



NORTH CAROLINA  
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# NOTES BEARING INTEREST

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## The Chair's Comments

For those of you who attended our Section Annual Meeting in Pinehurst, you enjoyed great programs as well as a variety of opportunities for fellowship with other business lawyers from across our state. Attendance was at an all-time high, and we again thank members of the Corporate Counsel Section for their contributions as joint planners and co-sponsors of the event. Also, many thanks to Stuart Johnson and Lisa McDougald, co-chairs of the Planning Committee, and to Steve Lynch, chair of our CLE Committee, for their leadership in planning this event.



William B. Gwyn Jr.

One of the highlights of the annual meeting was presentation of the first

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## In re Disney:

### A Stroll Through Chancellor Chandler's Magic Kingdom

By STEPHEN F. LATER

#### Introduction

The decision of the Delaware Supreme Court in *In re The Walt Disney Company Derivative Litigation*, 906 A.2d 27 (Del. 2006) is notable for its elaboration upon the good faith required of corporate directors, and, yet, *Disney* is significant, too, for its consideration of corporate minutes. The appropriate level of corporate minutes – minimal minutes that record acts without notes of discussion, minutes that record acts and synopses of debate, and verbatim transcripts of the proceedings – is a subject of longstanding debate amongst lawyers. *Disney* offers valuable guidance to lawyers in their advice to clients about the best manner in which to record corporate minutes.

#### Disney Litigation

*Disney* was a shareholder derivative action brought against Michael Ovitz ("Ovitz"), the former president of The Walt Disney Company ("Disney"), and the Disney directors in office at the time of the execution of an employment agreement between Ovitz and Disney (the "OEA") pursuant to which, Ovitz, terminated without cause just 14 months into the five-year OEA, collected a \$130 million severance package. *Disney* addressed the sufficiency of the directors' discharge of their duties of care and loyalty in their 1995 approval of the OEA and, ultimately, the directors' entitlement to the protections of the business judgment rule and its presumption that, so long as there is no evidence of director fraud, bad faith or self-dealing and "any rational business purpose"<sup>1</sup> can be attributed to the directors' decision, corporate directors "acted on an informed

basis... and in the honest belief that the action taken was in the best interests of the company [and its shareholders]."<sup>2</sup>

The *Disney* court turned, naturally, to the corporate record related to the approval of the OEA. Chancellor William B. Chandler III, in denial of a pre-trial motion to dismiss, noted the thin record of informed debate amongst the directors and thus concluded that the evidence was insufficient to support application of the business judgment rule prior to trial.

Chancellor Chandler observed that the *Disney* compensation committee, without the assistance of an executive compensation expert, reviewed the terms of the OEA but that committee members received an incomplete "rough summary" of the OEA in lieu of a draft of the OEA or "any of the materials already produced by Disney regarding Ovitz's possible employment. No spreadsheet or similar type of analytical document showing the potential payout to Ovitz throughout the contract, or the possible cost of his severance package upon a non-fault termination, was created or presented."<sup>3</sup> The Chancellor was, in fact, compelled to further note in his trial opinion that "[i]t would have been extremely helpful to the Court if the minutes had indicated in any fashion that the discussion relating to the OEA was longer and more substantial than the discussion relating to the myriad of other issues brought before the compensation committee that morning."<sup>4</sup>

The Delaware Supreme Court ultimately affirmed the conclusion of the trial court that the directors' review of the issue was sufficient but wrote that, "although the commit-

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## Comments *from page 1*

Distinguished Service Award for the Business Law Section. June Basden, chair of the Awards Committee, presented the award to Jim Beckwith for his extraordinary and distinguished service to the section over many years. The award was well-deserved, and emphasizes the importance of recruiting and retaining members who will provide an exceptional level of service and leadership in section activities.

Another highlight was the adoption of the first Statement of Professionalism for the Business Law Section. The distribution of the Statement was the culmination of a multi-year project of our Ethics Committee led by Anna Mills and Kathryn Purdom to provide aspirational guidelines for business lawyers in our state. We greatly appreciate their leadership on this project. A copy of the Statement is available in this newsletter and also on the section Web site at <http://business.ncbar.org/> I encourage each section member to distribute the Statement to attorneys within your respective firms. You might also consider using it as a basis for conversations with both partners and associates in maintaining focus while balancing the competing pressures on business lawyers in today's environment.

The meeting concluded with Milan Pham's update on NC LEAP, our pro bono initiative to provide legal services to low-income entrepreneurs. NC LEAP is actively recruiting business lawyers to provide limited pro bono legal assistance. We also need volunteers to spread the word about NC LEAP to organizations and agencies in their respective communities who know or work with low-income businesses. If you are interested in participating yourself or know of others with interest, please review the Web page at [www.ncbar.org/public/ncleap/index.aspx](http://www.ncbar.org/public/ncleap/index.aspx). You may also contact [NCLEAP@ncbar.org](mailto:NCLEAP@ncbar.org) or Patrick Johnson, NC LEAP Committee chair, at [pjohnson@brookspierce.com](mailto:pjohnson@brookspierce.com) with questions or to volunteer.

Also of note, the Legal Opinion Committee recently completed their work on the supplement to the Report on Third

Party Legal Opinions. Led by Kenny Greene, Chris Capel and Rich Schell, the committee wrestled for almost two years with recent issues affecting both givers and receivers of opinions in business transactions to develop an update to the 2004 Report. Many thanks to Kenny, Chris and Rich and their committee for their work and talents in preparing this Supplement. Both the Supplement and the 2004 Report are available on the section Web page.

Other current projects of our section committees include (i) revisions to the Business Corporation Act chaired by John Miller, (ii) revisions to the Limited Liability Company Act led by Warren Kean and Mark Davidson, (iii) development of a white-paper comparing the corporate laws of Delaware and North Carolina, chaired by Ben Baldwin and Kevin Pranke, (iv) study of possible revisions to the UCC chaired by Rick Brown, (v) study of additional practice tools to provide to members led by Jim Snow and Jeffrey Batts, and (vi) identification of better ways to provide more useful information to our members through our Web page and e-mail, led by Scott Dillon. Jim Beckwith, editor of our newsletter, continues to invite section members to propose articles on timely topics for our newsletter.

For many of us, March and April mean NCAA basketball playoffs, baseball season, the Masters Golf Tournament, and spending more time outdoors. As we all look forward to the activities of the spring and summer, please also consider getting involved in one of our projects if you are not already.

Also, if you have ideas as to how our section might provide other member benefits that you would find useful, please let us know. You can either contact me at [bgwyn@williamsmullen.com](mailto:bgwyn@williamsmullen.com), or our outstanding NCBA staff liaison, Jane Weathers at [jweathers@ncbar.org](mailto:jweathers@ncbar.org), with your thoughts. We look forward to hearing from you. ■

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tee's process did not fall below the level required for a proper exercise of due care, it did fall short of what best practices would have counseled.<sup>55</sup> The Supreme Court continued that, under a best practices scenario, "all committee members would have received, before or at the committee's first meeting..., a spreadsheet or similar document prepared by (or with the assistance of) a compensation expert.... Making different, alternative assumptions, the spreadsheet would disclose the... [payouts under the OEA] in each circumstance that might foreseeably arise.... The contents of the spreadsheet would be explained to the committee members, either by the expert who prepared it or by a fellow committee member similarly knowledgeable about the subject. That spreadsheet, which ultimately would become an exhibit to the minutes of the compensation committee meeting, would form the basis of the committee's deliberations and decision."<sup>56</sup>

The court noted, in fact, that, "[h]ad that scenario been followed, there would be no dispute (and no basis for litigation) over what information was furnished to the committee members or when it was furnished."<sup>57</sup> The failure of the Disney board to maintain sufficient corporate minutes thus resulted in a decade of litigation and a 37-day trial of the claims against the Disney directors.

### North Carolina Application

As the "center of the corporate universe,"<sup>58</sup> the decisions of Delaware courts are, of course, instructive to corporate practitioners in North Carolina. Indeed, although "North Carolina does not blindly follow Delaware corporate law..., it frequently looks to the wealth of experience and sound guidance found in the Delaware corporate law decisions when issues of first impression arise."<sup>59</sup>

The North Carolina Business Corporation Act (the "Act") provides that corporate directors are charged with oversight of corporate affairs and states that "[a] director shall discharge his duties as a director... (1) [i]n good faith, (2) [w]ith the care an ordinarily prudent person in a like position would exercise under similar circumstances, and (3) [i]n a manner he reasonably believes to be in the best interests of the corporation."<sup>60</sup> Further, in the absence of knowledge otherwise, "directors are entitled to rely on information, opinions,

reports or statements prepared or presented by corporate officers or employees reasonably believed to be reliable and competent, legal counsel, public accountants and others reasonably believed to be within their professional or expert competence, and board committees reasonably believed to merit confidence."<sup>61</sup>

Finally, whereas corporate directors are exposed to personal liability for, inter alia, gross neglect, mismanagement, and fraud, the business judgment rule shields directors from errors of judgment made in good faith. The business judgment rule "creates, first, an initial evidentiary presumption that in making a decision the directors acted with due care (*i.e.*, on an informed basis) and in good faith in the honest belief that their action was in the best interest of the corporation, and second, absent rebuttal of the initial presumption, a powerful substantive presumption that a decision by a loyal and informed board will not be overturned by a court unless it cannot be attributed to any rational business purpose"<sup>62</sup> and thus "protects corporate directors from being judicially second-guessed when they exercise reasonable care and business judgment."<sup>63</sup>

It is thus critical in North Carolina, as in Delaware, that corporate directors ensure the adequacy of the records of their proceedings in order to enjoy the protections afforded by the business judgment rule.

The references to minutes in North Carolina law are brief and, unfortunately, uninformative. Section 16-01(a) of the Act provides that "[a] corporation shall keep as permanent records minutes of all meetings of its incorporators, shareholders and board of directors, a record of all actions taken by the shareholders or board of directors without a meeting, and a record of all actions taken by a committee of the board of directors in place of the board of directors on behalf of the corporation."<sup>64</sup> There is, however, no elaboration upon the applicable, or indeed the expected, standards therefor.

Further, in North Carolina as in Delaware, "[a]s a general rule the minutes of a corporation are the best evidence of its acts, resolutions, and proceedings; and, when they are complete, when no fraud or mistake is shown, and it does not appear that there is any error or omission, parol evidence is not admissible to contradict, modify, or vary the record. If

the language is ambiguous or its meaning is indefinite, or if the minutes are incomplete and fragmentary, parol evidence may be heard to show what was done."<sup>65</sup>

The North Carolina Court of Appeals addressed the proper scope of the minutes, albeit in the context of a county board of commissioners and its obligations under the North Carolina Open Meetings Law,<sup>66</sup> and noted that "[t]heir purpose is to reflect matters such as motions made, the movant, points of order, and appeals-not to show discussion or absence of action."<sup>67</sup> The Court of Appeals cited Robert's Rules of Order Newly Revised and its statement that the minutes "should contain mainly a record of what was *done* at the meeting, not what was *said* by the members."<sup>68</sup> Indeed, whereas **Disney** commends the annexation to the minutes of all materials distributed to board members, Robert's Rules of Order Newly Revised simply notes that "[w]hen a committee report is of great importance or should be recorded to show the legislative history of a measure, the assembly can order it 'to be entered in the minutes,' in which case the secretary copies it in full in the minutes."<sup>69</sup>

### Conclusion

The traditional position, which generally favors minimal minutes, is that this approach reduces the likelihood of inaccuracies and the opportunities for exploitation by adverse parties because barebones minutes will not, for example, include detrimental statements in the course of debate or reveal the brevity of debate on certain topics. The decisions of corporate directors face increased attention, from regulators and litigants, in the wake of corporate misfeasance that prompted the Sarbanes-Oxley Act of 2002 and a tide of shareholder activism.

Therefore, as **Disney** indicates that insufficient minutes stand to jeopardize application of the business judgment rule to board actions, it appears that best practices dictate that corporate minutes (a) include thorough summaries of board proceedings, discussions, and presentations in order to evidence the informed debate of the directors, in which cursory notations that "a general discussion followed" are not likely to be sufficient, and

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(b) include, as appendices, materials distributed to board members at the meeting. Finally, although parol evidence may be admissible to supplement, but not to contradict, the minutes, the importance of a thorough corporate record is underscored by the unlikely prospect that, in the context of derivative or other litigation, corporate directors will look forward to contested efforts to introduce additional evidence of board meetings in efforts to secure the protections of the business judgment rule.

However, the risks that undergird the traditional preference for skeletal minutes clearly remain valid and, in our litigious environment, timely, and increased diligence is thus required of clients in all matters related to the decisions of corporate directors. The avoidance of self-inflicted damage in the corporate record – from evidence of perfunctory consideration of important matters to omissions or inaccuracies related to decisions and decision making – requires not just minutes that reflect the best practices identified by the Disney

court but due care in their preparation by the corporate secretary and in their review and approval by the directors. Consequently, all notes of the proceedings (and drafts thereof) should be delivered to the corporate secretary for synthesis in the minutes and thereafter disposed of pursuant to corporate document retention policies not to obscure the record or, of course, to subvert legal process, but, rather, to prevent the exploitation of incorrect or incomplete extracts of the proceedings.<sup>20</sup>

The production of comprehensive minutes, although clearly significant for purposes of the business judgment rule, is not without drawbacks. It is quite possible that boardroom candor will, in fact, suffer as directors, mindful of a thorough record and concerned about the potential role of their comments in litigation, limit their remarks and thus erode the deliberative function of the board. There is thus an ironic tension within the Disney opinion as its minutes-related requirements, intended to promote good governance, stand to chill the internal debate that is essential to a thoughtful and constructive board of directors. ■

#### End Notes

1. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).
2. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).
3. *In re Walt Disney Co. Deriv. Litig.*, 825 A.2d 275, 280 (Del. Ch. 2003).
4. *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 768 n.539, (Del. Ch. 2005), *aff'd sub nom.*, *Brehm v. Eisner (In re Walt Disney Co. Deriv. Litig.)*, 906 A.2d 27 (Del. 2006).
5. 906 A.2d 27,

56.

6. *Disney*, 906 A.2d at 56.

7. *Disney*, 906 A.2d at 56.

8. E. Norman Veasey, *Musings from the Center of the Corporate Universe*, 7 DEL. L. REV. 163, 166-167 (2005).

9. *In re Wachovia Shareholders Litigation*, 2003 WL 22996328, 14 (N.C. Super. Dec. 19, 2003).

10. N.C. Gen. Stat. § 55-8-30(a).

11. N.C. Gen. Stat. § 55-8-30(b); see N.C. Gen. Stat. § 55-8-30(d).

12. Russell M. Robinson II, *Robinson on North Carolina Corporation Law*, § 14.06, at 14-16-14-17 (2005).

13. *HAJMM Co. v. House of Raeford Farms*, 94 N.C.App. 1, 10, 379 S.E.2d 868, 873, review on additional issues allowed, 325 N.C. 271, 382 S.E.2d 439 (1989), and modified, *aff'd in part, rev'd in part on other grounds*, 328 N.C. 578, 403 S.E.2d 483 (1991).

14. Section 142(a) of the Delaware General Corporation Law similarly states that “[o]ne of the officers shall have the duty to record the proceedings of the meetings of the stockholders and directors in a book to be kept for that purpose.”

15. *Respass v. Rex Spinning Co.*, 191 N.C. 809, \_\_\_\_, 133 S.E. 391, 394, (1926).

16. N.C. Gen. Stat. §§ 143-318.9 to 143-318.18.

17. *Multimedia Publishing of North Carolina, Inc. v. Henderson County*, 145 N.C.App. 365, 373, 550 S.E.2d 846, 852, (2001).

18. *Multimedia Publishing*, 145 N.C.App. at 373, 550 S.E.2d at 852 (quoting Henry M. Robert, *Robert's Rules of Order Newly Revised* (9th ed.), § 47, at 458 (1990) (emphasis in original)).

19. Henry M. Robert, *Robert's Rules of Order Newly Revised* (10th ed.), § 48, at 454 (2000).

20. American Society of Corporate Secretaries, *Corporate Minutes: A Monograph for the Corporate Secretary*, at 6 (2006).

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# Statement on Professionalism for North Carolina Business Lawyers

BY ANNA MILLS AND KATHRYN PURDOM

*This Statement on Professionalism describes aspirational professional goals for business lawyers in North Carolina. The Statement's principles should serve as a reminder to experienced lawyers and a guide to newer lawyers of ways to practice business law that enhance the reputation of business lawyers in North Carolina. The goals described in the Statement are in addition to the North Carolina State Bar's Rules of Professional Conduct and do not establish a basis for discipline or standards of conduct.*

## Service to the Client

I will endeavor to continually develop my legal knowledge, professional skills and understanding of my clients' businesses and the environment in which they operate. In the course of representing my clients, I also will endeavor to understand and be guided by my clients' principal business goals and objectives. I will seek to explain all relevant legal issues to my clients and advise them of the important legal risks. I will strive to achieve efficiencies in time and legal expense.

## Working with Other Lawyers

I will be professional and courteous toward other lawyers during negotiations and other interactions. When making transactional due diligence requests, I will endeavor to request only relevant and necessary information appropriate to the size and scope of the transaction. I will strive to draft documents that reflect the agreement of the parties and that are appropriate for the transaction. If called for, when exchanging documents with other lawyers, I will clearly mark any revisions. When requesting a legal opinion or responding to a request for a legal opinion, I will follow the "Golden Rule" enunciated in the American Bar Association's Guidelines for the Preparation of Closing Opinions.<sup>1</sup> I will seek to ensure that all signed documents in my control are in the form agreed to by the parties involved.

## Fellow Business Law Section Members:

As Co-Chairs of the Ethics Committee of the Business Law Section, we are pleased to announce that the Business Law Section Council has adopted the enclosed Statement on Professionalism for North Carolina Business Lawyers. We greatly appreciate all of the thoughtful comments and constructive feedback we received from members of the Business Law Section Council, Section Committee Chairs and members of the Business Law Section throughout the drafting process.

The principal purpose of the Statement of Professionalism is to establish goals that will serve as a constant reminder to business and transactional lawyers of some basic tenets of professionalism that we should aspire to and keep at the forefront of our minds when representing our clients, dealing with other business lawyers, giving back to our profession, and serving those in need of business legal services on a pro bono basis.

We hope that the Statement on Professionalism serves as a useful tool in your practice and encourage you to share a copy of it with your business and transactional colleagues who may not yet be members of the Business Law Section of the North Carolina Bar Association. If you have any questions or comments about the Statement, we would welcome your further feedback as we hope this serves as a living document to guide all of us in our practice now and in the future. ■

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## Service to the Legal Profession

I will endeavor to participate in the continuing business legal education and training of other lawyers and law students. I also will strive to participate in organized bar activities to improve business laws.

## Pro Bono Service

I will strive to contribute to business development in North Carolina by providing pro bono business legal services to deserving individuals, businesses, and nonprofit organizations. ■

## End Notes

1. 57 Bus. Law. 875 (2002).

# Avoiding Accord and Satisfaction Under North Carolina's Unfriendly Lock Box Laws

By GREG HIGGINS

Many businesses use a “lock box” arrangement with a bank to collect payments from their customers. In the typical lock box scenario, a business directs its customers to mail payments to an address maintained by a bank. If the payment is in the form of a check, the bank endorses the check as an agent of the business and deposits the funds into the business’ account. While this is an efficient method for collecting payments, problems for businesses arise when a customer seeks an “accord and satisfaction” by tendering a check marked “paid in full,” and the payment tendered is less than the total amount owed to the business.

In North Carolina, an accord and satisfaction consists of the two elements enumerated in the term. “An ‘accord’ is an agreement whereby one of the parties undertakes to give or perform, and the other to accept, in satisfaction of a claim, liquidated or in dispute, and arising either from contract or from tort, something other than or different from what he is, or considers himself, entitled to; and a ‘satisfaction’ is the execution, or performance, of such an agreement.”<sup>1</sup> Under the common law, a business had only two choices when faced with a check marked paid in full: it could accept a check on the terms offered by the customer, or return the check to the customer.<sup>2</sup> Upon cashing a check marked “paid in full,” the customer would be discharged from the underlying debt even if there was a dispute as to the amount of the debt.<sup>3</sup>

The common law rules were not entirely compatible with present-day lock box practices because businesses may never see the checks tendered by their customers. As a result, the Uniform Commercial Code (“UCC”) modified the common law to reflect modern business conditions. While Section 3-311 of the UCC provides some safeguards to protect against an inadvertent accord and satisfaction, North Carolina’s lock box laws are less friendly to businesses than the UCC’s full version of § 3-311 because North Carolina declined to adopt a key provision of the “accord and satisfaction” section

of the UCC.<sup>4</sup> Pursuant to the original version of the UCC (which was adopted by most other states), if a check marked “paid in full” is cashed by a business, the debt is not discharged by accord and satisfaction if, within 90 days after the customer makes payment, the amount of the check is repaid to the customer.<sup>5</sup> The “repayment provision” is designed to prevent an inadvertent accord and satisfaction. The North Carolina legislature, however, did not adopt the “repayment” provision. Therefore, a business in North Carolina cannot avoid an accord and satisfaction by making repayment to its customer within 90 days.

As a result, businesses in North Carolina must rely on the U.C.C.’s five remaining safeguards, which were adopted by the North Carolina legislature. First, the customer must prove that it tendered a check in good faith to the business as full satisfaction of a debt.<sup>6</sup> The definition of good faith was moved from N.C. Gen. Stat. § 25-3-103(a)(4) to § 25-1-201 in 2006.<sup>7</sup> The good faith requirement is a two-pronged obligation that requires honesty in fact and observance of reasonable commercial standards of fair dealing. As such, the good faith standard includes both a subjective component (e.g. honesty in fact) and an objective component, which incorporates fairness (e.g. reasonable commercial standards of fair dealing). By incorporating an objective component, the dual standard better protects the reasonable expectations of creditors and helps ensure the parties deal with one another fairly.

Second, the customer must prove that the amount of the claim was unliquidated or subject to a bona fide dispute.<sup>8</sup> In other words, if there is not an authentic dispute regarding if the debt is owed, or the amount that may be owed, then tender of a full payment check will not effectuate an accord and satisfaction. Fortunately, the North Carolina’s Court of Appeals recently upheld this statutory requirement and has not weakened our already diluted statute. In **Bank One v. Friedman**, a bank sued one of its customers

to collect unpaid interest owed on a note.<sup>9</sup> The bank correctly indicated in its first demand letter to the customer that the customer owed \$516,103.65.<sup>10</sup> A subsequent demand letter sent less than one month after the first demand letter contained a clerical error omitting certain interest charges, which indicated that the customer owed only \$426,314.28.<sup>11</sup> The customer paid the lesser amount and asserted the defense of accord and satisfaction when he was sued for the unpaid interest.<sup>12</sup> The Court of Appeals held that “a clerical error cannot be considered a ‘bona fide dispute’ pursuant to N.C. Gen. Stat. § 25-3-311(a)” and affirmed the grant of summary judgment in favor of the bank.<sup>13</sup>

Third, the customer must prove that the business obtained payment of the instrument.<sup>14</sup> In this context, a business obtains payment if the check is processed for payment.<sup>15</sup>

Fourth, the customer must prove that there is a conspicuous written statement noting that the check is being tendered as payment in full.<sup>16</sup> Normally, the “paid in full” statement is written on the check. A written communication accompanying the check may also satisfy the requirement.<sup>17</sup> Fortunately, our courts have upheld the requirement that an accord and satisfaction contain a written communication. In **Investors Title Insurance Company v. Sturdivant**, debtors under a note contended that the note had been cancelled pursuant to an oral agreement.<sup>18</sup> The North Carolina Court of Appeals recognized that the debtors failed to “assert that a writing showing full satisfaction . . . exist[ed], as required by N.C. Gen. Stat. § 25-3-311(b),” and upheld summary judgment in favor of the note holder.<sup>19</sup>

Finally, the North Carolina version of the U.C.C. provides that businesses can avoid an inadvertent accord and satisfaction if within a reasonable time before a customer tenders a disputed payment, the business sends a conspicuous statement to the customer requesting that all communications concerning disputed debts, including the delivery of a pay-

ment tendered as full satisfaction of a debt, are to be delivered to a designated person at a designated place (the "Disputed Debt Notice").<sup>20</sup> The Disputed Debt Notice can be made by including a notice on the billing statement sent to the customer, and the person designated by the business should be a person with knowledge of the claim.<sup>21</sup> Once a Disputed Debt Notice is sent by the business, if a full satisfaction check is then sent by the customer to a lock box (rather than to the designated person), the clerk processing the check has no responsibility with respect to an accord and satisfaction.<sup>22</sup> As you might expect, the person designated by the business in the Disputed Debt Notice, however, does have a duty to review the checks and accompanying written statements and reject any checks marked with "payment in full" or similar language. This process is intended to allow businesses to avoid an inadvertent accord and satisfaction without burdening the check-processing operation with extraneous and wasteful additional duties.<sup>23</sup> Unfortunately, this process of sending disputed payments to one address and undisputed payments to another address may confuse customers and reduce the benefits associated with the rapid processing of checks sent to lock boxes.

In conclusion, although the lock box arrangement is an efficient method for collecting payments from customers, businesses should keep a close eye on any debts that may be disputed. If there is a bona fide dispute or if the business believes that a dispute is possible, the business should take the initiative to contact the customer in writing and require that the customer mail all payments to a designated person capable of making a decision about the payment. If a check is marked as "paid in full" or if it contains similar language, or if the check is accompanied by other correspondence asserting that the check represents payment in full, the check should be held (for a reasonable time if the dispute can be resolved quickly) or returned to the customer until the business can resolve the status of the debt with its debtor. While I generally advise clients to hold onto disputed checks because of the golden rule (e.g. he who holds the gold makes the rules), I caution against holding an uncashed check for too long because there is case law from other jurisdictions concluding that holding on to a check for several months can result in an

accord and satisfaction.<sup>24</sup> As a result, if you cannot resolve quickly a dispute with a debtor, you should ultimately return the check. ■

### End Notes

1. *Dobias v. White*, 239 N.C. 409, 80 S.E.2d 23 (1954).
2. *Moore v. Greene*, 237 N.C. 614, 75 S.E.2d 349 (1953).
3. *Id.*
4. Compare N.C. Gen. Stat. § 25-3-311 with U.C.C. 3-311.
5. U.C.C. §3-311(c)(2).
6. N.C. Gen. Stat. § 25-3-311(a)(i).
7. *See* S.L. 2006-112, § 12, eff. Oct. 1, 2006.
8. N.C. Gen. Stat. § 25-3-311(a)(ii).
9. 661 S.E.2d 789, 66 U.C.C. Rep.Serv.2d 170 (N.C.App. 2008).
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.*; *see also* *Hunter McDonald, Inc. v. Edison Foard, Inc.*, 157 N.C.App 560, 579

S.E.2d 490, 50 U.C.C. Rep. Serv.2d 326 (2003) (rejecting the defense of accord and satisfaction because the defendant "failed to meet its burden pursuant to N.C. Gen. Stat. § 25-3-311 'to prove the amount of the claim was unliquidated . . . .'").

14. N.C. Gen. Stat. § 25-3-311(a)(iii).
15. N.C. Gen. Stat. § 25-3-311 at cmt. 4.
16. N.C. Gen. Stat. § 25-3-311(b).
17. *Id.*
18. 173 N.C.App. 232, 617 S.E.2d 722, 58 U.C.C. Rep. Serv.2d 126 (2005).
19. *Id.*
20. N.C. Gen. Stat. § 25-3-311(c).
21. *Id.* at cmt. 5.
22. *Id.* at cmt. 7.
23. *Id.*
24. *Hoffman v. Ralston Purina Co.*, 86 Wis.2d 445, 273 N.W.2d 214 (1979).

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# Raising Capital or Facilitating Acquisitions?

## Beware of Broker-Dealer Issues

By JEFFREY C. HART

Many individuals, consulting firms, placement agents, and small investment banks are unaware that engaging in capital raise and acquisition activities for third parties may require them to register as broker-dealers with the Securities and Exchange Commission (the "SEC"). The failure to register can result in the inability to enforce fee obligations, the imposition of government sanctions and fines, and a prohibition on future securities and acquisition activities.

Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act") requires a person acting as a "broker" or a "dealer" in securities to register with the SEC. Both brokers and dealers are persons who are "engaged in the business" of buying and selling securities. Brokers arrange securities transactions for others, whereas dealers purchase and sell securities for their own accounts.

For purposes of the Exchange Act, persons are "engaged in the business" of buying and selling securities if they demonstrate a "regularity of participation" in such transactions. A person's participation in a single, isolated transaction is insufficient to require registration. Nevertheless, the SEC and the courts interpret the phrase "engaged in the business" broadly. Generally, if a person engages in more than one broker-dealer transaction, this part of the broker-dealer definition is satisfied.

The courts and the SEC have identified a number of business practices that constitute broker-dealer activity. These so-called "badges" of broker-dealer activity include, but are not limited to: (1) actively soliciting buyers or investors for a business; (2) advising buyers or investors as to the merits of a securities transaction; and (3) actively participating in the negotiation or execution of a securities transaction. If a person engages in any of these activities (e.g., a private placement of securities or a business acquisition structured as a stock sale or merger) and receives transaction-based compensation (e.g., a commission based on the size of the transaction or a success fee), the person likely must register with the SEC as a broker-dealer.

A person may attempt to refer to himself or herself as a "finder" and therefore claim an exemption from the broker-dealer registration requirements. The term "finder" is greatly misused in the private placement and investment banking industry. A finder is like anyone else whose activities fall outside the scope of the broker-dealer definition, as there is not a recognized "finder" registration exemption. Typically, a finder merely locates a buyer or an investor for a business for a flat or hourly fee. After making an introduction, a finder does not conduct due diligence, perform a valuation, participate in structuring the transaction, participate in negotiations, provide advice to parties, or otherwise facilitate a closing. If a person's activities fall within the broker-dealer definition described above, registration is required regardless of the label used by the person.

Rule 3a4-1 under the Exchange Act, known as the "Issuer Exemption," provides a safe harbor exemption from broker-dealer registration for certain "associated persons" of an issuer of securities. Generally, the exemption provides protection to individuals employed by an issuer whose occasional broker-dealer activities are incidental to their

employment and whose compensation is not linked to the sale of securities.

Contracts entered into with an unregistered broker-dealer are voidable, meaning that an unregistered person is unable legally to enforce his or her fee arrangements. Moreover, the failure to comply with broker-dealer registration requirements may result in a variety of penalties. First, the SEC may take injunctive or disciplinary action against an unregistered person. Second, the SEC may deny future broker-dealer registration to an offending party. Third, a willful violation of the Exchange Act can lead to criminal prosecution and sanctions. Fourth, unlawful non-registration may give rise to private litigation. Finally, an unregistered broker-dealer may be subject to penalties under state securities laws. ■

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# Business Law Developments

By ANDREW J. HAILE AND THOMAS J. MOLONY

## Can the LLC Veil Be Pierced? But of Course

In *State v. Ridgeway Brands Manufacturing, LLC*, 362 N.C. 431, 666 S.E.2d 107 (2008), the North Carolina Supreme Court concluded that, if a plaintiff is successful in piercing the veil of a limited liability company, a member of that limited liability company who later is added as a party in the litigation is not a “new” party for purposes of determining whether a claim is barred by a statute of limitations.

Ridgeway Brands Manufacturing, LLC (Ridgeway LLC) was a North Carolina limited liability company engaged in the business of selling tobacco products. Because its products were sold in North Carolina, it was subject to N.C. Gen. Stat. § 66-291. Under N.C. Gen. Stat. § 66-291, Ridgeway LLC was required either to (1) comply with the terms of the 1998 Master Settlement Agreement that North Carolina entered into with domestic cigarette manufacturers or (2) deposit funds annually in an escrow account to pay certain claims that might be brought against Ridgeway LLC. Ridgeway LLC elected to comply with the statute by making escrow deposits.

Ridgeway LLC primarily sold its products to Ridgeway Brands, Inc. (Brands), a Kentucky corporation that handled the sale of tobacco products in North Carolina. The arrangement between Ridgeway LLC and Brands benefited Brands by allowing it to increase its revenue and expand its market share, but the arrangement left Ridgeway LLC with insufficient funds to meet its statutory escrow obligations. As a result, Ridgeway LLC failed to make its required deposits in 2004 and 2005.

In May 2004, the State of North Carolina filed a lawsuit against Ridgeway LLC to recover the funds Ridgeway LLC was required to deposit in escrow in 2004, as well as related civil penalties. In October 2005, the State filed an amended complaint that, among other things, added a claim for the 2005 escrow deposit and related civil

penalties and sought to impose liability on James C. Heflin, among others, under a “piercing the corporate veil” theory. Heflin was a member-manager of Ridgeway LLC.

Ridgeway LLC and Heflin moved to dismiss the State’s amended complaint. Ruling on the motion, the trial court dismissed the claims against Heflin for piercing the corporate veil and for the civil penalties related to the deposit required in 2004. The North Carolina Court of Appeals reversed the trial court’s decision as to the piercing the corporate veil claim, but determined that the applicable statute of limitations barred assessment of the civil penalties against Heflin because the amended complaint added him as a party and the “relation-back” doctrine (under which an amendment is treated as being made at the time of the original filing) did not apply to “new” parties.

The North Carolina Supreme Court reversed the decision of the Court of Appeals and concluded that Heflin would not be a “new” party if he were determined to be an alter ego of Ridgeway LLC under the piercing the corporate veil theory. If Heflin were not a “new” party, the “relation-back” doctrine would apply and the State’s claim for the 2004 civil penalties could proceed.

In reaching its decision, the Supreme Court examined its prior jurisprudence with respect to piercing the corporate veil, noting that North Carolina applies the “instrumentality rule” adopted in *Glenn v. Wagner*, 313 N.C. 450, 329 S.E.2d 326 (1985). Citing *Henderson v. Sec. Mortgage & Fin. Co.*, 273 N.C. 253, 160 S.E.2d 39 (1968), the court explained that, under the instrumentality rule, a corporate entity is disregarded if it is a mere instrumentality or alter ego of the sole or dominant shareholder and limiting the liability of the shareholder through the corporate form would violate North Carolina public policy or statutory law. Applying these principles to the facts alleged by the State, the court concluded that the State’s pleadings were sufficient to support a claim that Ridgeway LLC was such an instrumentality. As a result, the State could

add Heflin as a party for purposes of the 2004 civil penalties, contingent on the State’s success in establishing Ridgeway as Heflin’s alter ego.

Interestingly, the Supreme Court’s opinion seems to ignore the fact that Ridgeway LLC was a *limited liability company and not a corporation*. Throughout its analysis, the court uses the terms “corporation” and “shareholder” rather than “limited liability company” and “member,” thereby implying that traditional piercing the corporate veil principles clearly apply equally to limited liability companies. In *In re DePaulis*, 2008 WL 4446999 (W.D.N.C. 2008), the United States District Court for the Western District of North Carolina stated that it was unaware of any cases under North Carolina law deciding that the “instrumentality rule” applied to limited liability companies. *State v. Ridgeway Brands Manufacturing, LLC* now is such a case.

## Purchasing Sight Unseen

In *Hospira Inc. v. AlphaGary Corp.*, \_\_\_ N.C.App. \_\_\_, 671 S.E.2d 7 (2009), the North Carolina Court of Appeals considered the extent to which a medical device maker that entered into a contract manufacturing arrangement could recover against one of the contract manufacturer’s suppliers.

Hospira Incorporated makes medical devices known as sight chambers that allow monitoring of fluids in intravenous lines. To produce the sight chambers, Hospira uses a specially formulated “radiation grade” material known as ADB that it converts into pellets in its manufacturing process. In 1999, Hospira contracted with Moll Industries, Inc. to manufacture its sight chambers and provided Moll with ADB pellets for that purpose. In 2001, Hospira engaged AlphaGary Corporation to pelletize ADB, and AlphaGary signed a specification letter under which AlphaGary guaranteed that the pellets would be manufactured in accordance with Hospira’s specifications. Also, Hospira again contracted with Moll in 2001

See DEVELOPMENTS page 10

## Developments *from page 9*

to manufacture its sight chambers. This time, however, Hospira did not provide Moll with ADB pellets, but told Moll to purchase the pellets from AlphaGary. Moll did so, but the pellets AlphaGary supplied to Moll were made from non-radiation grade material.

The sight chambers produced by Moll with AlphaGary's pellets started becoming severely discolored after repeated sterilization. Because of this problem, Hospira recalled and destroyed the sight chambers and the intravenous kits in which they were included and filed a lawsuit against AlphaGary asserting claims of negligence, fraud, negligent misrepresentation, unfair and deceptive trade practices, and third-party beneficiary breach of contract. The North Carolina Business Court dismissed the negligence claim and granted summary judgment to AlphaGary with respect to the other claims. The Court of Appeals reversed the dismissal of the negligence claim, but affirmed the Business Court's grant of summary judgment with respect to the other claims.

Reversing the Business Court, the Court of Appeals ruled that, because Hospira and AlphaGary were not parties to a contract, Hospira's negligence claim was not barred by the economic loss rule, which limits the ability of a plaintiff to recover on a tort claim when the plaintiff and the defendant are parties to a contract with respect to the matter on which the tort claim is based.

As to Hospira's fraud claim, the court noted that, in order to establish a claim for fraud, a false representation or concealment must be made to the party claiming fraud. In this case, the court concluded, the specification letter that AlphaGary signed for Hospira did not apply to transactions between Moll and AlphaGary and therefore AlphaGary did not make any false representation to Hospira with respect to the Moll-manufactured sight chambers. In addition, the court determined that Hospira could not sustain its fraud and negligent misrepresentation claims based on AlphaGary's statements to Moll with respect to the pellets: in the case of the fraud claim, Moll was not an agent or fiduciary of Hospira; and in the

case of the negligent misrepresentation claim, there was no evidence that Hospira directly relied on the statements. Similarly, the court ruled that the statements could not support an unfair and deceptive trade practices claim because there was no evidence that the statements deceived Hospira or that Hospira actually relied on them. Finally, the Court of Appeals concluded that Hospira could not establish a third-party beneficiary breach of contract claim because the evidence merely suggested that Hospira coordinated the contract between Moll and AlphaGary; the evidence did not show that Hospira was actively and directly involved in the contract. The court added that the breach of contract claim was not viable for another reason - any benefits accruing to Hospira were by their nature indirect.

The result in this case underscores the importance of having very specific contract rights when a party purchasing products from a vendor wants to have recourse against a supplier that supplies to the vendor a critical component of the end product.

### Hogs Got Slaughtered, But Not the Partnership

In *Wiggs v. Peedin*, \_\_\_ N.C. App. \_\_\_, 669 S.E.2d 844 (Dec. 16, 2008), the North Carolina Court of Appeals considered whether actions by the defendant's now-deceased husband resulted in a partnership between the plaintiffs and the defendant under the theories of partnership by estoppel and apparent authority.

According to the plaintiffs, in 1995 the defendant's husband and the plaintiffs discussed the possibility of developing and operating a commercial hog farm. Under the arrangement discussed, the plaintiffs would provide labor and expertise, and the defendant's husband would provide real property, together with financing secured by that property. The defendant did not participate in the discussions but, according to the plaintiffs, she was aware of them.

Following the discussions, the defendant's husband sent a handwritten and signed proposal to the plaintiffs setting forth detailed terms of the arrangement the parties had discussed. Under the proposal, the

defendant's husband would receive the first \$9 for each hog sold, one of the plaintiffs would receive the next \$1, and any additional profits would be used for operating expenses. The proposal also provided that if, after 10 years, the farm's sole customer remained "pleased" with the farm's operations, the plaintiffs would "each be deeded 10% of [the hog farm] operation if [the] venture [was] paid for." The plaintiffs claimed they accepted the defendant's husband's proposal and that, in doing so, the parties established a partnership.

In May 1999, the defendant's husband died from cancer. Following her husband's death, the defendant became the sole record owner of the hog farm property. Farm operations continued from 1999 to 2004, but in 2004, the defendant barred the plaintiffs from entering the hog farm property, claiming that they had improperly sold hogs without her permission. She denied that any partnership ever existed.

The trial court agreed with the defendant and granted her summary judgment. The Court of Appeals, however, determined that "not only may a partnership be formed orally, but it may be created by the agreement or conduct of the parties, either express or implied." The court stated that N.C. Gen. Stat. § 59-37 governs whether a partnership exists and added that "co-ownership and sharing of any actual profits are indispensable requisites" to the existence of a partnership. Applying these standards to the facts, the court held that "substantial evidence tends to establish a partnership existed between the plaintiffs and [the defendant's husband]." The court then considered whether that partnership could be imputed to the defendant under the theory of "partnership by estoppel" or the "agency theory of apparent authority."

The court described "partnership by estoppel" as requiring "a representation, either by words or conduct, made to another, who reasonably believing the representation to be true, relies upon it, with the result that he changes his position to his detriment." The court then stated that "there is virtually no difference between estoppel and apparent authority" because both theories

“depend on reliance by a third person on a communication from the principal to the extent that the difference may be merely semantic.”

Analyzing whether either or both theories might establish a partnership between the defendant and the plaintiffs, the court cited to testimony that after her husband’s death the defendant “made several oral representations” to one of the plaintiffs indicating that the hog farm operation would continue “just like it was” prior to his death. In addition, the court observed that, after the death of the defendant’s husband, the plaintiffs continued for five years to perform services for the farm just as they had prior to his death. The court noted that the defendant did nothing to modify this arrangement and that she reaped substantial benefits from their labor. Based on this evidence, the court found that a genuine issue of material fact existed regarding the defendant’s liability under the theories of partnership by estoppel and apparent authority. Consequently, it reversed the trial court’s grant of summary judgment in favor of the defendant.

The facts may be unusual, but this case is a good reminder that, whenever a business

## Many Thanks, Krista

On behalf of the section, we extend our thanks to Krista Bowen of Robinson, Bradshaw and Hinson, who, after two years, is stepping down from writing the Business Law Developments column.

Krista’s work was, in a word, exemplary. She writes with elegance, clarity, and humor.

We also welcome our new columnists, Andrew Haile and Thomas Molony, members of the faculty of the Elon University School of Law.

arrangement involves the sharing of profits, the arrangement should be evaluated to determine whether it might be deemed a partnership under N.C. Gen. Stat. § 59-37. This is particularly important because an unintended partnership could result in unintended liability exposure. ■

HAILE AND MOLONY ARE BOTH ASSISTANT PROFESSORS OF LAW AT THE ELON UNIVERSITY SCHOOL OF LAW IN GREENSBORO.

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