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Revision of the 1981 South Carolina Business Corporation Act, The--An Introduction

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THE 1981 REVISION OF THE SOUTH CAROLINA BUSINESS CORPORATION ACT—AN INTRODUCTION

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For over ten years, South Carolina lawyers enjoyed the clarity and flexibility of the South Carolina Business Corporation Act of 1962 (the Act)[1] with little complaint. During this time, the legislature amended few of its sections, and little reported litigation occurred.

In the early 1970s, however, the anxiety of directors, produced in large part by investigations into the questionable payments scandal in the defense industry,[2] and pragmatic concerns of corporate counsel led to a rethinking of the Act. In 1973 a group of corporations requested that the General Assembly replace the Act's indemnification provisions[3] with more detailed provisions from the Model Business Corporation Act (the Model Act).[4] The result was disaster. The General Assembly misapprehended the purpose of the bill. An amendment from the floor of the House of Representatives combined the bill's provisions on third-party indemnification with its provisions on indemnification in shareholder derivative actions against officers and directors. For good measure, the amendment added a prohibition against indemnificaton where crimes of moral turpitude were involved.[5] The result was unworkable. Corporate directors and officers had no idea what indemnification they were entitled to

* Member, South Carolina Bar; Chairman of the Corporate Law Revision Committee of the South Carolina Bar and the Bar's representative on the Joint Study Committee of the General Assembly established to study revision of the corporate laws. The Joint Committee reviewed the Report of the Bar Committee and was responsible for the text of the Bills that were enacted into law as Act No. 146 of 1981, which revised the Business Corporation Act of 1962.

1. 1962 S.C. Acts 1996, No. 847 [hereinafter cited as Act of 1962]. The Act received a high compliment when Delaware, the nation's leading corporate domicile, asked the Official Reporter for the Act to recommend revision of Delaware corporate law. *See* E. FOLK, THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS (1972).

2. *See* Sommer, *The Impact of the SEC on Corporate Governance*, in CORPORATIONS AT THE CROSSROADS: GOVERNANCE AND REFORM 177-79 (D. Demott ed. 1980).

3. Act of 1962, *supra* note 1, § 8.18. These provisions permit corporations to indemnify corporate officials for expenses.

4. ALI MODEL BUS. CORP. ACT. § 5 (1971) [hereinafter cited as MODEL ACT].

5. 1973 S.C. Acts 381, No. 316 (codified at S.C. CODE ANN. § 33-13-180(a) (1976)).

and insurers had no idea when their duty to defend corporate personnel commenced.

The indemnification debacle was but one of the factors moving the state toward revision. As the pace of economic activity in South Carolina increased, administrative problems caused by inadequacies in the Act began to arise. When one corporation undertook a diversification program, it discovered that it was not able to acquire another corporate business by means of the "cash merger" technique.[6] It was forced to form an out-of-state subsidiary to use this desirable type of merger. When the Arab oil embargo and ensuing economic recessions forced cutbacks in business travel, most businessmen increased their use of telephone conference calls, but this economizing tool was not available to directors of South Carolina corporations. Common law held that a corporate board could only meet in person,[7] and the 1962 Act contained no provision to allow meetings by telephone.[8]

In 1974 a group of corporate practitioners met to consider revisions of the Business Corporation Act. The group requested that the South Carolina Bar establish a Corporate Law Revision Committee (the Committee) as a special committee of the Bar. The Committee met with J. Kirkland Grant, then a professor of law at the University of South Carolina, to discuss a preliminary study of the scope of the needed revisions. Funding for this

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6. *See* S.C. CODE ANN. § 33-17-20(b)(3) (1976).

7. *See* 2 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, § 427 (rev. vol. 1969).

8. S.C. CODE ANN. § 33-13-120(b) (1976). This omisson was provoking to business lawyers who were allowed to use the conference call for the purpose of arguing motions in the South Carolina courts and could even take depositions by telephone. A provision in the Act allowed the directors to adopt a corporate resolution by unanimous written consent, but the provision was not available if a director were in a distant location or on a trip to a foreign country.

This flaw could be particularly onerous in the issuance of securities because in a public offering or merger a company's board of directors normally authorizes the issuance of the securities subject to negotiation of final terms by the Board's Executive Committee, which is authorized to bind the corporation to the same extent the Board could. This technique, however, was not available in the case of preferred stock, a useful security in acquisitions and mergers. Both the Act of 1962 and the Model Act expressly forbade the Executive Committee from amending the articles, and both provided that the fixing of the relative rights, preferences, and dividends for a preferred share constituted an act of amendment. Thus, because telephone conference calls could not be used, pricing of preferred shares required the directors to meet in person on the pricing date, and a quorum of directors could not always be guaranteed on short notice.

study was provided by a grant from the South Carolina Judicial Council.

In 1976, after several months of review, the Committee realized that a full revision of the Act was needed to keep it flexible and current. The Committee asked the South Carolina Bar to endorse an entire revision of the 1962 Act. The House of Delegates Executive Committee overwhelmingly approved the Committee's report. The Committee then set out to prepare the proposed revisions, again with funding from the South Carolina Judicial Conference.[9]

In 1979 the Committee submitted to the House of Delegates a complete revision of the 1962 Act. It also recommended that the Bar ask the General Assembly to establish a joint study committee to review the Committee's revisions and prepare a legislative bill. The House of Delegates unanimously approved both the revisions and the Committee's request.

The General Assembly agreed to establish a Joint Study Committee chaired by Senator Donald Holland, a member of the study committee that proposed the 1962 Act. The new Study Committee was comprised of members from each house of the legislature, from the Bar, and from the public. It met three times and reviewed the Bar Committee's report in detail. As a result of its deliberations, the Study Committee made several recommendations for improvements in the report, and these improvements were later incorporated in the 1981 Revision.[10]

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9. The Committee did not foresee the magnitude of the task before it. It met almost monthly for three years to debate each section of the Act and the proposed revisions and obtained comments from accounting experts and from the Secretary of State. Under the tutelage of the Reporter, it examined court decisions and corporate statutes from other states and prepared three drafts of the manuscript. The Committee members spent hundreds of hours and the Reporter logged 2800 hours of time.

10. The recommendations included removal of the requirement in the shareholder derivative suit provision that a plaintiff shareholder post a bond for costs and attorney's fees. South Carolina Business Corporation Act Amendments of July 2, 1981, 1981 S.C. Acts ___, No. 146 (to be codified at S.C. CODE ANN. § 33-11-290) [hereinafter cited as 1981 Act]. The Study Committee wisely concluded that the power of the trial court to dismiss a sham shareholder derivative suit and to award attorney's fees to the corporation for a suit brought in bad faith would adequately protect the interests of the corporation and, at the same time, would allay any fears of a member of the General Assembly that the shareholder derivative suit provision was an attempt to chill the exercise of the legitimate rights of a shareholder. Another important provision recommended by the Committee was section 110 of chapter 1, which will enable a nonprofit corporation to look to the 1981 Revisions for provisions on corporate governance. Revised § 33-1-110.

Legislators introduced a bill based on the Joint Study Committee Report early in 1980, but the pressure of legislative business in an election year prevented its consideration. During the summer and fall of 1980, proponents of the revision contacted leaders of both Houses to gain support for the bill. Sponsors refiled the bill simultaneously in both the House and the Senate. The Senate Judiciary Committee and the House Commerce, Labor, and Industry Committee held hearings in March of 1981, and after serious review of the proposed legislation, each unanimously reported the bill to the floor.

The use of identical text, the unanimous committee reports, and the lack of organized opposition to the bills did not insulate them from the vagaries of legislative action. One corporation held the bill hostage in committee until the corporation could obtain an ill-conceived "clarification" of the accounting provisions for payment of share dividends.[11] It appears that later,

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This section allows the nonprofit corporation to operate in the same manner as its for-profit relatives but protects it when a specific statutory provision governs nonprofit corporations. When application of a provision would be adverse to the interest of the nonprofit corporation, the corporation may apply to the circuit court for a decree relieving it of an undue burden. *See id.*

11. Revised § 33-9-150. The corporation had correctly noted that a large dividend is accounted for like a stock split and that a small dividend would require a different adjustment to the capital and surplus accounts. The Bar Committee and the Joint Study Committee had agreed to make a change, which would enable the board of directors to determine the proper adjustment to capital and surplus accounts at the time the dividend was declared. Unfortunately, the change was not completely incorporated in the Bill. The corporation decided that it wanted a more extensive and detailed change in the text to the effect that amounts in excess of par value or of stated value would be credited as required by generally accepted accounting principles (GAAP) to one of the surplus accounts of the corporation. The corporation then decided to use its political clout to obtain adoption of every detail of its own version despite the protests of the Reporter that GAAP were not applicable. Compromise was necessary for the Bill to be reported out, and so the corporation obtained its way. Unfortunately, the present version confuses the obligations of auditors under generally accepted accounting principles and accounting policies with the statutory accounting provisions of an organic corporate act. The amended text of the 1981 Revision in effect allows accountants to amend the statute on share dividends without obtaining legislative approval. 1981 Act, *supra* note 9 (Revised § 33-9-160(a)(1)(c)). Moreover, it contains the seeds of a difficult legal problem for corporate counsel rendering an opinion that shares issued in a share dividend are "fully paid," because he must certify that the transfer of surplus to the capital account is "proper" by accounting standards. *See generally Legal Opinions to Third Parties*, 34 BUS. LAW. 1891, 1911-12 (1979). Under the committee's version of the statute, the board of directors had discretion to make the accounting adjustment and corporate counsel was required only to certify that the assignment had been made. The validity of the accounting practice would not have been in issue. In the opinion of this author, the rendering of

while the bills were awaiting final report to the floor of the Senate, someone made phantom amendments.[12] In spite of these difficulties, the work of the Bar Committee emerged from the legislative process substantially intact.

The Revision is now law. Professor Adams' article, which follows, describes in detail the far-reaching changes it wrought. These changes are of great significance to South Carolina corporations and corporate lawyers and will enable South Carolina corporations to govern themselves with greater certainty and do business with greater flexibility in coming years.

The process of enacting a major, lengthy bill inevitably results in numerous small errors and omissions. These imperfections call for a bill of technical amendments to be introduced early in the 1982 legislative year.[13] More substantive revisions should also be considered. As the Bar Committee was preparing its final report, the ABA Committee on Corporate Laws made a major revision of the Model Act provisions on corporate finance that eliminated the concept of par value and the resulting accounting and financial difficulties associated with it.[14] Although

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such an opinion under the present version of the statute is an invitation to malpractice, shareholders' suits, and SEC enforcement action. The recent availability of malpractice insurance for corporate counsel should provide scant comfort to the attorney rendering such an opinion.

12. The Committee report originally deleted the requirement of § 33-23-20 of the Act of 1962 for an attorney's signature on the certificate to domesticate a foreign corporation. S.C. CODE ANN. § 33-23-20(b)(2) (1976). The Bar Committee and the Joint Study Committee had agreed that this requirement was an embarrassment to the state, that it did not protect any interest of its citizens or of a corporation's shareholders, and that it could not by any stretch of the imagination provide a significant source of income for practicing attorneys. Nevertheless, this provincialism suddenly appeared in the final text.

13. For example, in § 33-9-250, relating to issuance of convertible shares, the entire first sentence of the provision was dropped. Moreover, the 1981 revision is scattered with typographical errors that should be removed.

14. Professor Haynsworth states that a "serious mistake" was made when the new Model Act Amendments to Financial Provisions were not included in the 1981 Revision. Haynsworth, *The 1981 South Carolina Business Corporation Act: A Critique and Agenda for Reform*, 33 S.C.L. REV. 449, 455 (1982). Unfortunately, the posture of the proposed revision in the legislative process made it impossible to make the extensive changes in the text of the proposed bill that would be required to conform it to the Model Act Revisions. The Bar Committee's Final Report, dated December 1978, was approved and endorsed by the House of Delegates of the South Carolina Bar in June 1979. With this endorsement, the Bar Committee was able to obtain establishment of the Joint Legislative Study Committee as an amendment to the Appropriations Act for 1980. 1979 S.C. Acts 446, No. 194, Pt. III, § 3, at 489. The General Assembly directed the

the Committee was able to incorporate a number of the clarifying provisions of the new Model Act text, it was unable to make a complete revision of all of the sections affected by elimination of par value. The 1981 Revision incorporates most of the Model Act's flexibility, but the legislature and Bar may ultimately want to make the South Carolina Business Corporation Act conform to the Model Act. In addition, the Committee on Corporation Laws has just announced a new provision for statutory close corporations.[15] The Act and the 1981 Revision contain sufficient flexibility for creation and operation of the classic close corporation, but the new proposals represent a clear improvement over earlier practice. They allow a short-form type of incorporation for small businesses, which is simple and more economical than classical incorporation. These provisions may be a valuable future addition to South Carolina corporate law.

With passage of the 1981 revisions, corporate counsel and their clients should not rest on their laurels. Change continues to occur in corporate law. To avoid being overtaken by events, as happened in 1975, the South Carolina Bar should retain the Corporate Law Revision Committee as a permanent bar committee to recommend ongoing revisions of the South Carolina Business Corporation Act. The problem of maintaining a modern legal structure for commercial activity is broader, however, than corporate law alone. The entire realm of business law is changing with the continuous promulgation of comprehensive codes

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Study Committee "to make its report to the General Assembly during its 1980 session *as early as is possible.*" *Id.* (emphasis added). The Model Act Amendments to Financial Provisions were not released generally until the late summer of 1979. Committee on Corporate Law, *Changes in the Model Business Corporations Act—Amendments to Financial Provisions*, 34 BUS. LAW. 1867 (1979). Had either the Bar Committee or the Study Committee undertaken to make the extensive changes required to conform the drafts before it to the Model Act, in my opinion the 1981 Revision would not have been enacted into law. A major change of this nature would have required the reconvening of the Bar Committee and resubmission to the House of Delegates of the South Carolina Bar. Under the rules of the South Carolina Bar, the changes would have to have received approval of the House of Delegates or the *imprimatur* of the South Carolina Bar would have been lost. It was the consensus of the Bar Committee and the Study Committee that to maintain momentum in the legislative process it was essential to avoid the appearance of uncertainty or confusion that last minute changes on a large scale would create, and to maintain at all costs the broad support for the bill that ultimately resulted in unanimous votes in committee and on the floor of the House and the Senate.

15. Committee on Corporate Laws, *Changes in the Model Business Corporation Act Affecting Indemnification of Corporate Personnel*, 36 BUS. LAW. 99 (1981).

governing commercial transactions, and this evolution creates a continuing demand for statutory revision. A purely voluntary body, like the Corporate Law Revision Committee, cannot adequately respond to this tide of change. The present system is one of crisis management, and the State needs a more forward-looking approach. Some permanent body is needed to monitor changes in commercial law and promptly recommend needed statutory changes. This body should have a permanent staff to maintain a liaison between the Bar and the General Assembly. It should work to create an informed legislature that can move promptly in each session to keep the state's commercial laws up to date. In this way, the state can avoid intolerable statutory backlogs that hinder commercial activity.