UNC SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 44 | Number 4 Article 9

6-1-1966

Corporations -- 1965 Amendment to the North Carolina Business Corporation Act

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Linkletter allowed practical considerations to overcome considerations of justice and equality.

Fairness of trial would seem not to depend solely upon the accuracy of the ultimate determination of guilt or innocence. As Miss Mapp, Mr. Gideon and Mr. Griffin were deprived of certain elements of the ritual to which we refer as a "fair trial," so also was Mr. Tehan deprived. On this ground, there appears to be no distinction. Neither would a valid distinction between Mr. Gideon and Mr. Tehan seem permissible on the ground of accuracy of verdict.

Consequently, the *Tehan* result appears to be based upon an argument geared to support a preconceived decision against retroactivity, pleaded as a purpose argument but actually sounding in flooding the courts. In so extending the pragmatic approach, the Court has apparently lost sight of the remaining relevance of the theoretical approach based upon equality for persons similarly situated, equal protection of the laws and the often crucial image of judicial fairness.

How then do we reconcile the application of one constitutional principle to pre-1965 criminal judgments with the application of a different principle to post-1965 judgments? In Mr. Tehan's case, we can do so neither upon the basis of precedent nor of sound judicial policy.

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Corporations—1965 Amendment to the North Carolina Business Corporation Act

The following comments concern the changes in the North Carolina Business Corporation Act of 1955, Chapter 55 of the General Statutes, made by the 1965 General Assembly.

I. INSPECTION RIGHTS

Section 55-38 was amended by adding a new provision blocking shareholders of banks from inspecting "deposit records or loan records of a bank customer, except upon order of a court of competent jurisdiction for good cause shown."[1] This enactment obviously responds to the effort in *Cooke v. Outland*[2] to reach such records,

[1] N.C. Sess. Laws 1965, ch. 609, adding new subsection (i) to N.C. GEN. STAT. § 55-38 (1965).

[2] 265 N.C. 601, 144 S.E.2d 835 (1965).

although the legislation is not retroactive and thus does not affect that litigation. Although the new provision was doubtlessly motivated by the banking community's alarm over shareholder access to corporate records—and thus to some degree reflects the disposition of banks to curtail the information available to shareholders—it nevertheless achieves a sound balancing of the interests of shareholders on the one hand and of depositors and borrowers on the other in subjecting to court supervision the right of shareholders to obtain certain classes of documents.

The amendment does not generally affect the application of the inspection-right provisions of the corporation law to banks nor does it eliminate the shareholder's right to inspect deposit and loan records. What it does is to remove two types of corporate documents from the phrase "books and records of account" which, under the corporation law, may be inspected *as of right* by any shareholder, with the corporation carrying the burden of proving that the shareholder has no proper purpose.[3] It is doubtful that records of loans and deposit, which do have a confidential aspect, should be available *as of right,* with a penalty imposed on the bank officer who refuses to furnish them. However, *Cooke v. Outland,* the decision that this statute overturns for the future, had correctly read the phrase "books and records of account" to include such bank records instead of adopting a strained construction of the statute that would put them outside this inclusive category.

The effect of the amendment, then, is to throw loan and deposit records into the category of documents which may be inspected only on court order and on proof by a shareholder of his proper purpose.[4] Stated otherwise, the confidential character of the records overrides a shareholder's inspection as of right, but the documents may be available after a court has determined the shareholder's reasons and objectives. In contrast to the "proper purpose" standard generally applicable under section 55-38(f), the new test is framed in terms of "good cause shown." It is to be assumed, although the statute is not clear on this, (1) that the shareholder bears the burden of proving good cause, and (2) that "good cause" is a stricter standard than "proper purpose." Perhaps the difference, if any, is that "proper purpose" focuses more on a shareholder's

[3] N.C. GEN. STAT. § 55-38(b) (1965).
[4] See N.C. GEN. STAT. § 55-38(f) (1965).

motive and purposes, while "good cause" directs attention to objective factors and the reasonableness of the request.

II. Compulsory Dividends

Section 55-50 authorizes holders of at least twenty per cent of the shares of any stock class to compel payment of up to one-third of the "net profits" for a given accounting period, "allocable to [shares of] that class."[5] This statutory procedure for forcing dividends is in addition to, rather than in lieu of, traditional equity jurisdiction to compel declaration of dividends unreasonably withheld.[6] In 1965 subsection 55-50(i) was amended to make the provision inapplicable to "any corporation having total assets of one million dollars ($1,000,000) or more and whose shareholders number seven hundred and fifty (750) or more."[7] The evident purpose is to relieve larger corporations from possibly vexatious suits by shareholders seeking larger dividends, not to mention the fact that a compulsory dividend policy such as the statute prescribes would by exceedingly inconvenient to these corporations (as well as many others not so exempted). The author of this comment has criticized the compulsory dividend provision and welcomes any effort directed at removing the specific mathematical formula which makes dividend payments automatically enforceable and substituting as the exclusive test the sound "equitable" rule that directors may not withhold dividends unreasonably or for some unlawful purpose.[8]

In one respect, the new statute is a curiosity. Its language is obviously derived from section 12(g)(1)(A) of the federal Securities Acts Amendments of 1964.[9] The major thrust of the far-reaching amendments is to extend the protection[10] hitherto available only

[5] N.C. Gen. Stat. § 55-50(i) (1965). With certain limitations, the general rule is that the amount of dividends that must be paid is the difference between the amount paid during the relevant accounting period and one-third of "net profits" for that period allocable to shares of the class seeking the additional payout. "Net profits" receives a special definition in the first sentence of section 55-50(i).

[6] N.C. Gen. Stat. § 55-50(j) (1965).

[7] N.C. Sess. Laws 1965, ch. 726.

[8] See Folk, *Revisiting the North Carolina Corporation Law*, 43 N.C.L. Rev. 768, 843-45 (1965).

[9] Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. § 78*l*(g)(1)(A) (1964).

[10] Briefly stated, the 1964 amendments require corporations subject to the act to register their securities with the Securities Exchange Commission, § 12(g)(1); to make periodic reports to the SEC, § 13; to conform to federal standards as to proxy solicitation or, if proxies are not solicited,

to shareholders of corporations whose securities are listed on a national securities exchange to all corporations (with exceptions) meeting certain specific statutory standards as to asset size and number of shareholders. These corporations are the large "over-the-counter corporations," that is, corporations whose shares are traded more or less regularly on securities markets maintained by brokers and dealers.[11] Cannon Mills and Lance, Incorporated, are examples of local corporations in this category. The federal law took effect in two stages: Initially it applied to corporations with $1,000,000 dollars or more of assets whose equity securities of any class are held of record by at least 750 persons;[12] a year later it became applicable to corporations with 500 shareholders of record, the asset test remaining unchanged.[13]

The North Carolina statute is obviously intended to afford the compulsory dividend exemption to corporations subject to the federal requirements, or at least one infers so from the close similarity of language. Curiously enough, the state amendment is framed so that it applies only to those corporations that immediately became subject to the federal statute, that is, corporations with 1,000,000-dollar assets and 750 shareholders, but not to those that are now subject to the more expansive coverage of the statute—those with 500 to 750 shareholders. It is difficult to see why state law would make this distinction. Presumably if corporations with 750 or more shareholders can safely be left to manage their dividend policies, subject only to the "equitable" test, those with 500 to 750 shareholders equally can be trusted. The point is simply that the North Carolina amendment makes an irrational cut.[14] Since it chose not to go all the way and eliminate the compulsory dividend provision but instead seemingly aped the federal definition, it would have been more sensible to make the state law exemption coterminous with

to furnish shareholders with information comparable to that going out with proxy statements, § 14. The provision for recovering short-swing profits by insiders now applies to officers, directors, and 10% shareholders of corporations subject to the act. § 16.

[11] This, incidentally, is a definition recognized in the North Carolina Business Corporation Act. N.C. GEN. STAT. § 55-73(b) (1965).

[12] Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. § 78*l*(g)(1)(A) (1964).

[13] Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. § 78*l*(9)(1)(B) (1964).

[14] This is not to say that the federal test of 500 shareholders is more rational. Any such cut-off point is bound to be arbitrary, and a good case can be made for cutting it at a lower figure such as 200 or 300 shareholders.

the federal provision. Moreover, the North Carolina amendment is ambiguously worded. Unlike the federal provision which specifies 500 or 750 shareholders "of record"—a provision now interpreted by Securities Exchange Commission regulation[15]—the North Carolina statute leaves the matter open, so that one does not know whether or not to count the beneficial owners of shares held of record by a nominee. Thus if a broker owns of record shares for twenty-five customers it is uncertain whether this counts as one or as twenty-five shareholders. Absent some strongly persuasive reason to the contrary, to the extent corporate rights and obligations depend upon counting shareholders, the test should refer to shareholders of record. Otherwise, the corporation is inconvenienced in trying to get information concerning beneficial owners and may in fact never be able to obtain it.[16]

Thus, this faultily drafted amendment should be corrected in at least two respects: (1) it should exempt corporations with 500 (rather than 750) shareholders, and (2) it should specifically refer to shareholders of record. It would be better, however, to delete all of section 55-50(i) and leave compulsory dividends to the traditional equity test rather than to erect an automatically applicable formula, even though it is limited to relatively small corporations.

III. Miscellaneous Provisions

Section 55-14[17] and section 55-142[18] detail the procedure for corporations, domestic and foreign respectively, to change their registered office or agent or both, by executing and filing a statement of the change. Since many corporations are represented by a single agent, either an attorney or a corporation service company, it is worthwhile to authorize a simple method by which the *agent* itself may file a single document reflecting the change of the corporation's registered office to a different address. A 1965 amendment[19] adding a new subsection (e) to section 55-14 (domestic corporations) and

[15] SEC Securities Exchange Act Release No. 7492, January 5, 1965.

[16] In a different context, the Supreme Court of Delaware recently stated that "the corporation is entitled to confine itself to dealing with registered stockholders in intracorporate affairs such as mergers; it should avoid becoming involved in the affairs of registered stockholders vis-à-vis beneficial owners. . . ." Olivetti Underwood Corp. v. Jacques Coe & Co., 217 A.2d 683, 686 (Del. Sup. Ct. 1966).

[17] N.C. Gen. Stat. § 55-14 (1965).

[18] N.C. Gen. Stat. § 55-142 (1965).

[19] N.C. Sess. Laws 1965, ch. 298.

a new subsection (d) to section 55-142 (foreign corporations) permits the agent to handle this matter. It is of limited interest, but of considerable utility to agents serving corporations by furnishing a registered office and agency.

A 1965 amendment[20] added, to the tail-end of the Uniform Stock Transfer Act, a new section 55-97.1 authorizing stock transfer through transfers and pledges of shares within a central depository system, such as the New York Stock Exchange has available through its Clearing Corporation. The provision is identical with section 8-320 of the Uniform Commercial Code which was adopted when the Code was enacted in North Carolina.[21] Since the Code will be effective July 1, 1967, it is difficult to see why the same language was added to the corporation law, especially as a dangling appendix to the soon-to-be-repealed Stock Transfer Act, unless possibly it was intended to make immediately effective this new and sophisticated mode of transfer.

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Corporations—Stock Options—Validity and Federal Tax Requirements

The stock option plan as an incentive device for key corporate personnel has come into widespread use. Although the prime factor for the growth of such plans in the corporate community has been the favorable tax treatment of the proceeds, compliance with the requirements of the Internal Revenue Code provisions,[1] necessary to obtain capital gains rates, is not per se sufficient to insure the validity under state law of a plan challenged by a minority stockholder.[2] Thus, a corporation seeking to adopt an option plan must

[20] N.C. Sess. Laws 1965, ch. 843.
[21] N.C. GEN. STAT. § 25-8-320 (1965).
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[1] INT. REV. CODE OF 1954, §§ 421-425.
[2] [S]ince, under the Internal Revenue Code, the favored position with respect to options granted as part of compensation to corporate officials can be obtained only if the options are exercised while in the corporation's employ, the result will be to persuade the optionees to remain in the corporation's employ. Even if the inferences . . . are justified, they are dependent entirely upon the present state of the federal taxing policy and, as such, too insecure in nature to be regarded as a condition of the stock option plan designed to insure that the corporation will receive the contemplated benefit.
Kerbs v. California Eastern Airways, 33 Del. Ch. 69, 77, 90 A.2d 652, 657 (Sup. Ct. 1952).