] The test consists of three elements:

> (1) Control of the dominant shareholder, affiliated corporation, or parent corporation over the insolvent corporation, to the extent of complete domination of finances, policies and business, with respect to the particular transaction attacked;
>
> (2) Use of such control to perpetrate fraud or injustice; and
>
> (3) Proximate cause between such control and plaintiff's injury.[47]

Control over the insolvent entity is the element on which courts focus when deciding whether to impose liability on the dominant entity,[48] and it is in the examination of this element that courts differ most in their analyses and conclusions.[49] To determine the required degree of control, courts examine a number

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43. *See supra* notes 1-2 and accompanying text.

44. *E.g.*, H. BALLANTINE, BALLANTINE ON CORPORATIONS § 136, at 311-312 (rev. ed. 1946); *see infra* notes 56-60 and accompanying text.

45. The instrumentality rule of corporate disregard originally was introduced by Frederick Powell in 1931. F. POWELL, PARENT AND SUBSIDIARY CORPORATIONS (1931). Powell "perceived [his test] to be the test for determining whether a subsidiary is in fact so dominated by its parent that its veil should be pierced to find the parent liable." Krendl & Krendl, *supra* note 1, at 11. Although the test originally was designed to apply only to the parent-subsidiary relationship, now it is applied to the closely held corporation as well. *Id.*

46. *See* Krendl & Krendl, *supra* note 1, at 13.

47. *Glenn*, 313 N.C. at 455, 329 S.E.2d at 330. One of the first applications of this test was in Lowendahl v. Baltimore & O.R. Co., 287 N.Y.S. 62, 76, *aff'd*, 272 N.Y. 360, 6 N.E.2d 56 (1936). *Lowendahl* is frequently cited as the basis for the instrumentality rule.

For a detailed analysis of each of these elements, see F. POWELL, *supra* note 45. Powell's test for disregarding limited corporate liability includes all three elements, but he labels only the element of control as the "instrumentality rule." *Id.* at 4-6. He expresses concern that in jurisdictions stating the instrumentality rule "as the sole test of the parent corporation's liability, . . . the question [of liability] is apparently made to turn on the question of control alone, without reference to the element of fraud or wrong against the complainant," *id.* at 46, thus overlooking that not only must there be "excessive control over the subsidiary but the actual exercise of that control in such a manner as to defraud or wrong the complainant." *Id.* at 40. Although North Carolina does refer to its test as merely the instrumentality rule, it incorporates all three elements, including fraud or wrongdoing, under this heading. *See, e.g.*, *Glenn*, 313 N.C. at 455, 329 S.E.2d at 330; B-W Acceptance Corp. v. Spencer, 268 N.C. 1, 9, 149 S.E.2d 570, 576 (1966) (adoption of the rule in North Carolina).

48. *See, e.g.*, Horowitz, *supra* note 2, at 292 (there must be something akin to manipulation to justify disregarding a corporate entity); *cf.* E. LATTY, *supra* note 1, § 7, at 178 (suggesting that control is often used to justify imposing liability).

The test for the degree of control necessary to invoke the doctrine of corporate disregard used by North Carolina courts was first described by Fletcher:

> The control necessary to invoke what is sometimes called the 'instrumentality rule' is not mere majority or complete stock control but such domination of finances, policies and practices that the controlled corporation has, so to speak, no separate mind, will or existence of its own and is but a business conduit for its principal.

1 W. FLETCHER, *supra* note 1, § 43, at 472. *See, e.g.*, B-W Acceptance Corp. v. Spencer, 281 N.C. 1, 149 S.E.2d 570 (1966) (the first case in North Carolina to use Fletcher's description as the definition of the requisite control).

49. *See infra* notes 53-60 and accompanying text.

of factors.[50] Those most often considered are disregard of corporate formalities, inadequate capitalization, commingling of corporate funds and assets, and failure to hold out to the public that the two entities are in fact separate.[51] Because of the doctrine's equitable nature, an examination of any of these factors requires a case by case analysis.[52] Such an approach necessarily leads courts to juggle the factors differently.

Courts and commentators have identified other theories, including the "single enterprise" or "identity" theory[53] and the "agency" theory,[54] for imposing corporate liability. The equitable nature of the corporate disregard doctrine, however, makes it difficult to apply any mechanical test.[55] Consequently, although courts purport to apply one theory or another, they often merely state results rather than the analyses behind their conclusions.[56] A frequent consequence of such reasoning, or lack thereof, is either the mechanical application of a specific test to reach an inequitable outcome or the manipulation of a specific test to reach a just conclusion.[57] The confusion surrounding corporate disregard is only increased by the use of various terms and tests interchangeably;[58] the

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50. *See* F. POWELL, *supra* note 45, § 6, at 9-36; Krendl & Krendl, *supra* note 1, at 13. Although a number of factors may be considered, none is determinative. *Id.* at 22.

51. *See* Commonwealth Mutual Fire Ins. Co. v. Edwards & Broughton, 124 N.C. 116, 32 S.E. 404 (1899); 1 W. FLETCHER, *supra* note 1, § 41.3, at 428-29; H. HENN, *supra* note 1, § 16, at 258-59.

52. *See infra* text accompanying note 82.

53. The single enterprise theory was first introduced by A. Berle, *The Theory of Enterprise Entity*, 47 COL. L. REV. 343 (1947). The essence of this theory is that a subsidiary entity has no corporate identity apart from its parent. The four elements comprising this theory are

> (1) corporations with identity or substantial identity of ownership, that is ownership of sufficient stock to give actual working control;
>
> (2) unified administrative control (which follows almost automatically from such ownership) of corporations whose business functions are similar or supplementary;
>
> (3) involuntary as opposed to voluntary creditors; and
>
> (4) the insolvency of the corporation against which the claim primarily lies.

Glenn, 67 N.C. App. at 582, 313 S.E.2d at 844 (citing E. LATTY, *supra* note 1, §§ 49-57). For a comparison of the identity, agency, and instrumentality tests, see Krendl & Krendl, *supra* note 1, at 13.

54. Many courts include agency as a basis for corporate disregard. *See* H. BALLANTINE, *supra* note 44, §§ 136-137, at 311, 314-318. Liability on the basis of agency, however, is a separate legal theory in and of itself that renders the dominant entity primarily liable, as a principal, for the acts of its agents. Therefore, it is not properly included as a basis for determining when to pierce the corporate veil. *See* 1 W. FLETCHER, *supra* note 1, § 43, at 472-74; Hamilton, *supra* note 36, at 983-84. For a detailed discussion of the relationship of the agency theory and the instrumentality theory, see F. POWELL, *supra* note 45, §§ 21-25.

55. *See generally infra* text accompanying note 82 (specific lists of factors as inadequate to provide the flexibility needed for any equitable doctrine).

56. Hamilton, *supra* note 36, at 979."The statement that the insulation will be broken down when the subsidiary is an 'agency,' 'adjunct,' 'instrumentality,' 'alter ego,' 'tool,' 'corporate double,' or 'dummy' of the parent is not helpful. These concepts themselves need defining. At best they merely state results. And the results are significant only in light of the facts." Douglas & Shanks, *supra* note 1, at 195.

57. *See* Gillespie, *supra* note 6, at 405.

58. *E.g.*, Krendl & Krendl, *supra* note 1, at 7-8. The most frequently cited warning in the application of the corporate disregard concept is Justice Cardozo's: "The whole problem of the relation between parent and subsidiary corporations is one that is still enveloped in the mists of metaphor. Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it." Berkey v. Third Ave. Ry. Co., 244 N.Y. 84, 94, 155 N.E. 58, 61 (1926). For a discussion of the confusion generally surrounding the application of the doctrine, see

ultimate result is courts with no clear standard for addressing corporate disregard problems[59] and entrepreneurs with no clear guidelines to effective incorporation.[60]

The *Glenn* decision merely adds to the confusion surrounding corporate disregard in North Carolina. The court's loosening of the control standard marks a shift away from previous North Carolina cases. The instrumentality rule as originally adopted in North Carolina specifically requires control "in respect to the transaction attacked."[61] However, North Carolina courts have not consistently required actual control over the particular transaction. In *Whitehurst v. FCX Fruit & Vegetable Service, Inc.*[62] the facts before the court pointed to overall control rather than control over the specific transaction in question. In *Pilot Title Insurance Co. v. Northwestern Bank*[63] the court of appeals based its finding of liability on the opportunity to control the particular transaction rather than the actual exercise of control.[64] However, no North Carolina court has expressly dispensed with the requirement of control over the transaction in question. Furthermore, no other jurisdiction has specifically adopted the view that the corporate veil may be pierced regardless of whether the control extends to the specific transaction attacked.[65] In fact, most com-

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H. BALLANTINE, *supra* note 44, §§ 122, 136, at 292-93, 311-12; Comment, *Piercing the Corporate Veil in Federal Courts: Is Circumvention of a Statute Enough?*, 13 PAC. L.J. 1245, 1246 (1982).

The confusion regarding the doctrine of corporate disregard is exemplified by the fact even scholars differ in their views of the tests. One student author even distinguishes between an instrumentality theory and an alter ego theory. Comment, *Piercing the Corporate Veil in Maryland: An Analysis and Suggested Approach*, 14 U. BALT. L. REV., 311, 315-17 (1985) [hereinafter cited as Comment, *Piercing the Corporate Veil in Maryland*].

59. *See, e.g.*, Downs, *Piercing the Corporate Veil—Do Corporations Provide Limited Liability?*, 53 UMKC L. REV. 174, 175 (1985).

60. *Id.*; *see also* Gillespie, *supra* note 6, at 364 ("[K]nowledge of the doctrine's existence is not particularly helpful in assuring the investors goal of limited liability in entering the corporate enterprise . . . because of the imprecision of its various formulations and the inability to predict with reasonable certainty the moment or circumstances of its availability.").

61. North Carolina first adopted this statement of the instrumentality theory in B-W Acceptance Corp. v. Spencer, 268 N.C. 1, 9-10, 149 S.E.2d 570, 576 (1966).

62. 224 N.C. 628, 32 S.E.2d 34 (1944) (parent liable for contract to subsidiary because evidence showed that communications to plaintiff were on parent's stationery, invoices and bills were mailed to parent, both parent and subsidiary were designated by the same initials, parent and subsidiary had common employees, and parent paid for some of subsidiary's purchases). Furthermore, in Schlamowitz v. Pinehurst, 229 F. Supp. 278 (M.D.N.C. 1964), a federal district court in North Carolina, looking at North Carolina law, found a parent liable for negligence of subsidiary's employees because the evidence showed that the parent sent all invoices, the subsidiary maintained no office and kept no records, and the parent paid off subsidiary's deficit every year.

63. 11 N.C. App. 444, 181 S.E.2d 799 (1971).

64. *Id.* at 452, 181 S.E.2d at 805. *Cf.* Whayne v. Transportation Management Serv., Inc., 252 F. Supp. 573, 577 (E.D.N.C. 1966), in which a federal district court suggested that it is "not the opportunity to control but the actual control which [is] determinative of the issue of liability."

65. On the contrary, courts sometimes specifically deny liability because of the lack of control over the transaction attacked. *See, e.g.*, Angelo Tomasso, Inc. v. Armor Constr. & Paving, Inc., 187 Conn. 544, 557-59, 447 A.2d 406, 412-13 (1982). *But see id.* at 571, 447 A.2d at 418 (Borden, J., dissenting) (suggesting that defendant, as an experienced businessman, should have known without being told that the type of guarantee being contested was common); Lowendahl v. Baltimore & O.R. Co., 247 A.D. 144, 161, 287 N.Y.S. 62, 79 (suggesting that had the transaction in question happened after defendant became affiliated with plaintiff, knowledge might be imputed); *aff'd*, 272 N.Y. 360, 6 N.E.2d 56 (1936); Krendl & Krendl, *supra* note 1, at 25 (suggesting that even if it cannot be directly proven that defendant's control directly caused plaintiff's injury, it is sufficient if he or she had *some* knowledge).

mentators agree that there must be some connection between the plaintiff's damage and the solvent entity's control.[66] The *Glenn* court failed to cite any authority to support its position or to discuss the significance of its decision to loosen the control standard.[67]

The *Glenn* decision leaves additional questions unanswered. Although the court of appeals remanded the case because of the inapplicability of the instrumentality theory, it concluded that the single enterprise theory[68] of liability would apply to the D&S situation.[69] The supreme court failed even to comment on the court of appeals' recognition of a new basis of liability in North Carolina.[70] If the *Glenn* court had expressly affirmed or reversed the court of appeals' analysis, the precedential value of the decision would have been clear.

Moreover, although the *Glenn* court conceded "that it will be a rare case in which the corporate veil will be pierced when the domination does not extend to the transaction attacked,"[71] it failed to identify those "rare situations" in which constructive knowledge will satisfy the control element.[72] Affiliated corporations are now susceptible to inter-corporate liability under this constructive knowledge theory,[73] but it is unclear whether constructive knowledge will be imputed in other situations such as a dominant shareholder or parent-subsidiary arrangement.[74] The opinion discussed only "affiliated corporations,"[75] suggesting, but not specifying, that the theory will apply only to commonly-owned entities.[76] However, the opinion is deficient because it gives no basis for limiting

66. *See generally* 1 W. FLETCHER, *supra* note 1, § 43.10, at 490 (emphasizing that there must be proximate cause between defendant's act and plaintiff's injury); E. LATTY, *supra* note 1, § 7, at 166 (emphasizing that the damage must be traceable to the factor of control); Elson, *Legal Liability of Holding Companies for Acts of Subsidiary Companies*, 15 ST. LOUIS U.L.J. 333, 337 (1930) (holding company must be in the position to exercise and have actually exercised control over the subsidiary); Hamilton, *supra* note 36, at 990 (judgment must be based on activities that are interrelated to plaintiff's claim); Krendl & Krendl, *supra* note 1, at 16 (domination must be over the transaction in question). Dispensing with the requirement of control over the particular transaction might effectively eliminate the proximate cause requirement of the instrumentality test. *See supra* text accompanying note 47.

67. *Glenn*, 313 N.C. at 456-59, 329 S.E.2d at 331-33.

68. *See supra* note 53.

69. *Glenn*, 67 N.C. App. at 592, 313 S.E.2d at 847.

70. *See Glenn*, 313 N.C. at 459, 329 S.E.2d at 333.

71. *Id.* at 456, 329 S.E.2d at 331.

72. *Id.* at 459, 329 S.E.2d at 333.

73. *Id.* at 457, 329 S.E.2d at 331.

74. *See id.* at 456-59, 329 S.E.2d at 331-33.

75. *See supra* note 6.

76. The *Glenn* court initially appeared to restrict its analysis to the *Glenn* situation: "We hold in this case, however, that domination sufficient to pierce the corporate veil need not be limited to the particular transaction attacked." *Id.* at 456, 329 S.E.2d at 331. As it continued its analysis, however, it implied that any affiliated corporations might be susceptible: "It is sufficient where, as here, one affiliated corporation is dominated by another . . . ." *Id*; *see also* text accompanying note 41 (control need not be over the particular transaction when a corporation is operated as a "mere shell, created to perform a function for an *affiliated* corporation" (emphasis added)). Finally, in the last paragraph of the opinion, the court implied that other situations might call for imputed knowledge, so long as domination were present: "[W]hen there is evidence of common ownership and actual working control, as in the case of affiliated corporations, . . . an instruction as provided in the present case is adequate." *Glenn*, 313 N.C. at 459, 329 S.E.2d at 333.

the application of its new rule to affiliated corporations.[77]

On the other hand, if the "constructive knowledge" theory is stretched to apply in all cases seeking to pierce the corporate veil, the possibility for inequitable results would increase. For instance, a shareholder who owns one hundred percent of a corporation necessarily exerts control over the entire operation and finances of the corporation.[78] If a constructive knowledge basis of liability were extended to the extreme, any one hundred percent shareholder could be liable for the acts of the corporation's employees, based on his or her general control over the corporation.[79]

Because the application of mechanical tests such as the instrumentality theory only adds to the uncertainty surrounding corporate disregard, a better approach for the North Carolina courts would be a simple balancing test.[80] A balancing test would allow courts to focus on the heart of the corporate disregard question, weighing factors according to the policies at stake.[81] As one scholar has noted:

> A rigid enumeration of the elements to be used for different kinds of corporations or a mechanistic mode of analysis implies an immutability which is simply incongruent with an equitable doctrine as flexible as that of disregarding corporateness. . . . [C]ourts facing the doctrine ought to be preoccupied with the fundamental equities of the particular case and need not concern themselves principally with the respect shown all the statutory and corporate usages of internal operation and the manner of doing business.
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> . . . .
>
> [T]he doctrine of disregarding corporateness embraces several legal approaches which are always multi-factor and . . . the doctrine's continued vitality depends on the very imprecision which might cause some legal critics to denounce it.[82]

A case by case balancing test would offer the flexibility and adaptability that the doctrine's equitable nature requires and would therefore eliminate much of the

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77. Even commentators fail to distinguish between affiliated corporations and parent-subsidiary situations, *see supra* note 6 and accompanying text, so no justification may exist for limiting this new rule to affiliated corporations if the *Glenn* court intended such a result. The opinion may be an example of a court manipulating the corporate disregard concept to reach equitable results. *See supra* notes 53-60 and accompanying text.

78. *See, e.g.*, Douglas & Shanks, *supra* note 1, at 217.

79. Some courts, however, have argued that the element of *fraud* in the test for determining whether to pierce a corporate veil protects against this result, because it requires a definite wrongdoing by defendant. *See, e.g.*, Continental Sec. & Inv. Co. v. Rawson, 208 Cal. 228, 239, 280 P. 954, 958 (1929).

80. A form of balancing test was first introduced by Professor Latty, although he did not call it such. *See* E. LATTY, *supra* note 1, § 7, at 191; *see also* Horowitz, *supra* note 2, at 295 (recognizing that the doctrine is really equitable and is nothing more than the recognition of the breach of a duty owed, sometimes even in the absence of inequitable results or fraud); *cf.* Douglas & Shanks, *supra* note 1, at 195 (the characterization as inequitable also falls short as a standard of conduct).

For two recent commentaries suggesting balancing analyses, see Comment, *Piercing the Corporate Veil in Maryland*, *supra* note 58; Note, *supra* note 5.

81. *See supra* note 7 and accompanying text; *infra* notes 84-95 and accompanying text.

82. Gillespie, *supra* note 6, at 374, 380.

uncertainty and inconsistency that pervade this area of the law.[83]

A balancing approach would require examination of the same factors considered in the various structured tests, including undercapitalization, abuse of corporate formalities, commingling of corporate funds and assets, and failure to appear as two separate entities.[84] The traditional tests, however, focus on the mechanics of the rules and thus concentrate on shaping given facts to conform to these rules.[85] In contrast, a balancing test which concentrates on the "fundamental equities"[86] behind the competing policies of respecting corporate status and compensating injured plaintiffs cannot adhere to any rigid rule. It is only through extensive consideration of every factor and the entire situation that a court can determine what is just in a particular case. For example, consideration of undercapitalization in a balancing test entails focusing on *why* the inadequate capitalization exists rather than determining that there is inadequate capital to satisfy a particular obligation; if the inadequate funding is the result of a congenital deficiency,[87] equity might require that the plaintiff be reimbursed because the corporation had failed from the beginning to comply with a requisite for corporate formation. A shift to analyzing a case in light of *all* circumstances would eliminate conflicts concerning requirements such as "control in respect to the transaction attacked."[88] Through such a thorough analysis, a court could properly concentrate on whether a defendant has earned the right to shareholder limited liability or in fact abused the privilege to operate as a corporation.[89]

A balancing approach also could include many considerations that are presently overlooked because they do not fit neatly into any of the mechanical tests.[90] Scholars and commentators agree that different *types* of claims, such as

83. *Id.* at 365.

84. "In this equitable area involving as wide a variety of situations as foolishness or deviousness can contrive, there appears to be no single determinative factor. The relative importance and usefulness of various factors will vary from case to case . . . ." Krendl & Krendl, *supra* note 1, at 22.

Barber lists nineteen separate factors to be considered when determining whether to recognize a corporate entity. Barber, *supra* note 3, at 374-75; *see also* H. BALLANTINE, *supra* note 44, at 9 (naming factors such as parent's use of subsidiary's property, description of subsidiary as part of parent's business, and parent's payment of subsidiary's expenses as additional factors); Horowitz, *supra* note 2, at 292-93. *See generally* Krendl & Krendl, *supra* note 1, at 16-17 (listing factors that might be relevant to the Powell test). *But see* Gillespie, *supra* note 6, at 373 ("[A] statement of all the significant elements which should be applied to different types of corporations in different contexts for determining the applicability of the 'piercing doctrine' " is also unworkable.).

85. *See supra* notes 55-58 and accompanying text.

86. *See supra* text accompanying note 82.

87. *See* Commonwealth Mut. Fire Ins. Co. v. Edwards, 124 N.C. 116, 32 S.E. 404 (1899) (early North Carolina case that speaks of a congenital deficiency as one which exists from the outset of the corporation's existence).

88. *E.g.*, B-W Acceptance Corp. v. Spencer, 268 N.C. 1, 9, 149 S.E.2d 570, 576 (1966).

89. Powell recognizes that stockholders' "immunity was created for certain legitimate purposes and it should not, therefore, be permitted for purposes that are not legitimate. The basis, therefore, for abrogating the normal immunity of stockholders is *an abuse of the privilege to do business in corporate form* . . . ." F. POWELL, *supra* note 45, § 2, at 2. Scholars even contend that "corporate disregard" is a misnomer; instead, courts should emphasize that they will *recognize* a defendant's corporate status and limited liability when it has performed satisfactorily the requirements for a valid incorporation. *See id.* §§ 1-2, at 1-3; H. HENN, *supra* note 1, § 146, at 250 (citing *In re* Clark's Will, 204 Minn. 574, 578, 284 N.W. 876, 878 (1939)); H. BALLANTINE, *supra* note 44, § 122, at 292-93.

90. *See* Gillespie, *supra* note 6, at 365.

contract and tort, and different *relationships* between two defendants, such as parent-subsidiary and one dominant shareholder, should be analyzed differently.[91] They suggest that courts should be more willing to pierce the veil of a subsidiary corporation, because the ultimate burden will still fall on a corporate entity rather than on an individual shareholder.[92] Similarly, courts should be less willing to pierce the veil in a contract action, because the plaintiff has voluntarily entered into the relationship with the insolvent corporation.[93] Under the current approaches, courts must apply the same test to all variations of corporate disregard problems.[94] The balancing test, as a case by case analysis, would give courts the flexibility to examine such differences. The tendencies under the traditional approaches to manipulate the given rules to reach equitable results or to apply the mechanical rules only to reach inequitable results would be eliminated under a balancing test.[95]

A balancing approach in North Carolina also would be consistent with the state's traditional results. Although the instrumentality test as adopted in *B-W Acceptance Corp. v. Spencer*[96] strongly favors limited corporate liability,[97] the courts consistently have recognized that "a court of equity, seeking to do justice among all parties, . . . looks at the spirit and not the form of the transaction."[98] Furthermore, the results of the courts' application of the traditional tests have been much the same as they would have been under a balancing test.[99] The

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91. *See, e.g.*, H. BALLANTINE, *supra* note 44, § 137, at 314-18; E. LATTY, *supra* note 1, § 7, at 200-205; Krendl & Krendl, *supra* note 1, at 34 ("The relevant balancing procedure should, therefore, include not only the usual consideration of the ultimate issues but also questions of the relative sophistication of the parties and the legitimate business expectations and practices of the parties."); *cf.* Barber, *supra* note 3, at 397 ("One would expect to find no differences in the legal theories applied in [the two contexts of one hundred percent shareholders and the parent-subsidiary relationship].").

Gillespie suggests that "it is . . . true courts should be more attentive to the different natures, modes of operations, purposes, and resources of each type of corporation in framing standards and assessing the justice of a particular result. . . . As a concomitant to treating different corporate structures differently under the doctrine, account must be taken of the nature of the wrong, be it [tort] or contractual, and the nature of a claimant, whether an individual or an entity." Gillespie, *supra* note 6, at 365.

92. *E.g.*, E. LATTY, *supra* note 1, § 7, at 196 ("The difference is simply that the parent corporation *has already achieved limited liability*, or rather, its stockholders have; in other words, in allowing recovery against the parent, there is *no denial of limited liability* so long as the recovery does not go back of the parent to reach its stockholders and subject *them* to unlimited liability."); *see also*, Douglas & Shanks, *supra* note 1, at 217 (distinguishing between sole stockholders and the parent-subsidiary relationship).

93. *See, e.g.*, E. LATTY, *supra* note 1, § 7, at 201-205 (one can see the inequity in tort cases as opposed to contract cases, because the plaintiff has entered into a nonconsensual relationship); Hamilton, *supra* note 36, at 985-88 (inadequate capitalization should be more important in tort cases).

94. "A consequence is that the same tests under the principle in some instances will be applied to different types of corporations and relationships." Gillespie, *supra* note 6, at 365. *E.g.*, GM Leasing Corp. v. United States, 514 F.2d 935 (10th Cir. 1975) (applying the alter ego theory to a one hundred percent stockholder); *Pilot*, 11 N.C. App. 444, 181 S.E.2d 799 (1971) (applying the alter ego theory to a parent-subsidiary situation). *See generally*, Note, *supra* note 2, at 333, 356-58 (discussing the different factors relevant to analyses of contract and tort cases).

95. *See supra* text accompanying note 57.

96. 268 N.C. 1, 149 S.E.2d 570 (1966).

97. *See* Krendl & Krendl, *supra* note 1, at 12.

98. Continental Trust Co. v. Spencer, 193 N.C. 745, 746, 138 S.E. 124, 125 (1927); *see also* Mills v. Mutual Bldg. & Loan Ass'n, 216 N.C. 664, 670, 6 S.E.2d 549, 553 (1940) ("Equity regards substance, not form.").

99. For example, the decisions imply that courts will not pierce the corporate veil as readily in

courts have explicitly recognized that an intent to defraud is not a necessary element to disregard the corporate form,[100] suggesting that it is the element of injustice in a given case which is decisive. The courts have emphasized that liability must not "rest on a single factor . . . but must involve a number of such factors; in addition, it must present an element of injustice or fundamental unfairness."[101] In *Pilot*,[102] in which plaintiff sought injunctive relief from responsibility for defendant's loss, the court stretched to find a basis for corporate disregard to protect plaintiff from an "unusual and highly questionable transaction."[103] Concluding that defendant's "loss . . . [was] illusory rather than real,"[104] the court in effect held defendant responsible for its subsidiary's transaction because to do otherwise would be unfair.

The *Glenn* court itself implicitly recognized a factor-weighing analysis when it rejected the court of appeals' declaration that each of four factors—inadequate capitalization, non-compliance with corporate formalities, complete

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the one hundred percent shareholder situations, while they might be more willing to place the responsibility on a parent corporation because of the necessity to protect the public interests. *See, e.g.*, Martin v. Pilot Indus., 632 F.2d 271 (4th Cir. 1980) (refusing to pierce the corporate veil and to find liable two individual defendants who were the sole officers, incorporators, and shareholders of the corporations for violation of the North Carolina Business Opportunity Sales Act); State *ex rel* Utilities Comm'n v. General Tel. Co. of Southeast, 281 N.C. 318, 345, 189 S.E.2d 705, 723 (1972) ("doctrine of the corporate entity may be disregarded where it is used to defeat the public interest and circumvent public policy in the regulation of utility rates"); *Whitehurst*, 224 N.C. 628, 32 S.E.2d 34 (1944) (piercing the veil of the defendant corporation on the theory of agency); Air Traffic Conference of Am. v. Marina Travel, 69 N.C. App. 179, 316 S.E.2d 642 (1984) (refusing to pierce the corporate veil to hold one hundred percent stockholder of airline agency liable, even though she was president of the corporation); *Pilot*, 11 N.C. App. 444, 181 S.E.2d 799 (1971) (piercing the veil of a one hundred percent owned subsidiary). *But see* Fountain v. West Lumber Co., 161 N.C. 35, 76 S.E.2d 533 (1912) (piercing the veil of a sole shareholder); Keels v. Turner, 45 N.C. App. 213, 262 S.E.2d 845 (piercing the veil of a dominant shareholder), *disc. rev. denied*, 300 N.C. 197, 269 S.E.2d 624 (1980).

100. " '[T]he theory of liability under the "instrumentality" doctrine does not rest upon intent to defraud. It is an equitable doctrine that places the burden of the loss upon the party who should be responsible.' " DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 685 (4th Cir. 1976) (quoting Kirvo Indus. Supply Co. v. National Distillery & Chem. Corp., 483 F.2d 1098, 1106 (5th Cir. 1973)); *cf. B-W Acceptance Corp.*, 268 N.C. 1, 8-9, 149 S.E.2d 570, 576 (1966) ("There must be additional circumstances showing fraud, actual or constructive, or agency.").

101. DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 686-87 (4th Cir. 1976). The North Carolina Supreme Court has observed:

> The prevailing tendency to corporate absorption cannot be ignored, and it is the increasing duty of the state, while giving to all corporations the equal protection of its laws, to equally protect its citizens against corporate abuses. There should be no prejudice against corporations simply because they are corporations. They are not outlaws, but are the creature of the law, and are not only capable of becoming the most powerful agencies of civilization, but have become absolutely necessary in our present stage of material development. They can be justly condemned only when their powers are abused, but in proportion as their powers are greater than those of an individual, they are more liable to abuse and should be more carefully guarded.

Commonwealth Mut. Fire Ins. Co. v. Edwards, 124 N.C. 103, 120, 32 S.E. 404, 408 (1899).

102. 11 N.C. App. 444, 181 S.E.2d 799 (1971). In *Pilot* defendant bought land from a third party who subsequently loaned the proceeds from the sale to one of defendant's subsidiaries. When defendant discovered that the third party did not yet have good title to the land, it claimed the title insurance which had been issued by plaintiff. Plaintiff refused to pay, claiming that defendant had not lost any money (it was in the hands of the subsidiary) and sued for injunctive relief. *Id.* at 452, 181 S.E.2d at 807.

103. *Id.* at 452, 181 S.E.2d at 805.

104. *Id.* at 453, 181 S.E.2d at 805.

domination and control, and excessive fragmentation—are separate corporate disregard theories.[105] Although the supreme court formally held that the factors are merely inherent in an application of the instrumentality rule,[106] it concluded that "it is a combination of factors which, when taken together with an element of injustice or abuse of corporate privilege, suggest that the corporate entity attacked had 'no separate mind, will or existence of its own . . . ,' "[107] neatly summarizing the rationale behind an equitable test which balances factors. Its last appeal to the judicial system was that "courts should abjure 'the mere incantation of the term instrumentality' in applying the so-called 'instrumentality' or 'alter ego' doctrine."[108]

On the surface, *Glenn* appears to be in line with North Carolina's traditional instrumentality test for determining when to pierce the corporate veil. A closer look, however, reveals that the decision raises subtle questions that can only add to the inconsistency and uncertainty surrounding application of the rule. The court itself warned against mere incantation of the various terms, and it recognized that a combination of factors is the essence of the doctrine. A balancing test would provide the flexibility needed to compare factors essential to the equitable doctrine and would eliminate some of the unanswered questions surrounding corporate disregard. Concededly, a process of examining factors on a case by case basis is subjective, and some inconsistency and uncertainty would likely remain. Ultimately, however, both injured plaintiffs and investors relying on the corporate form would be served by the adoption of a balancing test, because the decision to pierce the corporate veil would be based on overall fairness rather than the application of a mechanical rule.

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105. *Glenn*, 313 N.C. at 457, 329 S.E.2d at 333; *see Glenn*, 67 N.C. App. at 581, 313 S.E.2d at 842.

106. *Glenn*, 313 N.C. at 458, 329 S.E.2d at 333.

107. *Id.*

108. *Id.* at 459, 329 S.E.2d at 333.