UNC SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 33 | Number 1 Article 7

12-1-1954

The Proposed North Carolina Business Corporation Act

E. R. Latty

L. S. Powers

M. S. Breckenridge

Follow this and additional works at: http://scholarship.law.unc.edu/nclr

Part of the Law Commons

Recommended Citation

E. R. Latty, L. S. Powers & M. S. Breckenridge, *The Proposed North Carolina Business Corporation Act*, 33 N.C. L. Rev. 26 (1954).
Available at: http://scholarship.law.unc.edu/nclr/vol33/iss1/7

This Article is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized administrator of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.

THE PROPOSED NORTH CAROLINA BUSINESS CORPORATION ACT

E. R. LATTY,* L. S. POWERS,† M. S. BRECKENRIDGE,‡ Draftsmen

In response to a wish often expressed by lawyers that the North Carolina Corporation Law be brought up to date by a thoroughgoing revision, rather than by patchwork amendment as in the past, the General Statutes Commission[1] has had drafted a new Business Corporation Act which it plans to offer to the next General Assembly along with a companion bill governing non-profit corporations. Over the many months of its preparation the original draft has been gone over line by line and word by word by the members of the Commission and it has been modified in innumerable places both pursuant to instructions of the Commission and in response to welcome criticisms and suggestions of members of the Bar who have taken time to study it. The Commission thinks that the Bar of the State should be able to examine in advance not only the proposed Act itself, copies of which have been made available in all but final form at courthouses throughout the state, but to examine also a brief exposition by the draftsmen of its contents, particularly those which differ from present law or which supply rules where none now exist. Hence this article.

The basic sources of the proposed Act have been the present North Carolina Corporation Law and the Model Act of the American Bar Association, but the acts of a dozen or more states whose corporation laws have been extensively revised over the last two decades have been constantly looked to for improved thought and phraseology. A small portion of the whole is the invention of the draftsmen, accepted by the Commission after full discussion.

The purposes behind the proposed Act have been not only to provide the best rules of substantive corporation law, but a guide as well which the lawyer can readily consult on many questions of practice. This results in considerable elaboration at points. Now to be specific.

* Professor of the law of Corporations and Corporation Finance, Duke University School of Law.

† Professor of Law, Wake Forest School of Law.

‡ Professor of the law of Corporation Finance, University of North Carolina School of Law.

[1] Present membership: Robert F. Moseley, Chairman throughout the period, Greensboro Bar; James H. Pou Bailey, Raleigh Bar; Professor E. C. Bryson, Durham, who has recently succeeded Professor Malcolm McDermott, Durham, former Vice Chairman; Professor F. W. Hanft, Chapel Hill, Vice Chairman; William Joslin, Raleigh Bar; Professor Robert E. Lee, Wake Forest; Henry A. McKinnon, Lumberton Bar; Buxton Midyette, Jackson Bar; William F. Womble, Winston-Salem Bar.

ARTICLES 1-3. GENERAL AND ORGANIZATIONAL PROVISIONS

The definitions include some novelties, but they can best be discussed later in connection with the sections in which they are employed.

Section 4 on the execution and filing of corporate documents differs from the present law chiefly in substituting, as does the Model Act, verification for acknowledgment in most cases (but not as to articles of incorporation), in dispensing with recording in the office of the Secretary of State (filing there, however, is to be required).

By Section 6, articles of incorporation may be executed by three natural persons (as now required), but they need not be subscribers to stock, a frank concession to practicality since the initial incorporators are likely to be mere nominees even when, to meet present requirements, they are subscribers as a matter of form. An effort to protect creditors of newly formed corporations better than by the subscription formality is found in the requirement of at least $1,000 of subscribed and paid in capital before business is conducted,[2] and to the same purpose is a provision expressly recognizing any common law or equitable doctrine of stockholder liability in so-called Salomon Corporations[3]—those in which the chief organizers take little stock, but large amounts of fixed obligations of the corporation and thus compete with outside creditors. The exact limits of this liability remain for court measurement.

To save both bother and delay it is proposed in Section 7 (1) that the first board of directors be named, and classified if desired, in the articles rather than await an organizational meeting as per the requirements of present law (or the paper record of one).

In addition to name-pirating restrictions, Section 12 of the proposals includes extensive name reservation provisions open to use by many classes of applicants in various situations justifying such a right.

Sections 13-15, dealing with the registered agent and service on domestic corporations, are drawn in greater particular than are those in the present law, but represent no substantial change.

The present convenient policy of allowing directors to make the by-laws, if the certificate of incorporation so provides, is enlarged in proposed Section 16 to allow the board named in the articles to adopt the initial by-laws at its organizational meeting. But stockholder control is perpetuated by three specific limitations on the subsequent exercise of the power by directors, as well as by a provision enabling the shareholders to take away the power. While the present law does not state what vote is necessary to adopt or amend by-laws, the inference is that

[2] Sections 7 (e), 9.
[3] Salomon v. A. Salomon & Co. [1897] A. C. 22.

a majority of a quorum is sufficient. The proposals are a little more exacting—a majority of the whole board or of the voting shares, unless a still greater vote is required by the charter or by-laws.

ARTICLE 4. POWERS AND MANAGEMENT

The doctrines of corporate powers and ultra vires have undergone much surgery at the hands of the courts since the older corporation laws were enacted. Section 18 of the proposals brings the statutory law into harmony with the cases by limiting the attack on unauthorized corporate activities to a few special situations: (1) non-collusive injunctive proceedings by non-assenting shareholders in executory transactions, with discretion in the courts to award monetary compensation, not including anticipated profits, where interference with the contemplated transaction causes loss; (2) actions against the wrongdoing officers; (3) direct attacks on the corporation by the Attorney General. The proposed Act advances onto new ground when it makes these rules applicable also to local activities of foreign corporations.

Corporate powers are divided into two groups by Section 17—those applicable to all corporations, and those granted to further the declared corporate purposes of a particular corporation.

In this area of corporate powers and proper activities the proposed Act in Sections 20 and 21 supplies what are believed to be much needed rules, where none are now discoverable, governing the policy of indemnifying officers and directors for expense incurred in defending themselves against charges by outsiders growing out of activities for the corporation, and against charges of dereliction of duty brought by or on behalf of the corporation. The proposed rules run all the way from an absolute right to reimbursement if the officer or director wins on the merits when sued by an outsider, through intermediate stages requiring director or stockholder approval of reimbursement, to finally, a right to have the court pass on his application, after notice and hearing, where he prevails in some degree in a suit brought by the corporation.

The present prohibition of loans to officers and shareholders is both enlarged and narrowed by Section 22. It is enlarged first by adding corporate guaranty to the prohibition, then by striking also at situations where affiliated relationships create similar abuses. Thus, while loans to and guaranties of the debts of a subsidiary are permitted, the reverse favor from subsidiary to parent is prohibited since the subsidiary's prosperity is at the mercy of the parent. The present law is narrowed chiefly in permitting a disinterested shareholder vote to approve the otherwise proscribed transactions.

Sections 24-29 deal in detail with directors, their election and activities, and cover a great deal of hitherto barren territory. As to changes—

the proposed Act permits all directors to be non-residents; it accepts the practicalities of small corporation management and, recognizing that directors do not get their powers from Mt. Olympus, permits shareholders to retain some direct managerial authority; it expressly recognizes the validity of board action taken without a board meeting, upon unanimous written approval by the directors and upon the basis of estoppel when action so taken goes unchallenged.

Classification of directors is continued, but with safeguards against the use of classification to defeat the policy of cumulative voting.

Elaborate provisions as to removal of directors, filling vacancies, meetings, delegation of board authority to an executive committee, the appointment of officers and their authority, are notable mostly for their effort to lay down a rule in nearly all cases where questions might arise. Drawing from several recent corporation laws of other states, they fill out the meager sections on these subjects in the present North Carolina law.

It was felt that the present section, North Carolina General Statutes § 55-116 (hereafter referred to as G.S.) on director liability for withdrawal of corporate assets, etc., went too far in the extent of liability imposed, and fell short in failing to impose liability for other injuries to corporate finances such as approving unwarranted guaranties, or use of corporate property as security. Liabilities are accordingly spelled out by proposed Section 32, limited to the excess over what, if anything, would have been proper, with each responsible director allowed contribution or reimbursement from his offending brethren. A simplified procedure for suit and a short statute of limitations are added.

Section 33, believed novel,[4] but sound and desirable, permits local suit against non-resident directors, or their joinder in a local action seeking to hold them for malfeasance in office, etc. This extension of local jurisdiction is thought supportable by analogy to non-resident motorist statutes.

Present law with reference to the execution of corporate instruments is preserved, but expanded in the interest of those dealing with corporate officers. Adopting an agency doctrine, Section 36 validates, as to relying innocent persons, instruments executed by certain chief officers of corporations in the ordinary course of business, even when authorization by the board of directors is lacking. It also gives prima facie validity to corporate documents bearing a purported corporate seal. The Section goes one step further in declaring these rules applicable when instruments seeming to be those of a foreign corporation are offered in evidence in local courts.

[4] The nearest approaches to this proposal in actual legislation seem to be in Indiana and South Carolina. See Note, 28 N. C. L. REV. 201 (1950).

The law regarding corporate books and records, and the terms on which various interested people may inspect them, has been dealt with by courts and legislatures in other jurisdictions with a variety of results. North Carolina law has been scanty on the subject. The proposals in Sections 37-38 are thought to adopt fairly complete middle-of-the-road rules. Thus, while a corporation is required to keep an annual balance sheet and operating statement open to shareholder inspection, for ten years it need not mail copies to shareholders unless requested. A right to mandamus is given and substantial penalties, subject to court modification, are laid down for refusing to permit inspection of the designated records, but efforts to prevent abuse are found in requiring, as a condition to the exercise of the right to inspection, ownership of shares for six months, or in an amount of five per cent of any class of stock, and the showing of a proper purpose. Furthermore, if a shareholder otherwise entitled is shown to have wrongfully used information obtained from a previous inspection of the record of any corporation, no penalties are in order for denying the right to inspect. In addition to the above, to aid local litigation large powers are vested in the superior courts to compel the production of records of both domestic and foreign corporations. The rather severe policy of the present law, which prescribes dissolution for disobedient corporations, is retained.

Aside from a brief section, G.S. 55-56, placing liability upon all corporate personnel for fraud (a section which seems to have had its origin in a day when all corporations were thought of as public in nature), the present law seems to have no provision which would apply to the making and circulating of false records and reports of corporate affairs, perhaps because general tort law principles were thought sufficient. Following the lead of other states, however, the draft has included provisions in Section 39 specifically directed to this subject. The salient points are: (1) the making or circulating of false reports of corporate business and assets subjects the offender to liability to all who rely upon these reports, whether the offender knew of their falsity or only lacked reasonable ground for thinking the statements true;[5] (2) the section subjects to similar liability those who make entries known to be false in corporate records, or alterations in them which produce like false showings; (3) officers and directors who know or ought to know of the making of false representations must take steps to prevent resulting injury, or be themselves similarly liable. Liberal provision is made for joinder of individual and corporate defendants, and a defendant official may have contribution from others "equally guilty." The draftsmen intend here, not that there shall be a meticulous weighing of guilt per-

[5] See Townsend v. Williams, 117 N. C. 330, 23 S. E. 461 (1895), involving a claimed innocent representation by a bank officer.

centages under the quoted phrase but that contribution is not to be decreed from subordinates who are pawns in the hands of higher officials.

ARTICLE 5. CORPORATE FINANCE

The thirteen sections (Section 40-Section 52) that constitute the corporate finance segment (Article 5) of the proposed Act are particularly significant for their coverage of areas untouched or only slightly touched by the present law. Much has happened in the law of corporation finance since the turn of the century when the present corporation law was enacted. Sporadic amendments have been inadequate.

Section 40 of the corporate finance article relates generally to authority to create and issue shares and to classify them. It grants large freedom, as does the present law, with respect to the characteristics to be given to any classes of shares. However, the proposed Act does not permit non-cumulative preferred shares which give uncontrolled power to the directors to make capricious division of earnings between different classes of shareholders. Instead it recognizes the right of non-cumulative shares to a "dividend credit" (as defined) to the extent of the amount of the per-share earnings of such shares, within their preferential limits. In short, even non-cumulative stock is cumulative under certain conditions of corporate earnings. This meets business needs[6] and legitimate desires for managerial flexibility and yet avoids the perils to which out-and-out non-cumulative stock is exposed when the management is not completely conscientious in regard to the relative property rights which it administers.[7]

Section 40 also contains provisions designed to aid in the interpretation of charter clauses. For example, are unpaid dividends on cumulative preferred shares (or "dividend credits" in the case of non-cumulative preferred shares) to be included in their liquidation preference? Do preferred shares participate in further dividends beyond their preferential amount? Neither prior legislation nor existing decisions in this state give much help on such questions.

The Section also forbids preferred shares redeemable at holder's option, except in the case of investment companies. Redemption at holder's option has created awkward situations,[8] has been termed a "trap and snare for the unwary investor"[9] (in that his right is illusory if it

[6] See W. H. S. Stevens, *The Discretion of Directors in the Distribution of Non-Cumulative Preferred Dividends*, 24 GEO. L. J. 371, 394 (1936).

[7] See remarks of Frank, J. in Guttmann v. Illinois Central R. Co., 189 F. 2d 927, 931 (2d Cir. 1951), to the effect that it is not for the court to remake the non-cumulative preferred stock contract so as to be fair: "Perhaps the making of such bargains should be prevented. But if so, the way to prevent them is by legislation. . . ."

[8] Crimmins & Pierce Co. v. Kidder Peabody Acc. Corp., 282 Mass. 367, 185 N. E. 383 (1933).

[9] Owen, J., in Koeppler v. Crocker Chair Co., 200 Wis. 476, 228 N. W. 130, 133 (1929).

would compete with creditors),[10] and has been outlawed occasionally by legislation.[11]

Section 41 expressly permits classes of preferred shares to be divided into series, as is permitted by the 1953 amendment to G.S. 55-61. However, the proposed Section 41 specifies what differences can exist between different series of the same class of stock, thus clarifying questions unsettled in the prior legislation.

Section 42 continues the prior policy of permitting the shareholders by resolution to define the characteristics of preferred shares which the charter has left undefined. It also adopts, and perhaps technically expands, the prior policy of letting the directors "fill the blanks" if they are so authorized by shareholders' resolution, or (as the proposed Act adds) if the charter so authorizes. Shareholders' resolutions relating to these matters must be adopted by a majority of the shares of each class outstanding, whether or not the holders thereof have voting rights in general. It was believed in drafting this voting requirement that such a virtual re-writing of the charter should receive the consent of a majority of all classes, being similar in this respect to important charter amendments. The present law (G.S. 55-61) merely requires action "by those holding a majority of its outstanding capital stock entitled to vote," which not only leaves out non-voting shares, but also dispenses with a class vote requirement, to the advantage of those classes which are composed of "little" shares. The directors' "filling up" power is not limited, as under the present law, to the situation where shares of a series of a class were being issued, and in this respect conforms more closely to the law of such other states as permit "blank" stock to be filled in by directors.

Section 42, however, makes it clear that the power to fix characteristics of hitherto "blank" shares cannot be used to create preferences over existing shares or to change the rights of the erstwhile "blank" shares after their issuance. For such changes, a charter amendment is necessary.

Finally, unlike the present law (at least, as many practitioners now interpret it), which requires no filing or other publicity in connection with the creation of blank stock, the proposed Act requires the public filing of a Statement of Classification of Shares defining the characteristics of the shares before their issuance. This conforms to the legislation of other states recognizing "blank" shares.

The proposed Act's Section 43 deals with subscriptions for shares in many aspects beyond those treated in the present law; that is, beyond those relating to assessment, default, and foreclosure sale of the shares.

[10] Koeppler v. Crocker Chair Co., *supra* note 9.
[11] CAL. CORP. CODE § 1101 (Supp. 1949).

Thus, Section 43 covers, for example, the following new matters: (1) it defines pre-incorporation and post-incorporation subscriptions, to facilitate use of those terms; (2) it requires subscriptions to be in writing, except where some payment thereon has been made and accepted; (3) it makes a written subscription irrevocable for six months, thus denying the privilege of withdrawing at any time before the corporation is organized and "accepts"; (4) it clarifies, by cross reference to Section 47, the effect of a subscription upon what the present law calls "capital stock" and which the proposed Act calls "stated capital"; (5) it forbids or nullifies certain clauses or representations that would give one subscriber an unfair advantage over another, and gives the subscriber in such cases not a defense against enforcement of the subscription, but an action against the wrongdoing promoter or agent; (6) it permits the promoter to name the board of directors, required in charters under the proposed Act, and permits those directors to adopt by-laws without participation of the subscribers, unless the parties expressly contract otherwise; (7) with respect to remedies for enforcement of subscriptions, it disregards the alleged differences between a "subscription" and an executory "sale,"[12] and would give in either case specific performance of the agreement; (8) against a defaulting subscriber the corporation may maintain an action for the agreed price, or an action for damages, or may rescind the subscription, in which latter event it must return any subscription payments in excess of ten per cent; (9) it permits the subscriber to rescind for fraud unless it can be shown that creditors or other investors relied upon his subscription; (10) it empowers the directors, unless otherwise provided in the charter or by-laws, to release, settle, or compromise the obligation of the subscriber, and makes such releases subject to certain other provisions relating to a corporation's purchase of its own shares; (11) it subordinates subscribers in respect of any payments made by them on their subscription, to the rights of creditors, regardless of any provision in the subscription agreement.

Section 44 covers an area completely untouched in the prior legislation: the matter of conversion rights and options. It expressly authorizes the issuance of creditor securities with rights to convert into shares, and also authorizes the grant of stock options either in connection with an issue of securities or independently thereof. The Section also provides for: the disclosure in financial statements of conversion ratios and of information relating to stock options; the summary statements of conversion rights in creditor instruments; the issuance of warrants, freedom in making option rights transferable or not, and in making them separable from other instruments; the reservation of authorized shares to meet conversion and option demands; the pre-emptive right problem

[12] *Cf.* Stern v. Meyer, 166 Minn. 346, 207 N. W. 737 (1926).

when there is granted a right to convert into, or an option for shares subject to, pre-emptive rights, and the effect of conversion on "stated capital."

Section 45 follows with a closely allied problem, also without counterpart in prior legislation: sale of shares and granting of options to employees. Specific treatment of the subject is warranted by the extent and timeliness of the many stock purchase plans offered in present times by corporations to employees. Section 45 expressly permits such plans and concedes them the greatest latitude, except that: (1) the charter can otherwise provide and presumably could forbid sales or options to employees; (2) the plan has to be adopted by vote of a majority of the shares (without distinction as to class) entitled to vote; (3) the adoption of the plan has to be fairly recent, *i.e.*, not more than two years old. (This restriction is based on the belief that a stale plan, or "sleeper," can be very unfair.) In addition to a "plan" of employee stock purchases or stock options, Section 45 permits the directors (unless otherwise stated in the charter) to grant a stock option at not under 150% of the market price at the time of the grant, in order to secure or retain an employee; but the 150% requirement is dispensed with if the option is approved by a majority of the shares entitled to vote. This represents an effort to reconcile managerial freedom with protection of shareholders against dilution.[13]

Since its earliest days the law of corporate finance has been deeply concerned with the problem of "consideration" received by the corporation for the shares which it issued, both as to kind and amount. Section 46 treats the matter in considerable detail far beyond the treatment in the present law. Certain basic policies of the present law are retained: property received by, and services actually performed for the corporation can be lawful kinds of consideration, as well as money; the amount of consideration must at least equal the par value of shares having par value; the judgment of the directors on the question of value is conclusive in the absence of fraud or bad faith; the directors can fix the consideration for the issue of no-par shares. But Section 46 clarifies a multitude of details: intangible property can be an appropriate kind of consideration, or the cancellation of other securities, or the satisfaction

[13] While this article is in preparation a new provision has been added to meet the situation disclosed by a recent case, Elster v. American Airlines, 106 A. 2d 202, 516 (Del. Ch. 1954), which held that employee optionees were necessary parties in an action to enjoin the corporation from carrying out the option contract and that failure to join them was fatal. If some were non-residents the difficulties are apparent. The proposed Act will now not only recognize the possibilities of a class action, but relying on principles of foreign garnishment and old stock attachment cases before the Stock Transfer Act introduced negotiability into share certificates, not present in employee option contracts under proposed Section 45, see Parks-Cramer Co. v. Southern Exp. Co., 185 N. C. 428, 117 S. E. 505 (1923), and 19 N. C. L. REV. 469 (1941), will allow a suit quasi in rem at the corporate domicile with service on non-residents by publication.

of accrued dividends, or the transfer of amounts from surplus to stated capital. On the other hand Section 46 makes it clear that a share purchaser's promissory note, or his guaranty of some obligation of the corporation, or his agreement to perform future services, is not a proper kind of consideration. Moreover, the propriety of issuing shares at such discount under par as does not exceed reasonable underwriting fees and expenses is expressly recognized. This Section also sets standards for measurement of the consideration deemed to be received in the case of conversion or exchange of shares into, or for, new shares differing in par value from the old ones.

Subsection 46 (h) contains an additional feature that can only be appreciated by perusing its actual text:

> Nothing in this section relative to the amount of consideration for which shares may be issued or disposed of by the board of directors shall impair any remedy which a shareholder may have against the corporation, the directors or others, on the ground that shares have been or are about to be sold or disposed of by the corporation at a price so low, after giving full recognition to freedom of business judgment, as to reduce substantially and unfairly the value of the shares of the complaining shareholder. A pre-emptive offer to all shareholders or to a class of shareholders to sell to them pro rata additional or treasury shares does not deprive a shareholder so aggrieved of a cause of action where there is no ready and adequate market for the sale of a shareholder's rights under the offer. If, however, such pro rata offer has been made, no shareholder may complain of unfairness of the price unless, before the expiration of a reasonable time for accepting the offer, he notifies the corporation in writing that he is financially unable to accept the offer and that he believes the offering price to be so low as to unfairly dilute his holdings. In any action brought by a shareholder who has complied with this requirement, evidence tending to show prior efforts to induce him to sell his shares to directors, officers or dominant shareholders of the corporation shall put upon the defendant or defendants the burden of proving that the offering price was fair.

The first sentence of the above-quoted text, while novel in legislation, reflects sound judge-made doctrines against dilutive sales found in several cases.[14] The second sentence rejects any notion that a pre-emptive offering to shareholders ipso facto cleanses the subsequent sale of any unlawful dilutive defects. The draft's theory is reinforced by the North

[14] See Atlantic Refining Co. v. Hodgman, 13 F. 2d 781, 788 (3d Cir. 1926); Bodell v. Gen. Gas & Inv. Corp., 15 Del. Ch. 119, 132 Atl. 442, 447 (1926).

Carolina Supreme Court's decision in *Gaines v. Long Mfg. Co.*[15] Actually, many "squeezes" of shareholders have been engineered in close corporations by pre-emptive offering carefully timed and calculated to dilute the "squeeze" (the family of a deceased substantial stockholder is often a target of this practice). The remaining quoted sentences require no comment.

The proposed Act, in Section 47, gives much closer attention to the determination of "stated capital," this being the term used in lieu of "capital stock" in almost every state which has thoroughly revised its corporation laws within the past twenty years. The old term was used with so many different meanings as to have become very confusing. For example, G.S. 55-31 (4) speaks of a charter amendment that would "increase or decrease its capital stock"; G.S. 55-66 purports to tell how a "decrease of capital stock may be effected"; the heading of present Article 7 of Chapter 55 reads "Capital Stock without nominal or par value." In all of these (and others), "capital stock" means different things. So the proposed Act uses "stated capital" in a technical, legal sense. It seems hardly necessary to state that this legalistic concept of corporate capital bears no relation to the "capital" of economists, and has no necessary counterpart in economic reality. In a partnership, capital means something pretty realistic. If the partners have contributed $300,000, have also had the firm borrow $100,000, and have in addition plowed back $200,000 of profits, there can be some argument over whether the "capital" is $300,000, or $500,000 or $600,000, but the argument is never out of touch with economic reality. If the partnership had been a corporation, with no-par or low-par shares, the "capital" (stated capital) should be a purely arbitrary figure, say, $45,000.

There is much to be said in favor of a scheme that would bring corporate "stated capital" back into touch with some kind of reality, even if only an historical one. The committee, indeed, had at one time worked out such a draft, but since this would have required all shares to be without par value (if the drafting were to remain intellectually honest), it was believed that the legislature might not react favorably. Instead, the proposed Act in Section 47 proceeds to define "stated capital" and to state its ingredients in considerable detail and with precision. The ingredients of "stated capital" are: the aggregate par value of all issued par-value shares, plus the entire consideration received for no-par shares unless the directors designate part as paid-in surplus, plus amounts transferred from surplus to stated capital in case of a share dividend or by resolution of the board of directors even without a share dividend. Accordingly, upon issuance of par shares for a consideration above par, as well as in any issuance of no-par shares, a part of the "capital" put

[15] 234 N. C. 340, 67 S. E. 2d 350 (1951).

in by the associates can be viewed as a kind of "surplus." This artificiality continues the present law in North Carolina and reflects as well the present law in most other states. The alternatives present disadvantages. Section 47 also contains accountancy guides with respect to premiums or discounts on par value shares, and with respect to subscriptions, as well as upon transfers from surplus to stated capital. The Section also prescribes the effect on stated capital when shares are exchanged, converted, sub-divided, or consolidated, or when shares are issued in satisfaction of accrued dividends on preferred shares. One need hardly add that prior legislation gives scant attention to these matters.

Section 48, dealing with reduction of stated capital, remedies one of the most serious defects of the corporation laws of North Carolina. By a series of eroding amendments, G.S. 55-66, on "decrease of capital stock," had lost all direction as to proper methods of reducing capital, so that the only definitely certain procedure was a charter amendment reducing the par value of outstanding shares. The proposed provisions expressly recognize a charter amendment reducing par value as one way of reducing capital, and also establish a somewhat similar procedure (though not designated as a charter amendment) for reduction of the stated capital represented by no-par shares. Section 48 ventures onto new ground when it permits formal reduction of stated capital to be effectuated by directors' action in case of cancellation of treasury shares and in case of exchange, conversion, or released subscription of shares. Besides specifying the contents and the filing steps for the Certificate of Reduction of Stated Capital, the new provisions recognize that often a reduction of stated capital coincides with a charter amendment and, accordingly, they permit consolidation of documents into a single Articles of Amendment and Certificate of Reduction of Stated Capital.

Another novel feature of the proposed Act is Section 49, which is devoted to accounting concepts and standards of valuation that are closely related to the notion of stated capital. This Section offers guiding principles for the determination of surplus and the various categories and sub-categories thereof (earned surplus, capital surplus, reduction surplus, etc.), including the effects thereon of mergers, consolidations, and receipt by a parent corporation of a stock dividend made by a subsidiary corporation. Unrealized appreciation of assets cannot create profits or earned surplus but can give rise to a type of capital surplus. Some accounting principles relating to treasury shares are also touched upon. In order to safeguard the sources of dividends for shareholders or some class thereof, the consent of shareholders of designated classes is required before the directors can shift amounts from earned surplus to capital

surplus, or from capital surplus to a deficiency in the earned surplus account.

One of the most important changes in the proposed law is that relating to dividends. It is difficult to measure the extent of the change because of the uncertainties and ambiguities in the present act. G.S. 55-116 permits dividends from "surplus or net profits arising from its business." This could mean any number of things: (1) that dividends may be paid either (a) from excess of assets over liabilities and "capital stock" or (b) from net profits, thus providing two sources of dividends and allowing dividends, even if capital is impaired, from net profits; (2) that the latter term means either the over-the-years net profits balance or merely the net profits of the current year; (3) that "surplus" is used as an adjective, so that the test is always one of profits, either the profits of a single year or of the corporation's entire existence; (4) that, as the court remarked in one case,[16] "surplus or net profits" are what remains after deducting from the present value of all the assets the amount of all liabilities plus capital stock. (This would be purely a surplus test, with overtones suggesting the propriety of a surplus arising from unrealized appreciation of assets.)

Section 50 permits dividends from several sources. One is earned surplus, a source which is clearly available under the present law despite its many ambiguities. A second proposed source is "net profits earned during the current or preceding accounting period" (of not more than one year nor less than six months), regardless of impairment of capital. This accords with one possible interpretation of the present law. If one were to comment that the present law's dividend provisions were also susceptible of another interpretation giving more protection of creditors, two points should be noted: (1) such protection is illusory, since the shareholders alone, and not the creditors, have control over a capital reduction which can eliminate any impairment of capital; (2) the proposed law permits the charter to forbid dividends from this source to *common* shareholders (although this is not so with respect to *preferred* shareholders, that is because this second source of dividends should be available for preferred shareholders to prevent them from being coerced into an unfair plan of recapitalization).

(Recapitalization plans are typically brought forward at a time when the business is making money but capital is impaired. If dividends can be paid from surplus, and only from surplus, the legal obstacle to dividend payments can be eliminated by a capital reduction. The common stockholders have it within their power to keep or wipe out the deficit that is an obstacle to dividends and are thus in strategic position to

[16] Cannon v. Wiscassett Mills Co., 195 N. C. 119, 141 S. E. 344 (1928).

coerce the preferred into accepting a sacrificial plan. This coercive power is removed by the above mentioned second source of dividend.)

A third proposed source of dividends is capital surplus, which, incidentally, can include a surplus from unrealized appreciation of assets, but this source is available only for preferred shareholders. (One must reflect that, despite the name "shareholder," the position of a holder of preferred shares is something of a hybrid position between that of an out-and-out proprietor and of a creditor.) Under one possible interpretation of the present law, capital surplus (with the same unrealized appreciation feature)[17] is also available as a source of dividends, without distinction as to classes.

In addition, the proposed Act permits, but with safeguards, a *liquidating* dividend, meaning not dividends out of "stated capital" but dividends to common shares from capital surplus. Among the safeguards are the necessity of the vote of a majority of shares of all classes and a 2-to-1 ratio of assests to liabilities after distribution of a liquidating dividend.

Except in the case of the liquidating dividend, the proposed Act does not require any such ratios. The present law requires a 3-to-2 ratio for all dividends but relaxes this to a 4-to-3 ratio for public service corporations. Since the enactment of the present law some 50 years ago, more kinds of enterprises do business on a large ratio of borrowed capital, and the ratio idea, while having much to recommend it in theory, is not feasible in practice when applied to the distribution of earnings. Under the proposed Act dividends are forbidden in any case (and despite current earnings) if there is reasonable ground for believing that the corporation would be unable to meet its obligations as they become due in the ordinary course of business, or if the liabilities would thereafter exceed the assets. The liabilities imposed on directors should be a strong deterrent against skating on thin ice.

Special dividend provision is made for wasting asset corporations. In the absence of such provision, dividend law relating to such corporations is very uncertain.

The proposed Act requires disclosure to shareholders of the source of dividends not paid from earned surplus, or even if paid from certain kinds of earned surplus.

The proposed Act rejects the provisions of troublesome G.S. 55-115, requiring a corporation to pay out in dividends the "whole of its accumulated profits," after such reservation of "working capital" as the shareholders or directors may make. That section has been a trap for corporations. Nevertheless, it is believed that a shareholder has a justified resentment against seeing the corporation operate profitably year after

[17] See text to footnote 16, *supra*.

year, yet paying no dividends. (In a close corporation, this non-payment may be part of a "squeeze-play," or be motivated by the dominant shareholders' income brackets.) Accordingly, the proposed Act tries to give the aggrieved shareholder something more than the vague right of equitable relief against abuse of discretion by the directors in not paying dividends. The provision in question, Section 50 (i), is rather complicated, but in general provides that if a corporation has been paying less than one-third of its profits in dividends, holders of twenty per cent of the shares of the aggrieved class can demand and force payment, subject to certain qualifications. The provision represents an attempt to avoid playing into the hands either of a high-handed management or of corporate sharpshooters.

Section 51 contains fairly elaborate provisions relating to stock dividends, technically labelled "share dividends" in the proposed Act. The extent to which this would change existing law is difficult to determine, since neither the statutes nor judicial decisions of North Carolina have touched upon stock dividends. Some of the important aspects of this proposed Section are: determination of the amount to be transferred from surplus to stated capital upon declaration of a stock dividend; prohibition against what might be called "disruptive" stock dividends when the outstanding shares are of different classes (for example, no dividend in preferred upon common), coupled with relaxation of the prohibition under certain safeguarding conditions (for example, consent of majority of shares of class that would be adversely affected); disclosure of source of dividend as in case of cash dividends (otherwise the recipient is entitled to believe that even a stock dividend is based upon earned surplus); distinctions between a stock dividend and a distribution of treasury shares among shareholders or a stock split-up.

The last section in the Corporate Finance Article, Section 52, deals with the acquisition by a corporation of its own shares. On this matter the present law says little, and only indirectly at that: G.S. 55-116 states that a corporation may not "reduce, divide, withdraw or in any way pay to any stockholder any part of its capital stock. . . ." Presumably, this means that a repurchase which does not impair capital is lawful. From a strictly doctrinaire point of view, there is a certain logic in permitting repurchases out of surplus, and only out of surplus, but in practice there are sometimes legitimate business needs for a repurchase, regardless of surplus. There are also other overriding doctrines, for example, the statutory right of a dissenting shareholder to have the corporation purchase his shares. Accordingly, Section 52 permits certain re-acquisitions of a corporation's own stock regardless of any impairment of stated capital, as, for example, to compromise in good faith claims against shareholders, eliminate fractional shares, satisfy statutory claims of dis-

senting shareholders, perform a repurchase contract with an employee, enable an investment company to perform its agreement to buy back its shares, and to acquire for retirement its redeemable preferred shares.

Except in the situations above mentioned, the proposed Act limits repurchases to those that are made from surplus and still leave a 2-to-1 asset-liabilities ratio, and are made either (a) pro rata from all shareholders or all those of a class, or (b) on an organized stock exchange, pursuant to all the shareholders' consent, obtained, with full disclosure, within a year's period, or (c) from a shareholder with the consent of a majority of the shareholders of that class and of a majority of voting shareholders of other classes, excluding all shares of the shareholder in question. The aim is to prevent favoritism and to discourage using company funds to bolster the stock market, as well as to safeguard creditors as fully as possible in those repurchases which are not based upon strong business need. In addition, no repurchase, regardless of how legitimate the business need, can be made if the corporation would be insolvent under either the insolvency or balance sheet test; and some repurchases are forbidden if the shares to be repurchased are junior to senior shares with unpaid accrued dividends. A further prohibition is included against buying redeemable preferred shares when there are accrued dividends unpaid on those shares. The underlying idea is that a corporation should not be allowed to depress the market, and then to buy shares which it is already privileged to buy at the fixed redemption price. It can be argued that the prohibition should be extended to all purchase of preferred shares with dividends in default. Additional features of this Section are: acquisition of treasury shares is not per se a capital reduction; redemption may be by lot or pro rata as contracted for, or if the contract is silent, by lot or pro rata as the directors determine;[18] and treasury shares do not vote or carry dividends.

ARTICLE 6. SHAREHOLDERS

Few subjects have been productive of as many divergent views in noted cases as promoters' profits and watered stock. Proposed Section 53 deals with several problems not covered by present North Carolina law. Under it no-par shares are not a haven of refuge against liability.[19] The dollar value entered on the corporate books, rather than the number of no-par shares issued, is the key to the question of over-valuation. Also, under this Section, the issuance of shares to different takers at a price differential not justified by business reasons may impose liability on the person who knowingly got the favored treatment. This is statutory adoption of an equitable principle recognized in a well known federal

[18] The present law, G.S. 55-61, requires that provision for redemption must be for pro rata redemption.

[19] *Cf.* Piggly Wiggly Del. Inc. v. Bartlett, 97 N. J. Eq. 469, 129 Atl. 413 (1925).

case.[20] The draft also explicitly provides that those acquiring property under a fiduciary duty to a corporation cannot get more for the property when turned in for stock than their fiduciary responsibility permits.

The remedies, (1) cancellation of excess shares or (2) recovery of a money judgment replacing the water (to the extent necessary to protect those who have relied and been misled by the supposed fully paid shares) both run to the corporation which, if the court so decree, will hold any recovery for the benefit of those injured—*i.e.,* as a sort of trustee for them.

These liabilities on watered shares are not imposed on an innocent purchaser. Neither are they imposed on a person acting as a fiduciary, such as executor, unless he misleads by failure to disclose his status.

The liability of directors who fail to disapprove improper distribution of corporate funds and assets (Section 32) is supplemented in Section 54 by a corresponding liability on any shareholder who receives a distribution from an insolvent corporation or receives one which will render it insolvent. Shareholder liability is also imposed where a shareholder knowingly receives a distribution improper in some other respect.

Shareholders' unfair competition with creditors for the corporate assets is sought to be checkmated by Section 55. In liquidation, stale salary claims of "dominant shareholders,"[21] and and all other purported indebtedness to stockholders not of a sort which might reasonably have been incurred in a transaction in the market, will be subordinated to the claims of outside creditors. This statutory innovation will call for judicial aid in application, but in liquidation the parties are quite commonly already in court.

The law of stockholders' pre-emptive rights has taken varying shapes in other states. The present North Carolina law does not cover this field. The basic policy now proposed in Section 56 is one of flexibility; that is, the charter may determine whether there are such rights and what they are. Where the charter does not do so, the proposed Section, with definite listed exceptions, provides that shares carry a right to pro rata portions of new issues of their class (and to options and convertible securities which would have a call on their class) on terms substantially equal to those in the offering to others. The exceptions are that shares limited as to dividends and liquidation rights carry no pre-emptive right, convertible securities without pre-emptive rights get no such rights until converted, and no shares carry such rights in new offerings to raise the initial capital, to acquire needed property, to satisfy employee options or purchase contracts, to pay a share dividend, to satisfy existing con-

[20] Atlantic Rfg. Co. v. Hodgman, 13 F. 2d 781 (3d Cir. 1926). See also Section 46.

[21] Defined in Section 2 (6).

version rights or options, or when those rights are released by a two-thirds class vote. Provisions are finally added to assure that the freedom first granted to deny pre-emptive rights shall not be used by the board or by a class to "rig" the corporate control in violation of fiduciary duty.

Section 57 entitles only owners of fully paid shares to a certificate[22] which must state fully all rights and limitations pertaining to the particular class, or a summary thereof with a statement that complete information will be sent by the corporation on request.

By Section 58 a corporation is given wide discretion in dealing with fractional shares. It may issue either fractional share certificates which carry voting and dividend rights, or scrip which need not carry these rights, and it may be required that scrip be turned into full shares within a fixed time. These matters are not covered by the present law.

The most striking feature of proposed Section 59 is the extent to which it protects a corporation and its representatives in treating holders of record as entitled to the incidents of ownership.[23] Thus, except in the cases of certain fiduciaries whose authority is a matter of public record, such as executors, guardians and receivers, the corporation may ignore off record claims until it is satisfied, by proof, of the claimant's rights.[24] It may even deal with minor and incompetent record holders as fully qualified shareholders, despite notice of their want of legal capacity, until a court order requires otherwise.[25] None of this extends beyond the relation *inter sese*. Third persons dealing with purported shareholders are left to their common law rights or those under the Stock Transfer Act.

The matter of record dates and closing of the transfer books is left by Section 60 largely in the hands of the directors, with specific provisions for conducting business and meetings if the directors do not act.[26]

The subject of stockholders' meetings and elections occupies a large place in present Chapter 55. Even more extensive treatment of the subject is found in Sections 61-71 of the proposed Act. Aside from detailed provisions charting the mechanics of calling meetings, giving notice, ordering adjournments which result in a later meeting being held under the original call, etc., the principal new features are these:

[22] A rigid rule as contrasted with the provisions relating to dividends on partly paid shares, Sec. 50 (f), and as to voting rights, Sec. 67 (a).

[23] The draft goes far beyond the narrow provisions of G.S. 55-107.

[24] Corporate liability of the sort found in Wooten v. Wilmington & Weldon R.R., 128 N. C. 119, 38 S. E. 298 (1901) will no longer exist. The bond of the defaulting fiduciary, not the corporate treasury, should afford the protection.

[25] As pointed out in the annotations to the draft, a comparable, though not as sweeping, policy is found in G.S. 53-55 permitting bank accounts withdrawable on a 15-year-old minor's order. See 17 N. C. L. REV. 345 (1939).

[26] A maximum period of fifty days of closed books for all purposes and a minimum of ten days for meetings is provided. *Cf.* G.S. 55-110 which bars the voting of shares transferred withint twenty days previous to an election.

meetings are not confined to the state; a shareholder, by following procedure outlined as to notice, may get before any meeting any matter which he wishes considered; meetings for which proper notice has not been given will produce valid corporate action if certain guarantees of universal shareholder approval exist, such as full attendance or quorum attendance plus waivers or consents. Action without meeting is valid if written assents to the specific action taken are filed by all entitled to vote. The countenancing in these last respects of practices which would once have been unlawful is in candid recognition of realities, but under limitations which are thought to prevent harm.

While provision is made for a voting list open to inspection at the meeting and for ten days prior thereto at the registered office instead of the present requirement (G.S. 55-108) that the stock and transfer books be produced at meetings, the corporation is spared the necessity of preparing such a list if the records produced will supply the information desired in readily accessible form.

Minimum quorum requirements are fixed by Section 65 at one third of the voting shares with permission to make the fraction larger. To meet the difficulty disclosed by litigation in other states, the draft allows a meeting to proceed validly even if the attendance, once a quorum, falls below that figure by the departure of some shareholders. A majority vote of a quorum is made the basic rule for valid action, though variations upward by charter or by-law are permitted if they do not conflict with voting requirements as to particular matters elsewhere in the Act.

An earlier draft of Section 67 would have incorporated into law a familiar feature of preferred share contracts transferring to those shares the voting control of the corporation (regardless of their general voting powers, if any) when there is a dividend default of three years' standing. The transfer was to be for not more than three years and it was made mandatory upon presently existing corporations which do not provide equivalent protection for the preferred shareholders. On suggestions from members of the bar and after fuller consideration, this feature was dropped.

In the same Section, the policy of G.S. 55-110 as to cumulative voting is extended to all elections of directors but, in order to safeguard against surprise, requirements of notice and recess are added.

Rather full provisions in proposed Section 68 on proxies fill in gaps in the present law and lay down helpful working rules, but present nothing considered controversial unless the increase in the life of a proxy from the present three years maximum (G.S. 55-110) to ten years is so considered. The new section may also go beyond present law in allowing delegation by a proxy holder, a power usually expressed in proxy forms

of large companies. Unless delegation is agreeable to the shareholder he will hereafter need to express the contrary intent when he signs his proxy.

Proposed Section 69 carries forward the substance of G.S. 55-111 with the addition of needed rules as to who actually casts the vote when the shareholder is another corporation or when title or voting rights are in more than one person in some sort of joint ownership. It is followed by a section on the appointment and activities of voting inspectors. Present law has nothing concerning these temporary officials though, of course, they exist in practice.

Election contests are rather unsatisfactorily covered in G.S. 55-114. An effort has been made in Section 71 to work this out with more precision. Provision has been made for service by publication where necessary, and the section has been made applicable to disputed elections locally held by foreign corporations.

North Carolina is one of the states which have held voting trusts illegal.[27] Although it is acknowledged that there are some dangers in them, it seems to be the consensus of present day opinion that under proper control they can be a useful device, especially to assure some continuity of management in case of, for example, attempted corporate rehabilitation. Section 72 adopts this change of policy, but limits the life of such a trust to ten years. The agreement must be on file with the corporation whose shares are trusteed and must be subject to examination by corporate shareholders. This is a protection to those not in the trust. Correspondingly those in the trust (the certificate holders) are given extensive rights as follows: (1) to inspect a list of certificate holders under rules like those set out in Section 38 for inspection of corporate records by shareholders; (2) similarly to inspect the corporate records though they are no longer shareholders of record; and (3) to vote as if they were shareholders on certain stated fundamental corporate changes, a scheme being set out for giving them notice of such proposals.

There has developed a feeling that some of the rules applicable to corporations whose shares are publicly held should be relaxed for small, close corporations which are essentially partnerships. Section 73, in addition to recognizing shareholders' agreements as to voting their shares as a unit,[28] seeks to give fruition to the argument just mentioned and would permit binding agreements relating to management, distribution of profits, etc., out of harmony with usual rules governing corporations, as for example, those concerning directors' discretion.

It has often been said that shareholders have no fiduciary duty to each other. That doctrine is beginning to crumble where a controlling

[27] Harvey v. Linville Imp. Co., 118 N. C. 693, 24 S. E. 489 (1896).
[28] *Cf.* Thompson v. Thompson Carnation Co., 279 Ill. 54, 116 N. E. 648 (1917).

shareholder or group dictates corporate action and Section 74 adopts the newer view by declaring that "dominant shareholders" (those who alone or in concert can elect the board)[29] "stand in a fiduciary relationship to the corporation and to other shareholders."[30]

ARTICLE 7. STOCK TRANSFER

This is the Uniform Stock Transfer Act incorporated without change from the General Statutes as Sections 75 to 98 of the proposed Act.

ARTICLE 8. FUNDAMENTAL CHANGES

Article 8 of the proposed Act deals with fundamental changes to or within the corporation as a going concern, *i.e.,* charter amendment, merger, consolidation, and the similar ends that are attained by sale of assets for corporate securities and by the consummation of plans that change shareholders' positions through exchange of securities. The grouping of these topics in one Article (Sections 99-113) departs from the sequence of the present law but is justified on functional grounds. The proposed Act, however, does far more than make a rearrangement; it explores entirely new areas, since here again is a field wherein great changes have taken place since the enactment of the present law.

The first of these sections, Section 99, relates to charter amendments. Like the present law, it empowers a corporation to amend in any respect, but it clarifies this generality by specifically indicating sixteen items of permitted change, as against the six specific items mentioned by the present law in G.S. 55-31. A lawyer often has misgivings about relying on general language and can proceed with greater certainty in making desired amendments if the specific amendment is expressly indicated in the statute. The present discussion is too general to explore each of these specific items, but one in particular deserves a few words. This is the one which authorizes amendments "to cancel or otherwise affect the right of the holders of the shares of any class to accrued dividends or dividend credits as defined in this chapter." Upon this paragraph would rest a charter amendment which effectuates the familiar so-called "recapitalization" which wipes out the arrearages which have piled up on cumulative preferred stock. Under the present law, these arrearages were considered "vested" and could not be eliminated without the consent of a preferred shareholder.[31] No doubt that afforded protection to the preferred shareholder (except for an ingenious evasion through a phony merger), but it was too rigid. It is better to authorize this type of amendment but to safeguard it, as does the proposed Act, by (1) requiring a class vote of the preferred, (2) granting rights to dissenters,

[29] See definitions, Section 2 (6).
[30] Zahn v. Transamerica Corp., 162 F. 2d 36 (3d Cir. 1947) shows this doctrine in application.
[31] Patterson v. Durham Hosiery Mills, 214 N. C. 806, 200 S. E. 906 (1939).

(3) removing the power of the common shares to "illegalize" dividends to preferred shares when capital is impaired[32] and (4) not leaving a loophole of evasion through phony mergers.

The procedure for charter amendment is set out in Section 100. (This section also includes a provision for a very simple procedure if the amendment is made before shares are issued.) Among the novel features, as compared with the procedure under the present law, are these: (1) for certain amendments, set forth in proposed Section 101, the vote of the shareholders must be by classes; (2) any charter clause requiring a larger vote than the normal two-thirds vote of shareholders can itself be amended only by such larger vote; (3) for certain types of amendments which would cut down the rights of preferred shareholders, a dissenter has the right to be paid off in cash; (4) the notice of shareholders' meeting to act on a charter amendment must apprise the shareholder of the statutory right of cash to dissenters.

Section 101 indicates twelve types of amendments which require a vote by classes. Speaking generally, this class voting is required where the amendment would reshuffle the position of the different classes of shareholders. Proposed Section 101 also indicates what types of amendment give rise to cash-to-dissenter rights. In general, these are amendments which trim down, or are a step in trimming down, the rights of preferred shareholders. These requirements are not found in the present law.

Section 102 is designed to protect dissenting preferred shareholders against such unfairness as may exist in a plan of recapitalization which needs no charter amendment but which subordinates those who do not accept the plan to those who do. Examples would be an offer to holders of six per cent cumulative preferred shares with unpaid arrearages to exchange their shares (with arrearages) for four per cent bonds or notes or for a four per cent prior preferred already authorized by the charter. Such exchanges have a coercive effect on those who do not accept, since the greater the number of shares which do accept, the further subordinated is the non-accepter. Section 102 gives to dissenters in such a case a right to appraisal and cash, and requires that the offer of exchange inform them of this right. The entire section reflects a new idea not in the present law.

Section 103 prescribes the contents of the Articles of Amendment and the mechanics of its execution and filing. It is a guide for the office lawyer. Though the details differ, the area is covered by the present law.

Section 104 simply preserves existing causes of action and rights of persons other than shareholders against a charter amendment, and pro-

[32] See discussion of the new Act's Section 50, *supra*.

vides for non-abatement of actions despite corporate change of name. These legal consequences are not spelled out in the present statute, but probably only reflect general principles of law.

Section 105 permits the directors to consolidate in one document the original charter and all subsequent amendments, and to file this document in public records as the restated charter of the corporation. A copy thereof certified by the Secretary of State shall be presumed, until otherwise shown, to be the full and true charter. This mechanism, new in North Carolina legislation, is for the purpose of having a handy charter document instead of, as heretofore, a charter plus, say, fifteen subsequent amendments.

The next seven sections of Article 8 relate to merger and consolidation of corporations. Sections 106 and 107 lay down the preliminary procedure for, respectively, merger and consolidation. This procedure consists of the approval by the Board of Directors of each corporation of a "plan of merger" (or of consolidation). These sections prescribe the contents of such plan and permit, in the case of the merger, inclusion therein of statements of any changes in the charter of the surviving corporation to be effected by the merger. Except for minor changes in details and terminology (for example, "plan" of merger to be *executed* by *corporate officers* instead of an "agreement" to be *signed* by the *directors*), this represents no substantial change from the present law, G.S. 55-165, first paragraph.

By Section 108, the plan of merger or consolidation is submitted to vote of the shareholders. At this point the proposed Act presents certain differences from the old one. (1) The proposed Act requires no "publication at least once a week for four successive weeks in a newspaper," as does present G.S. 55-165. (2) The proposed Act requires that the notice of meeting sent to the shareholders inform them of the cash rights of dissenters, whereas the present Act, though giving dissenters such rights, requires no such information. (3) The proposed Act requires the vote of two thirds of all the outstanding shares, regardless of whether otherwise entitled to vote, and requires the two-thirds vote of any classes of shares that are entitled to vote as a class. The present law merely requires the vote of a "majority of the outstanding shares entitled to vote." (4) Impliedly recognizing that a merger, particularly the so-called "phony merger," is often merely a device to effectuate a charter amendment when there is a desire to avoid the law relating to charter amendments, the proposed Act requires class voting on a merger that effectuates such changes as would require class voting if those changes were made directly by charter amendment. Similarly, if by virtue of the charter an amendment thereof would require more than the two-thirds vote, so does a merger. These features are not in the present law.

By Section 109, the proposed Act provides for the execution and filing of Articles of Merger (or Consolidation) and prescribes their contents.

The effect of merger or consolidation is set out in Section 110. As in the present law, in a merger one and only one of the constituent corporations survives, preserving its "entity"; in a consolidation, the old corporations disappear into a new corporate entity. As in the present law, though with fewer words, the rights (proprietary, contractual, etc.) of each constituent corporation become those of the surviving corporation, as do the debts and other obligations of each corporation.

Proposed Section 111 expressly authorizes, as does the present law, the merger or consolidation of North Carolina corporations with those of other states having similar authorization, and the surviving or successor corporation may be either of this state or of the other state. Rights of dissenting shareholders in any constituent corporation are preserved, and jurisdiction is retained to enforce these rights as well as the obligations of the constituent corporations.

Proposed Section 112 deals with sale, lease, exchange and mortgage of assets and is included in the Fundamental Change Article on the theory that such transactions, at least when covering all or substantially all the assets, are fundamental changes, particularly when the sale is for stock of a purchasing corporation. Indeed, the sale-of-assets-for-stock technique has long been a favorite device for achieving, in effect, merger, consolidation, charter amendment, reincorporation or other reorganization.

As to giving mortgages, proposed Section 112 authorizes the Board of Directors to act without vote of the shareholders, even though the mortgage covers all assets. Much can be said pro or con, but it was believed that, regardless of the view taken, the law should be clearly stated. Absent statute the law is uncertain on this point.

As to sale of assets, leases, and exchange of assets, the proposed Act provides that unless otherwise provided in charter or by-laws, the Board of Directors can itself authorize some of these, for example, sale for cash to meet liabilities when in failing condition, or sales by a corporation incorporated to liquidate certain assets, or dispositions not meant to terminate but rather to further the business. Other sales, leases, and exchanges of assets must be authorized by the shareholders. A sale of all, or substantially all, assets for stock of the purchaser not only requires shareholder authorization but is subject to cash rights of dissenting shareholders under proposed Section 113. The reason for granting dissenters' rights in such a sale is that the sale is, in effect, a merger or consolidation or even, in a given situation, a charter amendment. The voting rights and dissenting rights of shareholders in such a sale for

stock, therefore, are approximated in the new law to those granted in case of charter amendment. Accordingly, class voting is required if the sale for shares is part of plan of distribution of the shares which would so change shareholders' rights or entitle them to class voting were the change made directly by charter amendment. These features relating to sale of assets are new; about the only treatment of the matter in the present law is to give corporations the power to sell all corporate property on a "two-thirds vote of the stock entitled to vote." (G.S. 55-26, item 11).

The last section under Fundamental Changes is the cash-to-dissenters section, Section 113. It grants cash rights to dissenting shareholders in such fundamental changes as certain charter amendments (those specifically indicated in proposed Section 101, already discussed), merger, consolidation, sale of assets for shares, etc. The proposed plan is for the shareholder to register his written dissent prior to or at the shareholders' meeting and then, within twenty days after the vote, to make written demand for payment of the fair value of his shares. (In case of a fundamental change in shares effected by an exchange of securities without a meeting, the time of dissent and demand are necessarily somewhat different in detail but still along the same theory.) This dissenters' right to cash is expressly made a cumulative remedy, over and above any remedies which he may have in law or equity for fraud violation of fiduciary duties, etc. If the parties can't agree to the fair value, the court, upon petition of the shareholders, will determine it. Under the present law, with respect to merger or consolidation only, the court appoints three appraisers to determine the value. Presumably under the proposed Act the court can still refer the matter to referees or special masters, but more flexibility is provided. The scheme, therefore, in mergers and consolidations is, under the proposed law, much as before. It must be remembered, however, that the scheme of dissent and payment is now extended to other fundamental changes. Also, there is an important innovation which sets a floor to the determination of the value of preferred shares. If, under the corporate change giving rise to a preferred shareholder's right of payment, any *junior* shares retain their participation in the enterprise without fairly paying for it, then the fair value of the *senior* shares cannot be set below two thirds of the preference to which they would be entitled on voluntary liquidation. This innovation is meant to foreclose the paradoxical findings that (1) the preferred is worth far below its liquidation priority of, say, par plus arrearages but that (2) the enterprise is so valuable that the junior shares have a substantial equity in the business justifying the position

given to them in the fundamental corporate change from which the preferred shareholder is dissenting.[33]

If the notice of meeting sent to shareholders for their action on a fundamental change does not apprise them of their cash-to-dissenter rights, a shareholder otherwise entitled to bail out for cash may, if he so demands within a year after the effective date of the fundamental change, recover the damages which he may have suffered thereby.

Proposed Section 113 expressly recognizes that the corporation's liability so to pay a dissenter for his shares extends to the successor corporation in a merger, consolidation or sale of assets.

Proposed Section 113 concludes with provisions that shares acquired from a dissenter may be held and disposed of as in the case of other treasury shares, and that these cash-to-dissenters provisions do not apply to a merger between a parent and a wholly owned subsidiary where no changes are made in the relative rights of the shareholders. There is no reason to give the parent's shareholders a right to bail out in such a case.

ARTICLE 9. DISSOLUTION AND LIQUIDATION

Dissolution is the event which brings an end to a corporation as a going concern; it exists thereafter, not to carry on the business authorized by its charter, but to liquidate and distribute. The proposed Act recognizes in Section 114 that dissolution may come about in a variety of ways, both voluntary and involuntary. In succeeding sections it charts in detail the steps to be taken when the dissolution is to be accomplished (1) by voluntary action of the directors alone,[34] (2) by action of the stockholders, or (3) by proceedings in court to liquidate, initiated by the Attorney General or by private parties for various causes. The causes for which the Attorney General can force dissolution are those already found in the present statute, plus a few new causes designed to back up regulatory provisions in earlier sections of the draft;[35] however, those for which private parties may petition for liquidation include some that are new to local jurisprudence. The most notable among the new causes are those which permit judicial liquidation in a shareholder's action on (1) a showing that the directors are in a deadlock and the shareholders cannot break it, with resulting paralysis, or (2) that a deadlock of shareholders has for two years prevented the election of directors.[36] One other new basis for court intervention is the existence

[33] For such a paradox, see these aspects of valuation in the York Ice Machinery merger: Hottenstein v. York Ice Mach. Corp., 136 F. 2d 944 (3d Cir. 1943) and 146 F. 2d 835 (3d Cir. 1944).

[34] Permitted in a limited class of cases, as for example where the corporation has become bankrupt.

[35] Such as refusal to produce records on order, Section 38, or to observe rules relative to registered agent, Sections 13, 14.

[36] See Note, 32 N. C. L. REV. 335 (1954).

of a contract binding all shareholders which entitles the complainant to liquidation or dissolution. This last provision furthers the policy already noted of allowing shareholders in "incorporated partnerships" wide latitude in their contracts governing corporate matters.[37]

The provisions for liquidation contained in Section 119 (for non-judicial liquidation and dissolution) are routine, except that at the recent suggestion of a member of the Bar there has been added a subsection giving an objecting shareholder a right to be paid out under an appraisal as provided in Section 113 where the scheme of liquidation transfers the net corporate assets to the shareholders in co-ownership to operate as a new partnership.

After liquidation is complete, or supposedly so, the corporation still possesses a slender sort of existence, under Section 114, for the purpose of liquidating any assets "inadvertently omitted" theretofore, and can maintain or re-establish officials for that purpose. Aside from this newly discovered asset provision, rights of and against the corporation are cut off two years after the filing of a certificate of completed liquidation, unless, of course, they are sooner barred by the general statute of limitations. Under this provision, however, it is intended that a sealed obligation not so barred which is tardily discovered can still be liquidated and, what is more important, undisposed of real estate of vanished corporations can still be liquidated by use of the procedure set out for re-establishing the corporate structure, or by appointment of a receiver. It is understood that there is need of legislation for that situation.

ARTICLE 10. FOREIGN CORPORATIONS

The present requirement that foreign corporations doing business in this state must domesticate is preserved in the proposed Act, but a more definite guide for determining the necessity for local registration is provided. This is accomplished by listing, in proposed Section 131, a number of activities that may be carried on by a foreign corporation without procuring a certificate of authority. The present policy of excluding foreign corporate fiduciaries is continued by Section 132.

The proposed Act is perhaps the first in any state designed to discourage incorporation under the laws of states with lax corporation laws for the purpose of evading the local law. A "pseudo-foreign corporation" is defined in Section 2 (11) as a foreign corporation which after the enactment of the proposed Act obtains for the first time a certificate of authority to transact business in North Carolina and which engages in no substantial business activity in the state of its incorporation, and which by virtue of the place and character of its business is more closely identified with the business life of North Carolina than with that of any

[37] See Section 73.

other state. The directors of a pseudo-foreign corporation are, in Section 134, made subject, to the same extent as directors of a domestic corporation, to some of the liabilities of directors of a domestic corporation, to the jurisdiction of the courts of this state and to service of process. Various provisions for the protection of the rights of shareholders of domestic corporations are made applicable to shareholders of a pseudo-foreign corporation. The proposed Act defines also a "pseudo-foreign parent corporation" and provides that such a corporation and its directors, officers, and shareholders are subject to the same duties as a pseudo-foreign corporation (Section 135). It is also provided that an action may be brought against such corporations to compel them to reincorporate in North Carolina and dissolve in the state of incorporation when it appears that the laws of that state afford substantially less protection to creditors or shareholders than does the proposed Act. (Section 136).

The procedure for procuring a certificate of authority to transact business is set out in Sections 138 and 139, in much greater detail than in the present law. The maintenance of a registered office and registered agent is required of foreign corporations authorized to transact business in this state. For the convenience of the practicing lawyer, the procedure for effecting such registration and making changes as the need arises is prescribed in detail. (Sections 141-142).

Section 143 contains a provision, which goes considerably beyond the present law, for suits against domesticated foreign corporations. The policy is to treat the foreign corporation which is authorized to transact business in this state just as a domestic corporation is treated, insofar as suability is concerned. If such a corporation fails to appoint or maintain a registered agent in North Carolina, or whenever such agent cannot be found, then the Secretary of State becomes an agent upon whom process may be served. The substituted service provided is not limited to causes of action arising in this state. See Section 143 (c). This would change the rule established in certain North Carolina decisions,[38] but the change is justified not only on grounds of wise policy but also because any constitutional necessity for the present rule has apparently vanished. Express consent to such substituted service is required at the time the foreign corporation domesticates, and such express consent has been held to cure the constitutional difficulty presented by transitory causes of action.[39]

The present rule as to substituted service on foreign corporations which transact business here without domesticating is preserved by Sec-

[38] *E.g.*, Central Motor Lines, Inc. v. Brooks Transportation Co., 225 N. C. 733, 36 S. E. 2d 271 (1945); Hamilton v. Atlantic Greyhound Corp., 220 N. C. 815, 18 S. E. 2d 367 (1942).

[39] Pa. Fire Ins. Co. v. Gold Issue Mining Co., 243 U. S. 93 (1917).

tion 144. This provision limits such substituted service to causes of action arising out of business transacted in this state, so that it will not be available for transitory foreign causes of action. The explanation for the paradox that a foreign corporation which fails to comply with the law is treated more generously than the foreign corporation which does domesticate is that the former will have filed no express consent to such substituted service and constitutional problems might be presented in the absence of this limitation.

Foreign corporations are by Section 145 made subject to local suits by residents of North Carolina in some situations where they have engaged in specified activity giving rise to a cause of action locally, even though they are not so "transacting business" as to be required to obtain a certificate of authority.[40] *International Shoe Co. v. State of Washington*[41] is thought to have removed the constitutional barriers against such an extension of jurisdiction over a foreign corporation which is not so transacting business as to come within the domestication requirements. Provision is also made for substituted service in this situation. It is thought that wise policy favors subjecting such foreign corporations to suit here for the convenience of residents of this state where it is constitutionally possible, since the alternative is to force our residents to bring their actions in foreign jurisdictions.

A very detailed procedure is provided, in Section 146, for serving foreign corporations by service on the Secretary of State. This section should be of great assistance to the practitioner for it is modeled after the Non-resident Motorist Statute and provides a clear, step-by-step method of procedure.

Many gaps in the present law are filled by the provisions for withdrawal of domesticated foreign corporations and revocation of certificates of authority. (Sections 150-151). Various acts or failures to act will subject the domesticated foreign corporation to revocation; examples are failure to establish and maintain the required registered agent, and

[40] These far-reaching assertions of jurisdiction in favor of local citizens and of persons having a place of business in the state relate to causes of action arising out of (1) any contract made or to be performed here, see Compania de Astral, S. A. v. Boston Metals Co., —— Md. ——, 107 A. 2d 357 (1954); (2) business solicited here when there have been repeated solicitations, *cf.* Kneeland v. Ethicon Suture Labs., 257 P. 2d 727 (Cal. App. 1st Dist. 1953); Jeter v. Austin Trailer Equip. Co., 265 P. 2d 130 (Cal. App. 2d Dist. 1954); (3) the production or distribution anywhere of goods reasonably expected to be used here; (4) a tort committed here, see annotation, 25 A. L. R. 2d 1202. And jurisdiction is assumed in favor of any person over a foreign parent corporation by service on its local subsidiary on any cause of action against the subsidiary for which on principles of disregarding the corporate entity or otherwise the parent would be liable. *Cf.* Cannon Mfg. Co. v. Cudahy Pkg. Co., 267 U. S. 333 (1925); Industrial Research Corp. v. Gen. Motors Corp., 29 F. 2d 623 (N. D. Ohio, 1928); Skupski v. Western Nav. Corp., 123 F. Supp. 309 (S. D. N. Y. 1954).

[41] 326 U. S. 310 (1945).

the making of a willful misrepresentation as to any material matter in any document submitted as required by the proposed Act.

Foreign corporations already domesticated at the time the proposed Act becomes effective are placed, by Section 153, both as to rights and duties, in the same position as foreign corporations domesticating under the proposed Act. There are some saving clauses, however, which except such previously domesticated foreign corporations from some requirements, such as designating a registered office and registered agent if it has already done so under the present law.

The present penalties for transacting business in this state without a certificate of authority are preserved in Section 154, and several new ones have been added.

It is felt that the provisions concerning foreign corporations are a distinct improvement over the present law, both because many gaps are filled and because more policy considerations are resolved in favor of local interests.

ARTICLE 11. FEES AND TAXES

In two Sections, 155 and 156, the draft assembles the various exactions payable to the office of the Secretary of State which are scattered over several sections in the General Statutes and adds a few new fees for new services to be rendered by that office, such as those in connection with reserving a corporate name.

ARTICLE 12. MISCELLANEOUS PROVISIONS

The requirement, which is provided for in G.S. 55-53, of "special reports" by corporations to the Secretary of State on his call is a little vague as to the extent and nature of the information to be supplied, since the special reports are to be of the "same character as their regular reports," of which there seem to be none required. Section 157, following the Model Act, turns this requirement into one calling for answers to interrogatories from the Secretary which will show whether the corporation is complying with the law. Violations so uncovered are to be referred to the Attorney General and penalties are imposed for failure to answer and for knowingly answering falsely. The information received is not open to public inspection.

Certificates of the Secretary of State and copies of filed documents certified by him are made by Section 161 prima facie evidence of their recitals. To take advantage of scientific developments, Section 163 would permit the filing or recording of a photostatic copy as full compliance with a requirement that any document be filed or recorded. The proposals had already authorized the Secretary of State to use photostatic copies for certification under Section 4 (c).

Two provisions relative to the giving of notice are next set out, the first allowing a written waiver as a substitute for such notice, the second doing away with the requirement of notice to persons living in foreign countries when there are governmental restrictions, such as Trading with Enemy acts, on such action.

After an inquiry which disclosed that there still exist under present law some non-profit corporations with capital stock which might be prejudiced by being required to reincorporate under the proposed new non-profit (non-stock) corporation act, a clause was added to the repealer section which assures their continued existence governed, as consistently already provided in Section 3 (b), by this Act so far as it is appropriate.