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COMMENTS

The Wedding Veil or the Corporate Veil?: Appreciation of Close Corporation Stock Under North Carolina's Equitable Distribution Law

I. INTRODUCTION

Until the spring of 1985, the increase in value of shares in a close corporation¹ was not subject to equitable distribution under North Carolina law if the stock was acquired as separate property. North Carolina's equitable distribution statute provides that "[t]he increase in value of separate property . . . shall be considered separate property."² A rule developed in three recent North Carolina Court of Appeals cases contradicts the apparent meaning of this statute.³ As a result of these decisions, the major portion of share value may now be subject to equitable distribution regardless of how the shares are acquired. The implications of these decisions for North Carolina close corporations are far-reaching.

To illustrate, consider the fictitious "Widget Corporation." John Jennings is president, chairman of the board and sixty-percent shareholder of Widget. The company was founded by John's father and his two brothers. John acquired his interest in the company through his father's will. Shortly after his father's death, John married Susan. Under John's leadership, Widget expanded into new markets, and revenues grew. The company experienced a substantial increase in annual sales and net worth. After a fifteen-year marriage, Susan Jennings sued for divorce. In an equitable distribution proceeding, Susan claimed that the value of Widget had increased to twelve times its original value and that half of the increase in John's stock was marital property. The trial court agreed and awarded Susan a money judgment for one half the increase in value of the stock. John was unable to secure a loan to pay the judgment, and

1. One authority has defined the close corporation as one composed of few shareholders who are generally well-acquainted with each other and all of whom are active in the business, and one without an established market for its shares. 1 F. O'NEAL, CLOSE CORPORATIONS § 1.07 (1975). The vast majority of corporations in North Carolina are close corporations. "Of the estimated more than one million corporations in the United States, all but about 50,000 would fall into the category of closely-held." Hempstead, *Valuation of a Closely-Held Business*, 2 EQUIT. DIST. REP. No. 3, at 36 (1981).

2. N.C. GEN. STAT. § 50-20(b)(2) (1984).

3. *McLeod v. McLeod*, 74 N.C. App. 144, 327 S.E.2d 910, *disc. rev. denied*, 314 N.C. 331, 333 S.E.2d 488 (1985); *Phillips v. Phillips*, 73 N.C. App. 68, 326 S.E.2d 57 (1985); *Wade v. Wade*, 72 N.C. App. 372, 325 S.E.2d 260, *disc. rev. denied*, 313 N.C. 612, 330 S.E.2d 616 (1985).

the other shareholders could not finance a purchase of John's shares. The Jennings' divorce has cast a shadow on the otherwise prosperous future of Widget, Inc.

The uncertainty confronting the Widget Corporation and other close corporations in North Carolina is the product of three recent North Carolina Court of Appeals decisions: *Wade v. Wade*,⁴ *Phillips v. Phillips*,⁵ and *McLeod v. McLeod*.⁶ These decisions hold that the "active appreciation" of close corporation stock which accrues during marriage and before separation is marital property subject to equitable distribution. The method by which shares are acquired is immaterial. The court's interpretation of the statute in these cases was based on two concepts new to North Carolina law. First, the court adopted the "source of funds" theory of acquisition. Under this theory, property is acquired as it is paid for and, therefore, may include both separate and marital interests. Second, the court recognized a distinction between appreciation due to economic factors (*i.e.*, "passive appreciation") and appreciation due to the contributions of either spouse (*i.e.*, "active appreciation"). The court held in each case that active appreciation which occurs during the marriage is "acquired" by the marital estate and is not separate property within the meaning of North Carolina General Statute section 50-20(b)(2), a provision of the equitable distribution statute. Application of this section was limited to passive appreciation.

The *Wade* line of cases raises a number of significant questions for the close corporation in North Carolina. What factors should go into valuation of active appreciation? What should be the significance of compensation received from the corporation by the titled spouse? Will the corporate veil, otherwise meticulously maintained, succumb to the "wedding veil?" Should retained earnings belong to the marital estate or to the corporation? What form should the distributive award take? What are the implications of these decisions for other shareholders in close corporations? As will be shown under these cases, treatment of stock in a close corporation is decidedly different than treatment of stock in a publicly-held corporation.

Part II of this Comment examines the relevant North Carolina Court of Appeals cases. Part III explores the source of the court's rationale. Part IV discusses the policy issues raised for close corporations and applies the concepts discussed to the fictitious "Widget Corporation."

4. 72 N.C. App. 372, 325 S.E.2d 260, *disc. rev. denied*, 313 N.C. 612, 330 S.E.2d 616 (1985).

5. 73 N.C. App. 68, 326 S.E.2d 57 (1985).

6. 74 N.C. App. 144, 327 S.E.2d 910, *disc. rev. denied*, 314 N.C. 331, 333 S.E.2d 488 (1985).

II. THE COURT OF APPEALS CASES

A. *Wade v. Wade*⁷

The issue in *Wade* concerned real property rather than corporate stock, but this decision introduced the distinction between active and passive appreciation and the source of funds rule. During their marriage, Billy and Carolyn Wade built a home on a parcel of land he owned prior to the marriage. Carolyn Wade contributed substantial sums of money to construction and maintenance of the home. After eight years, the marriage was dissolved. The trial court awarded Carolyn Wade the home and subjacent land as marital property. The remaining land was characterized as separate property and was awarded to her husband.

On appeal, Billy Wade argued that the home represented an increase in value of his separate property and should also be considered separate property. His argument was based on the increase-in-value provision of section 50-20(b)(2).⁸ Carolyn Wade argued that the character of the land had been transformed from separate into marital property with the addition of the home.⁹ The court held that the increase-in-value provision of the statute refers only to passive appreciation and not to active appreciation.¹⁰ Passive appreciation was defined as income resulting from economic influences, such as inflation.¹¹ Active appreciation was defined as an increase resulting from the contributions, monetary or otherwise, by one or both spouses.¹² The trial court's division of the property was therefore upheld.

The rationale used in *Wade* was based upon dicta in an earlier case. In *Turner v. Turner*,¹³ the court of appeals suggested that a marital interest in real estate owned as separate property could arise if improvements or payments by the non-titled spouse contributed to an increase in value.¹⁴ The *Wade* court justified its broad interpretation of the increase-in-value provision on the basis of the remedial character of the equitable distribution statute. "As this court has previously recognized, G.S. section 50-20 was enacted in recognition of marriage as a partnership and is based at least in part on the policy of repayment of contribution."¹⁵ The appreciation of the Wade property was attributable, in part, to contributions by

7. 72 N.C. App. 372, 325 S.E.2d 260, *disc. rev. denied*, 313 N.C. 612, 330 S.E.2d 616 (1985).

8. N.C. Gen. Stat. § 50-20(b)(2) (1984).

9. This argument is known as the transmutation doctrine. *See infra* pp. 219-20.

10. *Wade*, 72 N.C. App. 372 at 379, 325 S.E.2d 260 at 268.

11. *Id.*

12. *Id.*

13. 64 N.C. App. 342, 307 S.E.2d 407 (1983).

14. "If, however, an equity in this property developed during the marriage because of improvements or payments contributed to by defendant, that equity (as distinguished from a mere increase in value of separate property, excluded by the statute) could be marital property, in our opinion, upon appropriate, supportable findings being made." *Id.* at 346, 307 S.E.2d at 409.

15. *Wade*, 72 N.C. App. at 379, 325 S.E.2d at 268 (citations omitted).

the marital estate (*i.e.*, construction and maintenance of the home). In turn, the marital estate was "entitled to a proportionate return of its investment."¹⁶ This return took the form of an interest in the property itself.

In finding that the real property appreciation was "acquired" during the marriage, the court adopted the source of funds rule. This theory of acquisition is based on "a dynamic rather than a static interpretation of the term 'acquired' as used in G.S. 50-20(b)(1) . . . [A]cquisition must be recognized as the ongoing process of making payment for property or contributing to the marital estate rather than being fixed on the date that legal title to property is obtained."¹⁷

B. *Phillips v. Phillips*¹⁸

Phillips was the first case under section 50-20(b)(2) to deal with appreciation of a corporate interest brought into the marriage by one spouse.¹⁹ The principal dispute was the characterization of the husband's interest in property purchased through the corporation of which he was ninety-eight percent stockholder. With funds both "borrowed" and "withdrawn" from this corporation, George Phillips acquired real property, a Swiss annuity, and another corporation. These loans and withdrawals were repaid from separate property, earnings after the marriage, and profits, rents, and sales of portions of these acquired properties.

The trial court concluded that the assets in question were separate property because they had been acquired with separate property. The trial judge relied on language in section 50-20 which includes property exchanged for separate property within the definition of separate property.²⁰ On appeal, Jane Phillips argued that there was no exchange of separate property and that the loans and withdrawals used to acquire the

16. *Id.* at 380, 325 S.E.2d at 268 (citations omitted). The court rejected the theory of transmutation through commingling. This theory would have completely transformed the character of the property from separate to marital. See *infra* at pp. 219-20.

17. *Wade*, 72 N.C. App. at 380, 325 S.E.2d at 268-69 (citations omitted).

18. 73 N.C. App. 68, 326 S.E.2d 57 (1985).

19. However, the decisions in *Phillips* and *McLeod v. McLeod*, 74 N.C. App. 144, 327 S.E.2d 910, *disc. rev. denied*, 314 N.C. 331, 333 S.E.2d 488 (1985), were signaled in *Wade*, 72 N.C. App. 372, 325 S.E.2d 260 (1985), by the court's reference to the result in, a pre-equitable distribution case, *Leatherman v. Leatherman*, 297 N.C. 618, 256 S.E.2d 793 (1979). The *Wade* court cited *Leatherman* as an example of the harsh results which equitable distribution was intended to avoid. 72 N.C. App. at 379, 325 S.E.2d at 267. Without compensation, Mrs. Leatherman worked full-time for eight years in a key role for a corporation formed by her husband after their marriage. Her claim at divorce for one-half of the stock was rejected by the North Carolina Supreme Court. The court held that services rendered by a wife in her husband's business are gratuitously performed in the absence of an agreement to the contrary. *Leatherman*, 297 N.C. at 622, 256 S.E.2d at 796. Had *Leatherman* been decided under the equitable distribution law, the wife would have been entitled to half the stock because the corporation was created with marital income. This would have been the pre-*Wade* result.

20. N.C. GEN. STAT. § 50-20(b)(2) (1984).

contested assets were marital property.²¹ George Phillips argued that the acquisitions represented an increase in the value of his separate property, the principal corporation, which retained its separate property status under the statute.²²

The court of appeals agreed that the acquisitions represented an increase in value of the corporation. However, citing *Wade*, the court recognized the increase as being comprised of both active and passive components.²³ The case was remanded to determine the active component of the increase in value of the corporation and the extent to which profits from it had been siphoned off to purchase other assets.

In *Phillips*, the court underscored the remedial nature of the equitable distribution statute, noting the immunization of separate property that would result if section 50-20(b)(2) were interpreted literally. Under such a reading, the court said, separate property would retain its character "even if the spouse who acquired [the assets] was only able to do so because his or her spouse devoted time and money to maintaining the household, enabling him or her to engage in profitable business dealings."²⁴ The court went on to say that such a result would render equitable distribution useless to someone who married "a businessman or entrepreneur who brings considerable corporate property into the marriage, and acquires most of the assets used in the marriage by profit-making manipulation of corporate funds."²⁵

C. *McLeod v. McLeod*²⁶

The principles developed in *Wade v. Wade* and *Phillips v. Phillips* were extended in *McLeod* to corporate stock inherited during marriage. The main issue on appeal was the effect of redemption by the husband's corporation of all its outstanding shares except those owned by him. During his marriage to the defendant, Edward McLeod inherited shares representing thirty-percent ownership in a trucking company. Later, the corporation redeemed, as treasury stock, all outstanding shares except those owned by Edward McLeod, president of the company. The redemption was financed with a loan co-guaranteed by his wife, Louisa, combined with company funds. The trial court held that the trucking company was the separate property of Edward McLeod.

On appeal, Louisa McLeod argued that the character of the stock had

21. Brief for Appellant at 18-19, *Phillips*, 73 N.C. App. 68, 326 S.E.2d 57 (1985). At the time her case was appealed, Jane Phillips did not have the benefit of the *Wade* decision, since the filing of *Wade* preceded *Phillips* by only fourteen days.

22. *Phillips*, 73 N.C. App. at 71-72, 326 S.E.2d at 59.

23. *Id.* at 73-74, 326 S.E.2d at 60-61.

24. *Id.* at 72, 326 S.E.2d at 60.

25. *Id.*

26. 74 N.C. App. 144, 327 S.E.2d 910 (1985).

been transformed from separate to marital property with the stock redemption.²⁷ In the alternative, she contended that equity dictated that she share in the increase, even if the court chose to characterize the redemption as an increase in value of the stock under section 50-20(b)(2).

This corporation . . . was the primary source of livelihood for Ed McLeod, III, and his wife and children. He took from it as salary each year all that it could reasonably afford to pay and continue as a viable business. . . . If the corporation yielded less because it was struggling to repay a loan procured for redemption of some of its capital stock, sustenance for the family was cut back proportionately. In the arena where equity is the name of the game, it was not the corporation but the family of Ed McLeod, III, and Mrs. McLeod in particular who paid for the stock redeemed by the corporation.²⁸

The court of appeals held that Edward McLeod's initial interest in the company acquired through inheritance was separate property.²⁹ However, any increase in value due to active appreciation during the marriage was held to be subject to equitable distribution. The court cited the redemption of stock by Edward McLeod as an example of active appreciation. "The redemption was a business decision from which plaintiff as president derived substantial economic advantage, which in terms of our statute and cases, is property acquired during the marriage."³⁰ The case was remanded to determine (1) the value of Edward McLeod's minority interest when it was inherited, (2) the value of the controlling interest when he and his wife separated, (3) the difference between the two values, and (4) the amount of the difference attributable to active appreciation.³¹

In these three cases, the court of appeals significantly narrowed the definition of separate property under the North Carolina equitable distribution statute. All three cases dealt with separate property which appreciated during marriage. At the root of these decisions are two concepts of property new to North Carolina jurisprudence—the "source of funds" rule and the dual nature of "appreciation." With the adoption of these concepts, the court analyzed the property on two levels. First, the acquisition of property now connotes both the point at which an equitable interest is first obtained and the period during which subsequent contri-

27. This is the same transmutation argument made by the appellant in *Phillips*. See *infra* pp. 219-20.

28. Brief for Appellant at 5, *McLeod*, 74 N.C. App. 144, 327 S.E.2d 910 (1985).

29. *McLeod*, 74 N.C. App. at 150, 327 S.E.2d at 914.

30. *Id.* at 151, 327 S.E.2d at 915.

31. *Id.* at 150-51, 327 S.E.2d at 914. The court rejected the wife's contention that her signature on the note securing the loan created a marital interest. However, the court noted that in some situations an equitable lien in favor of the one contributing to the separate property might be created. *Id.* at 151, 327 S.E.2d 914-15.

butions are made to its value. Second, the property may be comprised of two interests— both marital and separate.

III. THE SOURCE OF THE COURT'S RATIONALE

A. *When Is Property Acquired?—Three Theories*

The touchstone of the court's rationale in *Wade v. Wade* is its treatment of the term "acquired." The *Wade* court considered three theories of acquisition: inception of title, transmutation, source of funds. Under the inception of title theory of acquisition, property is acquired when the owner first obtains an equitable interest in the property. The character of the property is forever fixed at that point.³²

[T]he status of title, as belonging to one estate or the other, is determined by the status of the original right, subsequently matured into full title. Under this rule, property to which one spouse has acquired an equitable right before marriage is separate property, though such right is not perfected until after marriage.³³

The character of the property is thus not affected by an enhancement in its value. For instance, a spouse who brought real property into the marriage would retain title to it despite the fact that most of the mortgage payments were made with marital property after the marriage. The retention of title to separate property by the acquiring spouse under these circumstances has led to criticism of the inception of title theory.³⁴

The theory of transmutation is based on a party's intent, express or implied, to alter the status of the property. The commingling of separate and marital property raises an inference that the titled spouse intended to create a marital interest in his separate property.³⁵ Commingling also creates a rebuttable presumption of intent to change the character of the property.³⁶ In *Wade*, the court of appeals held that there was no basis in section 50-20 to support adoption of transmutation in North Carolina.³⁷ The court noted that this theory of acquisition was based on a preference

32. L. GOLDEN, *EQUITABLE DISTRIBUTION OF PROPERTY* § 1.06 (1983).

33. *Fisher v. Fisher*, 86 Idaho 131, 135-36, 383 P.2d 840, 842 (1963).

34. Sharp, *Equitable Distribution in North Carolina: A Preliminary Analysis*, 61 N.C.L. REV. 247, 255 (1983); see also L. GOLDEN, *supra* note 32, § 5.07. Under the Spanish community property system, while title was fixed at inception, the community was entitled to reimbursement under some circumstances. Reimbursement was required where acquisition was initiated before the marriage and completed afterward with part of the consideration coming from marital property. The labor or industry of either spouse during marriage constituted marital property. The measure of reimbursement was the value of the community's contribution toward completion of the acquisition. W. DEFUNIAK & M. VAUGHN, *PRINCIPLES OF COMMUNITY PROPERTY* § 64 (2d ed. 1971).

35. L. GOLDEN, *supra* note 32, § 5.33.

36. *Id.* See also W. DEFUNIAK & M. VAUGHN, *supra* note 34, § 61. To effect transmutation, generally some affirmative act must be undertaken. The act may take the form of contract, transfer of title or commingling. 1 VALUATION AND DISTRIBUTION OF MARITAL PROPERTY § 18.07(3) (J. McCahey ed. 1984).

37. *Wade*, 72 N.C. App. at 381, 325 S.E.2d at 269; see also Sharp, *supra* note 32, at 258.

for classifying property as marital. The court concluded that the North Carolina statute demonstrated a contrary preference, *i.e.*, that separate property remains separate property.

Applied to the mortgage payment example used to illustrate the inception of title theory, transmutation would yield diametrically opposite results. Despite the fact that real property was brought into the marriage by one spouse, it would be transformed entirely into marital property because most of the mortgage payments were made with marital property.

Transmutation has not been widely accepted as the solution to the alleged inequities of the inception of title theory. Transmutation has been faulted for ignoring the respective contributions of marriage partners to the acquisition of property.³⁸ Critics of both the inception of title and transmutation theories agree that the source of funds concept of acquisition eliminates the inequities of the other two theories.

With *Wade*, North Carolina joined a minority of equitable distribution states and a majority of community property states in adopting a dynamic definition of the term "acquired."³⁹ Under the source of funds rule, acquisition occurs along a continuum, rather than at a fixed point; property is acquired as it is paid for. Consequently, property may contain both marital and separate interests, depending upon the source of the contribution.⁴⁰

The policy foundations of the source of funds rule are fairness to the parties and consistency with the expectations of the parties.⁴¹

That theory [source of funds] is premised on the concept that it is unfair to permit a spouse who has contributed separate funds to the purchase or improvement of property to enjoy all of the benefits of sole ownership of the property without regard to the fact that it had been purchased or improved in part with community funds.⁴²

The source of funds rule is considered the most equitable of the three theories because of the greater flexibility it affords in determining property interests. The marital estate is deemed to have an interest in property acquired by either spouse in proportion to their contributions to the total value of the property.

Applied to the mortgage payment illustration, the source of funds rule yields results between those dictated by the inception of title and transmutation theories. The value of the property represented by pre-marital

38. L. GOLDEN, *supra* note 32, § 5.07.

39. *See id.* § 1.07.

40. Sharp, *supra* note 34, at 255; *see also* Krauskopf, *Marital Property at Marital Dissolution*, 43 Mo. L. REV. 157, 180 (1978).

41. Sharp, *supra* note 34, at 259.

42. *Harper v. Harper*, 49 Md. App. 339, 431 A.2d 761 (1981), *rev'd in part on other grounds*, 294 Md. 54, 448 A.2d 916 (1982).

payments remains separate property. However, the remaining value is considered to be acquired by the marital estate and is classified as marital property.

All three theories of acquisition have their origin in community property states.⁴³ Inception of title and transmutation were adopted by those states from the Spanish Community Property System. The general rule of acquisition under Spanish law was inception of title. Transmutation was developed as an exception to the general rule where separate and community property were so intermingled that the respective components could not be traced; the intermingled property was presumed to be community property.⁴⁴ Transmutation is now followed by a distinct minority of American community property states.⁴⁵ While the source of funds rule was first used in community property states,⁴⁶ it represents a departure from Spanish community property law.⁴⁷ The earliest adoption of this concept by an equitable distribution state was in 1979 by Maine.⁴⁸ The adoption of the source of funds doctrine provided the foundation for the active/passive appreciation distinction in North Carolina.

B. *Distinguishing Between Active and Passive Appreciation*

The source of funds rule was first applied to determine the marital interest in property acquired before marriage. However, it has also been applied to determine the marital interest in increases in separate property. The same remedial objectives which prompted development of the rule underly its application to increases in separate property. The concept of appreciation, like that of equity, has been bifurcated to serve this end. "Passive" appreciation is defined as an increase in value which occurs without any contribution by either party.⁴⁹ "Active" appreciation is defined as appreciation attributable to some affirmative effort by one or

43. W. DEFUNIAK & M. VAUGHN, *supra* note 34, § 64. Community property is a system where the property of both spouses belongs to each in halves. Each spouse's interest is devisable during the marriage and, the spouses are joint owners of all property acquired during the marriage. The community property system is employed in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington. *Id.* § 1. Only Texas and New Mexico strictly adhere to the inception of title concept today. L. GOLDEN, *supra* note 32, § 5.33.

44. W. DEFUNIAK & M. VAUGHN, *supra* note 34, § 64.

45. Illinois is the leader in the application of transmutation. *In Re Marriage of Smith*, 86 Ill. 2d 518, 427 N.E.2d 1239 (1981); *In Re Marriage of Lee*, 88 Ill. App. 3d 1044, 410 N.E.2d 1183 (1980), *aff'd*, 87 Ill. 2d 64, 430 N.E.2d 1030 (1981). Transmutation is also recognized in Missouri, *Anderson v. Anderson* 605 S.W.2d 524 (1980); Oregon, *In Re Marriage of Jenks*, 294 Or. 236, 656 P.2d 286 (1982); and the District of Columbia, *Darling v. Darling*, 444 A.2d 20 (D.C. App. 1982).

46. D. King, *The Challenge of Apportionment*, 37 WASH. L. REV. 483, 484 (1962); *see also* W. DEFUNIAK & M. VAUGHN, *supra* note 34, § 64.

47. W. DEFUNIAK & M. VAUGHN, *supra* note 34, § 64.

48. *Tibbets v. Tibbets*, 406 A.2d 70 (Me. 1979).

49. 1 VALUATION & DISTRIBUTION OF MARITAL PROPERTY, *supra* note 36, § 18.06.

both parties.⁵⁰

The active/passive distinction is a vestige of Spanish community property law. Under that system, property acquired during the marriage was characterized in one of two ways. Property acquired through labor, industry or valuable consideration contributed by either party was considered "onerous property." Property acquired without the efforts of the marriage partners, *e.g.*, by gift or inheritance, was characterized as "lucrative property."⁵¹ At the foundation of the onerous/lucrative distinction was the proposition that effort by one of the marital partners "depleted" the marital estate. The "cost" to the marital estate gave it an interest in the resulting gains or earnings of each spouse. The earnings or gains of the spouse:

are gained at the expense of the community in that the one making the earnings or gains is furthered therein by the use of community property or by the joint efforts of the other spouse, joint efforts on the part of the other spouse which may consist, as in the case of the wife, in maintaining the home and rearing the children, for that is a sharing of the burdens of the marital partnership and a contribution to the community effort.⁵²

The effort of one spouse, therefore, was attributable to both. The concept of depletion was based on the partnership theory of marriage central to the law of community property.⁵³ The earnings of one spouse were presumed to be for the benefit of both.⁵⁴

The principles underlying the onerous/lucrative distinction were also applied to the determination of the amount of reimbursement to the community where it contributed to increases in the value of separate property. While ownership was determined by the inception of title theory, the community was entitled to reimbursement for its contribution to the increase in separate property. Increases that resulted from the "intrinsic" nature of the separate property or from contributions of other separate property by the titled spouse were not part of the community. Intrinsic gains were considered to be those derived from "the benefit of nature or of time, without industry or work."⁵⁵ On the other hand, increases originating from the industry or work of either spouse or from

50. *Id.*

51. L. GOLDEN, *supra* note 32, § 5.21; W. DEFUNIAK & M. VAUGHN, *supra* note 34, § 62; see also Krauskopf, *supra* note 40, at 178.

52. W. DEFUNIAK & M. VAUGHN, *supra* note 34, § 62.

53. *Id.*

54. This view was consistent with the Spanish community property approach to income from separate property, *i.e.*, that such income was community property. This approach was abandoned by most community property states in the United States. They classify income from separate property as separate property. *Id.* § 64. This treatment of income from separate property is termed the "American Rule" as distinguished from the "Spanish Rule" whereby such income is considered marital property. 1 VALUATION & DISTRIBUTION OF MARITAL PROPERTY, *supra* note 36, § 20.04[2][b].

55. W. DEFUNIAK & M. VAUGHN, *supra* note 34, § 73 n.34.

contributions of community property belonged to the community.⁵⁶ Again, the concept of depletion of the marital estate was key to the distinction. Where increases were attributable to the community, reimbursement in the amount of one half of the enhanced value was the rule.⁵⁷

Passive appreciation represents an "intrinsic" increase in the value of the separate property. Active appreciation is the enhancement of value attributable to the "industry or labor" of one or both of the spouses. This distinction is recognized by a majority of states which have statutes that classify property as marital or separate.⁵⁸ It is, in many instances, a product of case law rather than statutory provision. For example, the increase in value of separate property is excluded from equitable distribution by statutes of eight common law states, including North Carolina.⁵⁹ Nevertheless, appellate decisions in six of these states have interpreted their statutes so as to include increases attributable to active appreciation in marital property.⁶⁰ Active appreciation is recognized expressly in the statutes of two common law states, New York and Kentucky. These statutes provide that the increase remains separate property except to the extent that the increase resulted from marital effort.⁶¹ However, in the absence of statutory provision, the active/passive distinction is generally recognized where a direct contribution of money or effort by a non-titled spouse has contributed to the increase.⁶²

IV. *Policy Issues for Close Corporations*

Four policy issues raised by the *Wade* line of cases will be examined within this section: (1) the definition of active appreciation, (2) the use of compensation as a method of apportioning the marital interest in active appreciation, (3) the application of the corporate separateness doctrine to the remedial objectives of equitable distribution, and (4) the form of the distributive award and its impact on other shareholders. Throughout this

56. *Id.* § 73; see also Krauskopf, *supra* note 40, at 180.

57. W. DEFUNIAK & M. VAUGHN, *supra* note 34, § 73.

58. Sharp, *supra* note 34, at 260. The classification-based system subjects to distribution only property acquired during the marriage through the efforts of the marital "team." Both community property and equitable distribution are classification based systems; see L. GOLDEN, *supra* note 32, § 2.01.

59. L. KORNFIELD & M. KRANZ, *EQUITABLE DISTRIBUTION: AN UPDATE 7* (1982). See also the position of the UNIF. MARRIAGE AND DIVORCE ACT § 307 (original version), 9A U.L.A. 143-44 (1973).

60. *E.g.*, *Tibbets v. Tibbets*, 406 A.2d 70 (Me. 1979); *J.D.P. v. F.J.H.*, 399 A.2d 207 (Del. 1979).

61. KY. REV. STAT. ANN. § 403.190(2)(e) (1984); N.Y. DOM. REL. LAW. § 236, Part B(1)(d)(3) (McKinney Supp. 1977-84). Colorado is the only state in which the entire increase is considered marital property. COLO. REV. STAT. § 14-10.113(4) (1973).

62. 1 VALUATION & DISTRIBUTION OF MARITAL PROPERTY, *supra* note 36, § 18.06.

section the reader will be asked to consider the predicament of "Widget, Inc." in light of the body of law on each of these four issues.

A. Valuation

The distinction between active and passive appreciation adds to the difficulty inherent in the valuation of close corporations. Judges now face not only the challenging task of valuing the corporation, but also the determination of the amount the stock has appreciated since its acquisition and then apportionment of that increase between the separate and marital estates. It is not the purpose of this Comment to consider in depth the exceedingly complex subject of valuation of close corporations. However, a brief orientation to the problem sets the stage for the main topic of this section.

For purposes of equitable distribution, the value of the corporation must be determined at two points—at the time it was brought into the marriage and the time the parties were separated. The value of stock in publicly-traded companies is determined by the market price at which it is traded at the time of valuation. No such basis of valuation exists for close corporations. By definition, there is no public trading market for stock in a close corporation.⁶³

Determination of the fair market value of a close corporation is fundamentally a subjective process which considers a number of factors. Among these are the history and nature of the enterprise, the economic outlook and condition of the industry, the general financial condition of the corporation, the book value of its stock, and its earning and dividend-paying capacities.⁶⁴ Another intangible factor that must be considered is goodwill. Goodwill of a publicly-held corporation is reflected in its trading price. However, in a close corporation, goodwill must be treated as a component part of the stock value of the corporation. Measuring these factors is a complex process often requiring accountants, appraisers, and consultants.

The determination of the active and passive components of appreciation may also require expert testimony. The opinions in *Wade v. Wade*, *Phillips v. Phillips* and *McLeod v. McLeod* have provided little guidance on how to discern the two forms of appreciation. The court's discussion of the subject in *Phillips* underscores the complexity of the task. On remand, Judge Arnold instructed the trial court:

to determine the "active appreciation" of the Pak-a-Sak corporation during the marriage of the parties, that is, the increase in net value due to the

63. See *supra* note 1.

64. Rev. Rul. 59-60, 1959-1 C.B. 237; 2 VALUATION AND DISTRIBUTION OF MARITAL PROPERTY, *supra* note 36, § 22.01-.11; see also Schreier & Jay, *Judicial Valuation of "Close" Corporation Stock: Alice in Wonderland Revisited*, 31 OKLA. L. REV. 853 (1978); Hempstead, *supra* note 1.

contributions in *personal effort or money* earned during the marriage by either or both of the spouses. In turn, the court should determine the extent to which that increase in net value was siphoned off and used to purchase the assets at issue . . . and the degree to which those assets increased in value due to plaintiff's or defendant's *personal managerial efforts or investment*.⁶⁵

In *McLeod*, the court cited as a specific example of active appreciation the increased value of the husband's interest in the company resulting from the corporation's redemption of all outstanding shares. The court held that the redemption "was a business decision from which plaintiff as president derived *substantial economic advantage* "and attributed the increased value to active appreciation.⁶⁶

On the basis of these two cases, active appreciation in North Carolina is apparently defined as "substantial economic advantage"⁶⁷ to the titled spouse derived through the "personal managerial efforts or investment"⁶⁸ by either spouse. To shed more light on the meaning of active and passive appreciation and their implications, the treatment of appreciation by other jurisdictions will be examined below.

1. What is Active Appreciation?

Among the states that recognize active appreciation, most require some showing of a contribution to the appreciation by the non-titled spouse.⁶⁹ This requirement raises both the issue of the type of the contribution (direct or indirect) and the source of the contribution (the titled spouse or the non-titled spouse).

By *whom* must contributions be made to entitle the marital estate to a share of the increase? Some states explicitly require by statute that contributions be made by the *non-titled spouse* for the community to share in the appreciation.⁷⁰ The New York statute states that the appreciation in value of separate property remains separate "except to the extent attributable in part to the contributions or efforts of the other spouse."⁷¹ In Oklahoma, case law holds that, where a non-owning spouse makes no contribution toward the appreciation of separate property, separate property retains its original character.⁷²

65. *Phillips*, 73 N.C. App. at 74, 326 S.E.2d at 61 (emphasis added).

66. *McLeod*, 74 N.C. App. at 151, 327 S.E.2d at 915 (emphasis added).

67. *Id.*

68. *Phillips*, 73 N.C. App. at 74, 326 S.E.2d at 61.

69. See, e.g., MICH. COMP. LAWS § 552.401 (West Supp. 1985); N.Y. DOM. REL. LAW § 236, Part B(1)(d)(3) (McKinney Supp. 1977-84); TENN. CODE ANN. § 36-4-121(c)(5) (1984). Colorado is the only state that by statute specifically includes the appreciation of value of separate property in the definition of marital property. See *supra* note 61.

70. MICH. COMP. LAWS § 552.401 (West Supp. 1985); N.Y. DOM. REL. LAW § 236, Part B(1)(d)(3) (McKinney Supp. 1977-84).

71. N.Y. DOM. REL. LAW § 236, Part B(1)(d)(3) (McKinney Supp. 1977-84).

72. *Templeton v. Templeton*, 656 P.2d 250 (Okla. 1982).

In other states, only the joint efforts of *both spouses* will impress the enhancement of value with a marital character.⁷³ Therefore, efforts by one spouse alone would not result in characterization of the increase as marital property.

A third approach is the one adopted by the North Carolina Court of Appeals.⁷⁴ A contribution by *either spouse* yields a marital interest in the appreciated value.⁷⁵ This approach is based on the community property principle of marriage as an economic partnership. This concept of contribution relates to the idea that effort by one spouse "depletes" the marital estate.⁷⁶

Another issue raised by the active appreciation concept is the *type* of contribution which creates a marital interest in the appreciation. Distinctions normally are drawn between direct and indirect, substantial and insubstantial contributions.

Most courts require a showing that there has been some direct contribution by the non-titled spouse to the growth in value of the separate property.⁷⁷ Some states require the direct application of money, effort or skill to the enterprise.⁷⁸ The Michigan Court of Appeals has held that a wife was entitled to a portion of the increased value of her husband's bowling alley, which he acquired before marriage, because she worked a regular shift in the business.⁷⁹ However, participation alone may not be enough; proof of efforts beyond that expected of a normal employee may be required to establish a direct contribution.⁸⁰ For example, proof that the non-titled spouse worked without compensation or for inadequate compensation may be sufficient.⁸¹

There have been relatively few decisions on the effect of indirect contributions.⁸² In one case, however, a New York court held that a wife's performance of social functions on behalf of her husband's company and her services as a travelling companion to him on business trips were too remote to be considered factors in the increase in value of his close corporation stock.⁸³

Some states distinguish among direct contributions on the basis of

73. *E.g.*, TENN. CODE ANN. § 36-4-121(b)(1) (1984).

74. *Phillips*, 73 N.C. App. at 74, 326 S.E.2d at 61.

75. *Scherzer v. Scherzer*, 346 A.2d 434 (N.J. 1975), *cert. denied*, 69 N.J. 391, 354 A.2d 319 (1976); *Pascoe v. Pascoe*, 11 FAM. L. REP. (BNA) 1091 (Pa. C.P. 1985).

76. *See supra* pp. 221-22 and accompanying notes.

77. 1 VALUATION & DISTRIBUTION OF MARITAL PROPERTY, *supra* note 36, § 18.06.

78. *Templeton v. Templeton*, 656 P.2d 250 (Okla. 1982); *Wright v. Wright*, 577 P.2d 922 (Okla. Ct. App. 1978).

79. *Gregg v. Gregg*, 113 Mich. App. 23, 348 N.W.2d 295 (1984).

80. 2 VALUATION AND DISTRIBUTION OF MARITAL PROPERTY, *supra* note 36, § 22.09[4].

81. *Id.*

82. *Id.*

83. *Jolis v. Jolis*, 98 A.D.2d 692, 470 N.Y.S.2d 584 (1982).

whether enough effort or money was applied to the enterprise. This "substantiality test" may be applied to measure the contribution of either spouse. "In either instance, the critical inquiry is whether the marital contribution is sufficiently substantial to warrant inclusion of the increase in value . . . as marital property."⁸⁴ Statutes in both Tennessee and Illinois address the degree of contribution required. In Tennessee the appreciation of separate property retains its original character unless each party has "substantially contributed" to it.⁸⁵ The Illinois legislature recently amended that state's statute to provide that all appreciation of separate property shall remain separate property regardless of the how the increase came about.⁸⁶ However, if the marital estate contributes substantial effort which results in substantial appreciation, there is a limited right of reimbursement under the new law.⁸⁷ This is also the position taken in the new Uniform Marital Property Act.⁸⁸ Under the act, an increase in separate property generally remains separate property. However, if the increase is substantial and results from substantial and uncompensated efforts of the other spouse, the resulting appreciation is marital property.⁸⁹

A key contribution issue is whether homemaker services are "direct" or "substantial" enough to be treated as contributions which create a marital interest in the increase in separate property. It is not uncommon to consider homemaker services as a factor in distribution of marital property, and the North Carolina statute includes such a provision.⁹⁰ However, few states have considered the influence of such services on the threshold issue of whether property should be characterized as marital or

84. Sharp, *supra* note 34, at 261. In an Illinois case the husband owned music stores before the marriage. The corporation increased in value during the marriage due to reinvestment of business earnings, personal efforts of the husband and small family loans. In holding that the husband's contributions were not substantial, the court stated that it was possible "for one spouse to improve the other spouse's non-marital property without making that property marital." *In re Marriage of Kennedy*, 94 Ill. App.3d 537, 547, 418 N.E.2d 947, 954-55 (1981). In a Missouri case the claim to a share of the increased value of her husband's close corporation stock was based in part on her contributions as an entertainer and traveling companion to her husband, the president of the company. The court held that her claim had no merit since "she made no substantial financial contributions to the business. . . ." *Hoffman v. Hoffman*, 676 S.W.2d 817, 826 (Mo. 1984) (en banc).

85. TENN. CODE ANN. § 36-4-121(b)(2) (Supp. 1984).

86. Illinois Marriage & Dissolution of Marriage Act, Public Act No. 83-1362 art. II, § 49 (codified at ILL. ANN. STAT. ch. 40, § 503(a)(7) (Smith-Hurd Supp. 1985)).

87. ILL. ANN. STAT. ch. 40, § 503(c)(2).

88. UNIF. MARITAL PROPERTY ACT § 14(b) (1983).

89. *Id.*, Section 14 of the Act creates this exception. That portion of the Act reads as follows: (b) Application by one spouse of substantial labor, effort, inventiveness, physical or intellectual skill, creativity, or managerial activity on individual property of the other spouse creates marital property attributable to that application if: (i) reasonable compensation is not received for the application, and (ii) substantial appreciation of the individual property of the other spouse results from the application.

Id.

90. N.C. GEN. STAT. § 50-20(c)(6) (1984).

separate.⁹¹ The policy underlying a claim to appreciation based on homemaker services is that performance of those services enabled the other spouse to devote himself more fully to the enhancement of his separate property. "The presumption is that less effort would be devoted to the business, and less enhancement in value would result if the business participant had to divert some efforts to meal preparation or housekeeping duties."⁹² Courts in New York, Kentucky, and Washington have concluded that homemaker services should not be used to determine whether an increase in separate property is marital or separate.⁹³ The Supreme Courts of both Montana and New Jersey have held that homemaker services constitute a contribution sufficient to create a marital interest in appreciation of separate property.⁹⁴ In sum, a distinct minority of states regard homemaker services as giving rise to a marital interest in the appreciation of separate property.⁹⁵

The majority of jurisdictions hold that increases in separate property retain that character, absent a direct contribution by the non-titled spouse.⁹⁶ The opinion in an Iowa case is characteristic of the preference of most courts for some direct relationship between contribution and increase.⁹⁷ The court held that a wife was entitled to share in the increased value of her husband's separate property only to the extent that the increase could be attributed to her efforts. "The underlying premise of our analysis is that an equitable property division of the appreciated value of the property should be a function of the tangible contributions of each party and not the mere existence of the marital relationship."⁹⁸ The term active appreciation is thus frequently defined in terms of a direct contribution to the increase in separate property by the non-titled spouse.

91. 2 VALUATION & DISTRIBUTION OF MARITAL PROPERTY, *supra* note 39, § 22.09[4][a].

92. *Id.* This rationale has a basis in Spanish community property law. In discussing the concept of onerous property, deFuniak notes that "joint efforts . . . may consist [of], as in the case of the wife, . . . maintaining the home and rearing the children, for that is a sharing of the burdens of the marital partnership and a contribution to the community effort." W. DEFUNIAK & M. VAUGHN, *supra* note 34, § 62.

93. *Brandenburg v. Brandenburg*, 617 S.W.2d 871 (Ky. Ct. App. 1981); *In re Marriage of Johnson*, 28 Wash. App. 574, 625 P.2d 720 (1981).

94. *In re Marriage of Brown*, 587 P.2d 361 (Mont. 1978) (wife who worked part-time on a ranch and provided homemaker services, held entitled to a portion of the appreciated value of husband's separate property ranch); *Griffith v. Griffith*, 185 N.J. Super. 382, 448 A.2d 1035 (1982) (homemaker services entitled wife to share in the amount of mortgage paydown on a house which husband owned as separate property).

95. 1 VALUATION & DISTRIBUTION OF MARITAL PROPERTY, *supra* note 36, §§ 18.06, 20.09[4][a]. For a discussion of homemaker services, see Grossman & Casey, *Valuation of a Homemaker's Services*, 1 EQUIT. DIST. REP. at 9 (Jan. 1981).

96. 1 VALUATION & DISTRIBUTION OF MARITAL PROPERTY, *supra* note 36, § 18.06.

97. *In re Marriage of Lattig*, 318 N.W.2d 811 (Iowa Ct. App. 1982).

98. *Id.* at 815.

2. What is Passive Appreciation?

The meaning of active appreciation has been more fully developed in the case law than its corollary, passive appreciation. Passive appreciation has been described variously as attributable to inflation,⁹⁹ to changes in the law affecting business¹⁰⁰, and to general market conditions.¹⁰¹ Thus it follows that the increase in value of publicly-traded stock would be treated as passive appreciation and therefore as an increase in separate property under section 50-20(b)(2).¹⁰² Absent some showing that one of the spouses effected the increase in market price,¹⁰³ an increase in publicly-traded stock will be treated as passive appreciation in equitable distribution and community property jurisdictions. Passive appreciation has essentially been defined by exclusion. In opinions which recognize the active/passive appreciation distinction, the threshold question has been whether the increase was attributable to active appreciation. If not, the increase has typically been characterized as passive in nature.

3. Valuation and The Widget Corporation

The North Carolina Court of Appeals has adopted a liberal approach toward active appreciation. To sustain a marital claim against an increase in separate property, the non-titled spouse need not demonstrate a direct contribution. The implications of this view are illustrated in the context of the Widget, Inc. scenario.¹⁰⁴ Susan concedes that she made no contribution to the increase in value of Widget—direct or indirect, substantial or insubstantial. There were no homemaker services to consider. Yet solely by virtue of her status as wife, Susan has a claim to the rise in value of Widget stock. An award to Susan of any of the increased value of Widget would not appear to further the remedial purpose of the equitable distribution act. The predicament of Widget highlights the significance of whether active appreciation depends upon a showing of direct contribution by the non-titled spouse.

The scenario described above is distinguishable from the facts upon

99. *Wade v. Wade*, 72 N.C. App. 372, 379, 325 S.E.2d 260, 268, *disc. rev. denied*, 313 N.C. 612, 330 S.E.2d 616 (1985).

100. *Hoffman v. Hoffman*, 676 S.W.2d 817, 826 (Mo. 1984) (en banc).

101. *Jolis v. Jolis*, 98 A.D.2d 692, 470 N.Y.S.2d 584 (1983).

102. N.C. GEN. STAT. § 50-20(b)(2) (1984).

103. *See Nolan v. Nolan*, 107 A.D.2d 190, 486 N.Y.S.2d 415 (1985) (held increase in husband's stock portfolio marital property where husband left a salaried position to devote his full energies to managing the stocks).

104. *See supra* pp 213-14. For the purpose of this illustration, however, further, assume that when Susan met John, she had just passed the bar and was starting as an associate with a local law firm. Within three years of their marriage, she became a partner in the firm. John and Susan chose not to have children, both preferring to pursue their respective professional careers. They worked long hours and had little time for or interest in domestic tasks. They employed a maid and a yard service to maintain the home.

which *Wade v. Wade*, *Phillips v. Phillips* and *McLeod v. McLeod* were decided. In each of these cases, the court found a direct contribution by the non-titled spouse. In *Wade*, the wife contributed significant sums of money to the construction and maintenance of the marital home.¹⁰⁵ In *Phillips*, though the property was initially purchased with loans from the corporation, these loans "eventually were paid for at least in part by income earned during marriage."¹⁰⁶ In *McLeod*, the court rejected the wife's claim that her signature as co-guarantor on the loan to the corporation transmuted the redeemed shares into marital property; however, the court did specifically recognize the contribution represented by her signature.¹⁰⁷

B. *Compensation—An Alternative to Active Appreciation?*

In *McLeod*, the court of appeals rejected the husband's argument that the marital interest in the corporation was limited to his salary.¹⁰⁸ The rationale behind the husband's argument was that the salary compensated the marital estate for the effort he expended on his separate property, the corporation. The concept of active appreciation is based on the idea that such effort constitutes depletion of the marital estate.¹⁰⁹ Some courts have held that the salary paid a corporate officer/shareholder compensates the marriage for this depletion. These courts recognize a marital interest deriving from the effort of the titled spouse; however, the interest is represented by compensation received by that spouse rather than by the increased value of the corporate stock. Compensation, therefore, is used as a means of apportioning the total increase. This approach is recognized by all of the community property states¹¹⁰ and is the most likely method of apportionment to be used where a corporation is involved.¹¹¹

The leading case employing the compensation approach is *Van Camp v. Van Camp*¹¹². In this 1921 California case, the husband was majority

105. 72 N.C. App. at 378, 325 S.E.2d at 267.

106. 73 N.C. App. at 73, 326 S.E.2d at 60.

107. 74 N.C. App. at 151, 327 S.E.2d at 915. "We note, however, that where a spouse puts him or herself at risk guaranteeing repayment of a loan whose proceeds do not partake of marital property interests, courts have found the community entitled to an equitable lien for its contribution" *Id.* (citations omitted) (emphasis added).

108. *Id.*

109. See *supra* pp. 221-22 and accompanying notes.

110. *Cockrill v. Cockrill*, 124 Ariz. 50, 601 P.2d 1334 (1979); *Nace v. Nace*, 104 Ariz. 20, 448 P.2d 76 (1978); *Speer v. Quinlin*, 96 Idaho 119, 525 P.2d 314 (1974); *Katson v. Katson*, 43 N.M. 214, 89 P.2d 524 (1939); *Cord v. Neuhooff*, 94 Nev. 21, 573 P.2d 1170 (1978); *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984); *Hamlin v. Merlino*, 44 Wash. 851, 272 P.2d 125 (1954).

111. *King*, *supra* note 46, at 488.

112. 53 Cal. App. 17, 28, 199 P. 885, 889 (1921). The salary system of apportionment was developed as an alternative to a method adopted in an earlier case, *Pereira v. Pereira*, 156 Cal. 1, 103 P. 488 (1909). The method of apportionment adopted in *Pereira* is known as the "interest system."

shareholder and president of Van Camp Seafood Company prior to the marriage. He retained that position throughout the marriage and devoted all of his time to the company. He was paid a salary which was applied to community uses. The court held that "while [the husband] devoted his energies and personal efforts to making [the company] a success, he was by the corporation paid what the evidence show[ed] was an adequate salary, and for which another than himself with equal capacity could have been secured."¹¹³ Therefore, the court held that the full value of the company stock would be retained by the husband.¹¹⁴

Under this method of apportionment, payment of salary by a corporation does not automatically insulate the appreciation in value of stock from a marital claim. To insulate, the salary must be adequate compensation to the marital estate for the cost of the titled spouse's effort. If not, the court will impress a marital character on the amount of the appreciation equal to the difference between a fair salary and that actually received.¹¹⁵ Adequacy of compensation is generally determined with reference to comparable commercial situations.¹¹⁶

The compensation method of apportionment has not received much attention in equitable distribution states. Missouri is the only equitable distribution state that has used this method.¹¹⁷ A Pennsylvania court rejected the idea that salary adequately compensated the marital community, holding that this idea was inconsistent with the economic partnership principle underlying equitable distribution.¹¹⁸ In *McLeod*, the North Carolina Court of Appeals rejected the salary argument.¹¹⁹ The court based its conclusion on the degree of control the shareholder

Under the interest system, a fair rate of return is calculated on the value of the separate property at the time of the marriage. The original value of the equity and the return are awarded to the owning spouse as separate property, and the balance is awarded to the community. This system is still used in some instances in California and in some other community property states. 1 VALUATION & DISTRIBUTION OF MARITAL PROPERTY, *supra* note 36, § 20.04[2].

113. *Van Camp*, 53 Cal. App. at 28, 199 P. at 889.

114. *Id.* at 29, 199 P. at 890.

115. *Weinberg v. Weinberg*, 67 Cal. 2d 557, 432 P.2d 709, 63 Cal. Rptr. 13 (1967); *Tassi v. Tassi*, 160 Cal. App. 2d 680, 325 P.2d 872 (1958); *Kenney v. Kenney*, 128 Cal. App. 2d 128, 274 P.2d 951 (1954); *Hamlin v. Merlino*, 44 Wash. 851, 272 P.2d 125 (1954); *In re Buchanan's Estate*, 89 Wash. 172, 154 P. 129 (1916); *see also* 1 VALUATION AND DISTRIBUTION OF MARITAL PROPERTY, *supra* note 36, § 20.04[2]; *King*, *supra* note 43, at 486.

Application of traditional corporate law principles would lead to the same result. The corporate veil may be lifted where there is a finding that the corporate form has been used to circumvent public policy. *See* R. ROBINSON, NORTH CAROLINA CORPORATION LAW AND PRACTICE § 2-12 (1983). The shortfall between actual and adequate compensation raises an inference of fraudulent intent. Absent an effective rebuttal, this inference would provide grounds for disregarding the corporate form; *see infra* pp. 232-34 and accompanying notes.

116. *King*, *supra* note 43, at 497.

117. *Hoffman v. Hoffman*, 676 S.W.2d 817 (Mo. 1984) (en banc).

118. *Pascoe v. Pascoe*, 11 FAM. L. REP. (BNA) 1091 (Pa. C.P. Jan. 1, 1985).

119. 74 N.C. App. 144, 327 S.E.2d 910, *disc. rev. denied*, 314 N.C. 331, 333 S.E.2d 488 (1985).

spouse has over the amount of salary paid.¹²⁰ A majority shareholder spouse could intentionally limit the amount of salary paid to himself, thereby, undercompensating the marriage.¹²¹ Neither the Pennsylvania court nor the North Carolina Court of Appeals recognized adequacy of compensation as a measure of the fairness of an apportionment of active appreciation.

Application of the compensation approach to the Widget Corporation requires the assumption of additional facts. At the time of his marriage John's annual salary was \$30,000. The year prior to the filing of the divorce action, Widget paid John \$125,000. John also received sizable bonuses during ten of the previous fifteen years. His income and bonuses were applied to marital expenses and assets. John's attorney offered evidence showing that the compensation John received was comparable to that paid to the presidents of similar-sized companies in the region.

Upon a showing of adequate compensation, should it matter that John was employed by Widget, Inc. or IBM, Inc. so long as the corporate integrity of each is properly maintained? Susan has made no direct contribution to the growth of Widget, nor has she provided homemaker services. Under these circumstances, should not John's substantial compensation from Widget provide a fairer measure of the marital interest in the company than the allocation of stock to Susan? The underpinning of the economic partnership theory in this context is contribution by the non-titled spouse to the enterprise. While most courts require direct contribution, a minority of courts recognize homemaker services as sufficient to create a marital interest in the increase of separate property. In the absence of either direct contribution or homemaker services, a persuasive argument can be made that the marital partnership has been sufficiently remunerated for John's effort.¹²²

C. *Equitable Distribution and the Corporate Veil*

The potential erosion of a corporate law principle—separateness of the corporate entity—is another issue raised by the *Wade* line of cases. Though this issue was not briefed by either of the parties, the court made reference to it in *Phillips v. Phillips*.¹²³ "We do not believe that merely by covering his transactions with the corporate veil plaintiff can claim that any assets acquired thereby are wholly insulated from equitable distribution."¹²⁴ The issue therefore presented is whether creating a marital interest in the appreciation of separate property stock violates the integ-

120. *Id.* at 151, 327 S.E.2d at 915.

121. There is no evidence of such an intent in *McLeod*. *Id.*

122. This argument raises the question whether the rise of two-career families will erode some of the basis of the economic partnership model of marriage.

123. 73 N.C. App. 68, 326 S.E.2d 57 (1985).

124. *Id.*, at 74, 326 S.E.2d at 61.

ity of the corporate form as a distinct entity. Though yet to be presented in North Carolina, the corporate veil question has been raised in this context in other jurisdictions.

The metaphor of the corporate veil is based on the concept of corporate separateness. A corporation is a legal entity "which is regarded in law as having a personality and existence distinct from that of its several members."¹²⁵ The distinction between the corporation and its shareholders is fundamental to the law of corporations.¹²⁶ This distinction is the essence of "corporateness." "[T]he corporate entity is distinct, although all of its stock is owned by a single individual or corporation."¹²⁷ If the corporate existence is properly created and maintained, the shareholders' personal obligations will not be enforced on the corporation. In turn, the corporation's obligations will not be imposed on the non-director shareholders beyond the value of their equity in the enterprise. "The corporation is a person and its ownership is a nonconductor that makes it impossible to attribute an interest in its property to its members."¹²⁸

1. Disregarding The Corporate Entity

A court will disregard the corporate form and "pierce" the veil of separateness in limited circumstances. When the veil is pierced, the court ignores the immunity that otherwise exists between the corporation and its stockholders for their respective obligations. Piercing the corporate veil is considered an extreme measure employed to "avoid the perpetration of a fraud or otherwise to serve the ends of justice."¹²⁹ Disregarding the corporate form is a remedy used "reluctantly and cautiously."¹³⁰

A recent North Carolina Supreme Court decision reviewed the grounds for disregarding the corporate entity.¹³¹

When a corporation is so operated that it is a mere instrumentality or alter ego of the sole or dominant shareholder and a shield for its activities in violation of the declared public policy or statute of the state, the corporate entity will be disregarded and the corporation and the shareholders treated as one and the same person, it being immaterial whether the sole or dominant shareholder is an individual or another corporation.¹³²

*Glenn v. Wagner*¹³³ enumerated a three-part test for determining whether the corporation is the alter ego of the dominant shareholder.

125. BLACKS LAW DICTIONARY 307 (rev. 5th ed. 1979).

126. R. ROBINSON, *supra* note 115, § 2-10.

127. Troy Lumber Co. v. Hunt, 251 N.C. 624, 627, 112 S.E.2d 132, 134 (1960); R. ROBINSON, *supra* note 115, § 2-10.

128. Klein v. Board of Tax Supervisors, 282 U.S. 19, 24 (1930).

129. R. ROBINSON, *supra* note 115, § 2-12.

130. *Id.*

131. Glenn v. Wagner, 313 N.C. 450, 329 S.E.2d 326 (1985).

132. *Id.* at 453, 329 S.E.2d at 329.

133. 313 N.C. 450, 329 S.E.2d 326 (1985).

First, it must be shown that the corporation is dominated and controlled by the shareholder.¹³⁴ The court cited numerous factors which would support a finding of domination and control, including non-compliance with corporate formalities, "non-payment of dividends, insolvency of the debtor corporation, siphoning of funds by the dominant shareholder, non-functioning of other officers or directors, absence of corporate records."¹³⁵ The second prong of the test requires evidence that the control has been used to "commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest and unjust act in contravention of plaintiff's legal rights. . . ."¹³⁶ Stated another way, the corporate veil will be pierced when the corporate form is used to circumvent public policy and defeat the public interest.¹³⁷ Third, the control and fraud must be established as the proximate cause of the complainant's injury.¹³⁸

2. Marital Property Distribution: Application of the Separateness Doctrine

In the context of property distribution, the corporate separateness doctrine has been applied to determine the marital interest in an increase in value of stock. Most of these decisions come from the community property states, and they apply the separateness doctrine with predictable results. This doctrine has not been applied to determine the marital interest in an increase in corporate retained earnings. However, cases deciding this issue have based their decisions on related factors, *e.g.*, the degree of control exercised by the titled spouse.

a. Increased Stock Value

In a case where the husband owned ninety-nine and one-half percent of the corporate stock, maintained a combined checking account both for the corporation and for personal business, and used part of his salary to defray corporate operating expenses, a Texas court held that the corporation was the alter ego of the husband and pierced the corporate veil. The wife's claim to a community interest in the appreciation of his separate property stock was sustained.¹³⁹ Once again relying on established principles of corporate law, the same court resolved a later case against the non-titled spouse refusing to pierce the corporate veil.¹⁴⁰ The wife ar-

134. *Id.* at 454-55, 329 S.E.2d at 330.

135. *Id.* at 458, 329 S.E.2d at 332.

136. *Id.* at 455, 329 S.E.2d at 330.

137. R. ROBINSON, *supra* note 115, § 2-12.

138. *Glenn*, 313 N.C. at 455, 329 S.E.2d at 330.

139. *Uranga v. Uranga*, 527 S.W.2d 761 (Tex. Civ. App. 1975); see *Dillingham v. Dillingham*, 434 S.W.2d 459 (Tex. Civ. App. 1968).

140. *Vallone v. Vallone*, 644 S.W.2d 455 (Tex. 1982). The court split five-to-four with the mi-

gued that the appreciation in value of a restaurant was community property. Evidence showed that cash was taken from the business for personal expenses, that officers' and directors' meetings were not regularly held, and that the business was operated by the titled spouse rather than the officers and directors. While noting that the enterprise was not operated by ideal business practices, the court concluded that there was no indication that the husband's acts as president of the company were committed for the purpose of defrauding his wife.

In equitable distribution states, the separateness doctrine generally either has not been mentioned or has been subordinated to the remedial purpose of the statute. "So far as equitable distribution principle is concerned, there should be no essential difference between a situation in which the husband has an interest in an individual business and one held in a corporate name. The form should not control."¹⁴¹

On the surface, application of the separateness doctrine as a defense to equitable distribution appears questionable. A stock certificate simply manifests an equity interest in a corporation.¹⁴² Stock is freely alienable and can be transferred without impugning the integrity of the corporate entity. Therefore, transferring to a non-titled spouse an amount of stock which equals his share of the active appreciation does not raise a separateness doctrine question.¹⁴³ However, if the court awards an asset of the corporation rather than an equitable interest, the veil issue appears to be more relevant. Absent a basis for disregarding the corporate entity, should the court go "inside" the corporation and transfer its assets? On the other hand, should the separateness doctrine restrict a court from dealing with the interest in, rather than the assets of, the enterprise.

Again, an intent to circumvent public policy or to defeat the public interest is a basis for piercing the corporate veil.¹⁴⁴ A showing that the titled spouse used the corporate form to improperly conceal assets or income to stymie the intent of the equitable distribution law is a proper

nority registering a strong dissent, citing the community property principle that the efforts of one spouse are presumed to be for the benefit of both. The dissent argued that community interests were to be guarded with "jealous vigilance. The mere formation of a corporate entity, a legal fiction, cannot be permitted to create an obstacle to a critical, equitable or proper analysis of the status of marital property." *Id.* at 468. *But cf.* *Troy Lumber Co. v. Hunt*, 251 N.C. 624, 112 S.E.2d 132 (1960). "But it leads nowhere to call a corporation a fiction. If it is a fiction, it is a fiction created by law with intent that it should be acted on as if true." *Klein v. Board of Tax Supervisors*, 282 U.S. 19, 24 (1930). *See also* *Mifflin v. Mifflin*, 97 Idaho 895, 556 P.2d 854 (1976) (court refused to disregard the corporate entity to determine a community share in a corporation of which the husband owned 249/250 shares where wife contended that the corporation was husband's alter ego); *Wells v. Hiskett*, 288 S.W.2d 257 (Tex. Civ. App. 1956) (corporate entity should not be disregarded unless a well recognized basis exists for doing so).

141. *Scherzer v. Scherzer*, 136 N.J. Super. 397, 400, 346 A.2d 434 (1975), *cert. denied*, 69 N.J. 391, 354 A.2d 319 (1976).

142. R. ROBINSON, *supra* note 115, § 17-2.

143. *See infra* pp. 240-44 for other issues raised by the distributive award.

144. R. ROBINSON, *supra* note 115, § 2-12.

basis for piercing the corporate veil under traditional principles of corporate law. This issue is brought into sharper focus by cases dealing specifically with claims against the retained earnings balance of a close corporation.

b. Retained Earnings

In *McLeod v. McLeod*,¹⁴⁵ the North Carolina Court of Appeals suggested in dicta that corporate retained earnings could be marital property.¹⁴⁶ "To suggest, as plaintiff does, that only his salary constitutes marital property ignores the reality of a closely-held corporation wherein persons in control have broad discretion in allocating salary, dividends, and *retained earnings*."¹⁴⁷ Courts in other states have addressed the issue directly and have held that retained earnings either are or may be marital property under some circumstances.¹⁴⁸ Retained earnings represent "the amount by which the shareholders' equity exceeds the par value or stated value of the outstanding capital stock. It is, thus, growth in value."¹⁴⁹ The purposes served by retained earnings are to provide the enterprise with working capital and to finance future growth. One rationale for subjecting retained earnings to equitable distribution is that they represent "undistributed current income and have no pertinent relationship to the value of the previously acquired stock."¹⁵⁰

Courts not sympathetic to this argument have addressed it as a violation of the separateness doctrine. "Generally, the wife could not claim the retained earnings as marital property, because the earnings and profits of a corporation remain *its* property until severed from other corporate assets and distributed as dividends."¹⁵¹ A related argument against treatment of retained earnings as marital property is that it disregards the legitimate business needs of the corporation.

The control of the titled spouse over retained earnings and the amount of earnings retained in relation to the business needs of the corporation have been the major factors considered by courts faced with this issue. The reference to retained earnings by the *McLeod* court was made as an example of one aspect of corporate finance subject to those in control of a close corporation.¹⁵² This aspect was also considered in a Delaware decision. In *J.D.P. v. F.J.H.*,¹⁵³ the husband appealed from a trial court

145. 74 N.C. App. 144, 327 S.E.2d 910, *disc. rev. denied*, 314 N.C. 331, 333 S.E.2d 488 (1985).

146. *Id.* at 151, 327 S.E.2d at 915.

147. *Id.* (emphasis added).

148. *J.D.P. v. F.J.H.*, 399 A.2d 207 (Del. 1979); *Pascoe v. Pascoe*, 11 FAM. L. REP. (BNA) 1091 (Pa. C.P. Jan. 1, 1985).

149. 1 VALUATION & DISTRIBUTION OF MARITAL PROPERTY, *supra* note 36, § 22.07.

150. *J.D.P.*, 399 A.2d at 209.

151. *Hoffman v. Hoffman*, 676 S.W.2d 817, 827 (Mo. 1984) (en banc) (emphasis added).

152. 74 N.C. App. at 151, 327 S.E.2d at 915.

153. 399 A.2d 207 (Del. 1979).

holding which characterized as marital property an increase in retained earnings in a close corporation in which he held a separate property interest. When he married, the husband owned a sixty-five percent interest in two Delaware corporations. The retained earnings of both companies increased substantially during the marriage. The husband argued that the earnings were separate property and therefore exempt from equitable distribution.¹⁵⁴ His wife contended that the earnings were simply deferred income. The court took note of the power a majority shareholder holds over whether dividends are declared and what amount of dividends are paid. The court noted that excluding retained earnings from consideration as marital property would enable a majority shareholder spouse to effectively insulate these earnings from all equitable claims.¹⁵⁵ However, the court also held that the control factor alone was not conclusive of the issue, and the characterization of the earnings surplus was a question to be determined by all surrounding circumstances.¹⁵⁶

The control issue was also the focal point of the court's analysis in a Missouri case dealing with retained earnings.¹⁵⁷ In that case, the wife appealed the trial court's finding that retained earnings were separate property where her husband had a thirty-percent separate property interest in the corporation in which he was chief executive officer, president, and director. Two of his brothers and another officer comprised the remainder of the board. The wife argued that her husband's position of influence in the company permitted him to control and limit the amount of earnings distributed, thereby enabling him to conceal disproportionate sums under the corporate veil. The appellate court cited as significant the fact that the husband was not a majority shareholder and that he was only one of four members of the board which had the power to declare dividends. The court held that in "the absence of evidence of collusion with other board members to defraud petitioner of marital property by minimizing dividends, the trial court finding will not be disturbed. . . ."¹⁵⁸ In other words, the court was unconvinced that the husband either possessed or exercised sufficient control over the amount of earnings retained to defraud his wife by manipulation of the earnings surplus.

While an unusually large retained earnings balance might raise the

154. The Delaware statute provides that all property acquired by either spouse after marriage is presumptively marital property. However, the presumption is rebuttable if the property results from an "increase in value of property acquired prior to the marriage." 13 DEL. CODE ANN. tit. 13, § 1513(b)(3)(c) (1981).

155. *J.D.P.*, 399 A.2d at 210.

156. *Id.* at 211. The case was remanded to the trial court for consideration of this and other factors. The supreme court made it clear that just as retained earnings were not conclusively exempt from equitable distribution, they were not always to be included. *Id.*

157. *Hoffman*, 676 S.W.2d 817 (Mo. 1984).

158. *Id.* at 827.

specter of manipulation, other considerations might militate against such a conclusion, e.g., legitimate business needs. The importance of considering the legitimate business uses of retained earnings was underscored by a recent New York decision. In *Jolis v. Jolis*,¹⁵⁹ the husband had received a gift of stock in a family diamond business the year before his marriage. The company was very successful, in part due to the husband's efforts, but it had never declared a dividend. The wife claimed an interest in the substantial earnings retained by the corporation. The appellate court affirmed the trial court's denial of her claim and noted that it was "undisputed that [the corporation] needed the accumulated surplus to provide working capital for daily operations, including maintenance of a \$12,000,000 diamond inventory, and to comply with banking agreement requirements."¹⁶⁰ "Ordinary and necessary business reasons" were also listed by the *J.D.P.* court as a factor to be considered in the evaluation of a marital claim on retained earnings.¹⁶¹

In *McLeod*, the North Carolina Court of Appeals addressed the issues of both control and business needs. The court suggested that proof of an improper use of retained earnings would not be necessary to sustain a marital claim. Under this view, proof of control is tantamount to proof of the improper exercise of control. Nor would evidence of a legitimate business need for the retained earnings balance vitiate the marital claim. "A decision which is entirely sound from the standpoint of corporate policy still might operate to the disadvantage of a shareholder's spouse so as to deprive the spouse of a share of the fruits of the shareholder's labor."¹⁶²

Control is a proper factor to consider in a marital claim on retained earnings. However, should proof of control alone be *prima facie* evidence of an improper exercise of that power? If the titled spouse has manipulated the earnings surplus so as to insulate income from equitable distribution, a sound basis exists for piercing the corporate veil. Traditional principles of corporate law provide for disregarding the corporate entity where the corporate form has been used to circumvent public policy. On the other hand, to treat retained earnings as marital property

159. 98 A.D.2d 692, 470 N.Y.S.2d 584 (1983). The court also made reference to the tax implications for the corporation of retaining an excessive earnings surplus. "DDI's books have been examined annually by Internal Revenue agents, and these audits had never resulted in a finding that DDI's retained earnings account was excessive, a finding which would have resulted in a substantial tax penalty to DDI." *Id.* at 693, 470 N.Y.S.2d at 586. A Missouri court declined to consider the size of a surplus earnings account, stating that the court did not have jurisdiction to determine that issue since the corporation was not a party to the action. *Hoffman*, 676 S.W.2d 817, 827 (Mo. 1984). The court also noted that the petitioner was without standing to challenge action of the corporation's board.

160. *Jolis*, 98 A.D.2d at 693, 470 N.Y.S.2d at 586.

161. 399 A.2d at 211.

162. *McLeod*, 74 N.C. App. at 151, 327 S.E.2d at 915 (quoting *Hoffman*, 676 S.W.2d at 830).

without such evidence would violate the doctrine of corporate separateness.

The size of the retained earnings balance is also a proper factor to consider in a marital claim on retained earnings. However, should the size of the balance alone be *prima facie* evidence of an intent to defraud the non-titled spouse? A large retained earnings balance which is not required by legitimate business needs supports an inference of an intent to defraud. If not rebutted, this inference provides a sound basis for piercing the corporate veil. Absent these circumstances, characterizing retained earnings as marital property would also be an improper violation of the integrity of the corporate entity.

3. The Separateness Doctrine and the Widget Corporation

The integrity of the fictitious Widget Corporation is unassailable. The corporation was duly organized under the laws of North Carolina and was operated in strict accord with those laws. There is nothing in the recorded activity of this company which would provide a basis for disregarding the corporate form. There is also no evidence of an attempt to circumvent the remedial purpose of the equitable distribution law. John has not improperly exercised his control position with the corporation, and the retained earnings balance is a consequence of economic factors.¹⁶³ Nevertheless, Susan has a legitimate claim under the *Wade* line of cases, not only to the stock of the company, but to its assets and, specifically, to its retained earnings.

In *Phillips*¹⁶⁴ and *McLeod*,¹⁶⁵ the claims on stock appreciation were not considered in relation to corporate law principles. However, consideration of Susan Jennings' claim on Widget stock value without reference to the doctrine of corporate separateness may be an unnecessary assault on the corporate form. Piercing the corporate veil is an equitable exception to the legal doctrine of corporate separateness by which fairness can be accorded to both the marital and the corporate estates. A persuasive argument can be made that the equities in the Jennings' divorce weigh more heavily in favor of the corporation than the "economic partnership" of the marriage.

163. These "economic factors" include the following: John's two uncles own all the company stock not held by John. They have served on the board of directors since the inception of the company, and each serves as an officer. The uncles have taken an active role both on the board and as officers. In late 1984, the economy showed signs of an oncoming recession, and the prime rate had risen from ten to thirteen percent within a few months. The company had a large backlog of orders. The raw material required to make widgets is very expensive; therefore, during the fall quarter, the board decided to build up its retained earnings account to minimize the need for borrowing at the higher rate. Dividends were regularly declared by the Widget board but were necessarily smaller in 1984 and 1985.

164. 73 N.C. App. 68, 326 S.E.2d 57 (1985).

165. 74 N.C. App. 144, 327 S.E.2d 910, *disc. rev. denied*, 314 N.C. 331, 333 S.E.2d 488 (1985).

D. *The Distributive Award: Its Impact on Other Shareholders*

1. The Widget Corporation

Beyond its implications for corporate law, the manner in which the marital interest in active appreciation is awarded has a substantial impact on the corporation's other shareholders. Relying on *McLeod*, Susan claims a one-half interest in the appreciated value of John's Widget stock. For illustrative purposes, assume the trial court finds the following facts: Widget, Inc. has a current value of \$6,000,000; John's interest is worth \$3,600,000, of which \$300,000 represents his pre-marital interest, or separate property; \$650,000¹⁶⁶ represents passive appreciation in the value of John's initial capital; the remainder of John's interest is attributed to active appreciation and is classified as marital property. Based on these facts, the court awards Susan a lump sum cash award equivalent to one half of this sum, or \$1,325,000.

If John is not able to finance the amount of the judgment and the other shareholders fail to buy enough of John's shares to yield the judgment amount, John would be forced to liquidate his Widget stock. In doing so, the close corporation would be essentially lost as an entity. The consequences of Jennings's divorce are entirely conceivable under the *Wade* line of cases. This final chapter of the Widget scenario highlights the significance of the distributive award and its impact on the corporation and its other shareholders.

The North Carolina equitable distribution statute gives the court wide discretion to fashion an award of marital property.¹⁶⁷ Among these options are an in-kind distribution, a cash award, or an adjustment of alimony after the equitable distribution proceeding.

2. The Types of Distributive Awards

a. In-kind Distribution

In the Jennings/Widget scenario, the district court could order an in-kind distribution of stock, equivalent to the non-titled spouse's interest in the appreciated value of the company. This option creates the potential for significant management problems for the corporation. One of the distinguishing characteristics of the close corporation is that the "relationship between the participants, like that among partners, is one which requires close cooperation and a high degree of good faith and mutual respect. . . ."¹⁶⁸ The North Carolina Supreme Court quoted one com-

166. This figure is the current value of John's pre-marital interest based on eight percent growth over fifteen years.

167. N.C. GEN. STAT. § 50-20 (1984).

168. *Meiselman v. Meiselman*, 309 N.C. 279, 289, 307 S.E.2d 551, 557 (1983) (quoting 2 F. O'NEAL, CLOSE CORPORATIONS § 9.02 (2d ed. 1971)).

mentator who observed that “[a]n organizational structure of this nature [the close corporation]—in which the investment interests are interwoven with continuous, often daily, interaction among the principals—necessarily requires substantial trust among the individuals.”¹⁶⁹ This trust and close cooperation is not likely to be extended to a divorced spouse who may acquire not only stock through the divorce but also hold a seat on the board of directors. If the new stockholder is unreceptive to a purchase offer from the original shareholders, they may prefer voluntary dissolution of the corporation.¹⁷⁰

If dissolution is not sought, the potential exists for discord among the shareholders and distrust by the new shareholder of management decisions made by the majority. In turn, if this shareholder’s reasonable expectations of stock ownership are frustrated, he may seek involuntary dissolution of the corporation.¹⁷¹ This raises an interesting question of what the reasonable expectations of such a stockholder would be. However, there is language in the landmark *Meiselman v. Meiselman*¹⁷² decision that arguably supports the position of such an outsider shareholder. The language is found in the North Carolina Supreme Court’s rebuttal of the argument that a minority shareholder should bargain for protection of his expectations before agreeing to accept a minority position in a close corporation:

[W]hen a minority shareholder receives his shares in a close corporation from another in the form of a gift or inheritance, as did the plaintiff here, the minority shareholder never had the opportunity to negotiate for any sort of protection with respect to the ‘reasonable expectations’ he had or hoped to enjoy in the close corporation.¹⁷³

Therefore, could the shareholder who acquired a minority position by equitable distribution successfully argue that he did not have an opportunity to negotiate for protection of his rights and thereby force dissolution of the corporation?

b. Cash Award

Choice of a cash award to the non-titled spouse does not necessarily avoid problems of the type discussed above. The court may choose a lump sum payment or a payment over time.¹⁷⁴ The demise of Widget described *supra* is a potential consequence of lump sum cash award. A

169. *Meiselman v. Meiselman*, 309 N.C. 279, 289, 307 S.E.2d 551, 557 (1983) (quoting Comment, *Deadlock and Dissolution in the Close Corporation: Has the Sacred Cow Been Fetched?*, 58 NEB. L. REV. 791, 795 (1979)).

170. See N.C. Gen. Stat. §§ 55-117 to -118. (1982).

171. *Meiselman*, 309 N.C. at 279, 307 S.E.2d at 551 (1983).

172. 309 N.C. 279, 307 S.E.2d 551 (1983).

173. *Id.* at 291, 307 S.E.2d at 558-59.

174. N.C. GEN. STAT. § 50-20(b)(3) (1984).

recent California decision indicated that courts are concerned about the potential consequence of a cash award.¹⁷⁵ Accordingly, the court of appeals rejected a wife's argument that the trial court's in-kind distribution of her husband's separately-owned, close corporation stock should be rejected as unfair and that a cash award would be more equitable. The court noted that the trial court had taken "careful account of matters of liquidity, restrictions on transfer, and tax consequences, . . ."¹⁷⁶ and concluded that it would be unfair and unworkable to require the husband or the corporation to cash the wife out.

c. Alimony Modification

Another option available to the court would eliminate the potential problems described above in certain circumstances. The equitable distribution statute specifies that equitable distribution shall be made without regard to alimony. However, it also provides that "[a]fter the determination of an equitable distribution, the court, upon request of either party, shall consider whether an order for alimony or child support should be modified"¹⁷⁷ Where alimony is ordered, the non-titled spouse's share of active appreciation could be apportioned through the alimony award. This approach would preserve corporate ownership and leave management intact by linking the property distribution to alimony. However, inasmuch as alimony is based on fault, this type of award is of limited utility.¹⁷⁸

3. Impact of Award

The type of distributive award chosen by the court may have a significant impact on other shareholders of the corporation and thus result in competing equities—equity for the non-titled spouse against equity for the other shareholders. Only a handful of cases have dealt with this issue.¹⁷⁹ A New Jersey appellate court reviewed a trial court's award to the wife of a fifty-percent interest in her husband's corporation as her marital interest in the enterprise. The court overturned the award indicating that this award could lead to corporate deadlock and ultimately force dissolution.¹⁸⁰ In *J.D.P. v. F.J.H.*,¹⁸¹ the Delaware Supreme Court recognized the impact on other shareholders as a factor in determining whether retained earnings should be characterized as marital property.

175. *Behrens v. Behrens*, 137 Cal. App. 3d 562, 187 Cal. Rptr. 3d 201 (1982).

176. *Id.* at 572, 187 Cal. Rptr. 3d at 205.

177. N.C. GEN. STAT. § 50-20(F) (1984).

178. *Id.* § 50-16.2 (1984).

179. *J.D.P. v. F.J.H.*, 399 A.2d 207 (Del. 1979); *Bowen v. Bowen* 96 N.J. 36, 473 A.2d 73 (1984); *Borodinsky v. Borodinsky*, 162 N.J. Super. 437, 393 A.2d 583 (App. Div. 1978).

180. *Borodinsky*, 162 N.J. Super. 437, 393 A.2d 583 (App. Div. 1978).

181. 399 A.2d 207 (Del. 1979).

While this question has not yet arisen under section 50-20(b)(2), the North Carolina Supreme Court has considered other shareholders in a related context. Justice Martin, concurring in *Meiselman*, observed that:

the court [in deciding whether the complaining shareholder's reasonable expectations have been frustrated] should also consider what effect the granting of relief will have upon the corporation and other shareholders. Will it interfere with the corporation's ability to attract financing for its business? Will it interfere with its ability to attract additional capital? Will it require burdensome financing upon the corporation or the shareholders? Will it interfere with the rights of creditors? If a buy-out of plaintiff's shares is forced upon the company, it may be far from painless. If it is determined that the granting of relief will be unduly burdensome to the corporation or other shareholders, the trial court should consider this in determining whether to grant relief and, if so, whether this should affect the purchase price or value attached to plaintiff's shares or the method of payment. *It is an equitable proceeding.*¹⁸²

The balance of interests suggested by Justice Martin also has its place in the context presently being considered. The same considerations outlined above should be taken into account in fashioning an award of the marital interest in active appreciation. It might be argued that consideration of the distributional factors¹⁸³ under the statute would prevent an inequitable result. However, the distributional factors do not take into account the adverse impact on business that the property settlement proceeding itself will have in the wake of the *Wade* line of cases.

Another issue facing close corporation shareholders is the effect of shareholders' agreements concerning stock transfers. Should the court be constrained by a shareholders' agreement from effecting an in-kind stock transfer to award the non-titled spouse his or her share of the active appreciation? While this specific question has not yet been answered, the Minnesota Supreme Court addressed the same general issue in *Castonguay v. Castonguay*.¹⁸⁴ In this case, the total value of the husband's forty-three percent share of close corporation stock was in dispute rather than only the appreciation. The articles of incorporation prohibited stock transfers without the stock first being offered to other shareholders or to the corporation. Nonetheless, the trial court chose an in-kind stock distribution to award the wife her marital interest in the corporation. The supreme court held that the transfer restriction did not apply in a divorce property distribution in the absence of a specific provision in the shareholders' agreement to that effect.¹⁸⁵

182. 309 N.C. at 316, 307 S.E.2d at 572-73 (Martin, J., concurring) (emphasis added).

183. N.C. GEN. STAT. § 50-20(c) (1984).

184. 306 N.W.2d 143 (Minn. 1981).

185. *Id.* at 145.

A related issue was considered in-depth by the Supreme Court of New Jersey. The question in *Bowen v. Bowen*¹⁸⁶ was whether the valuation formula fixed in the shareholders' agreement controlled the court's valuation of the close corporation for equitable distribution purposes. The agreement excluded goodwill and other intangible assets from the valuation formula. The supreme court held that the agreement did not control because it did not contemplate valuation for the purpose of equitable distribution.¹⁸⁷ Both *Castonguay* and *Bowen* suggest that a court might give authority to a shareholders' agreement which specifically addresses distribution of a divorced shareholder's interest in the company.

V. CONCLUSION

In *Wade v. Wade*, *Phillips v. Phillips*, and *McLeod v. McLeod*, the North Carolina Court of Appeals significantly redefined the meaning of separate property under North Carolina's equitable distribution statute.¹⁸⁸ Under these decisions, an increase in separate property is no longer necessarily separate property as provided by the statute.¹⁸⁹ Instead, the increase attributable to active appreciation is now considered marital property. The court has defined active appreciation as a contribution by either spouse to the increase in value. In the context of a close corporation, these principles will often subject the major portion of the corporation's share value to equitable distribution.

The parties in *Wade*, *Phillips* and *McLeod* did not raise, and the court did not consider, the plethora of important issues these decisions raise for North Carolina close corporations. The purpose of this Comment has been to explore some of these issues in light of the principles developed in the *Wade* line and against the larger backdrop of American case law. The significance of the definition of active appreciation has been highlighted, and a variety of alternative approaches have been discussed. The advantages of the compensation method have been considered as a means of apportioning the marital interest in active appreciation. The threat to the close corporation posed by active appreciation has been examined. In turn, this Comment has considered the suitability of the corporate separateness doctrine as a framework for analysis of marital claims on the value of stock and retained earnings. Finally, the impact of a distributive award under the *Wade* line of cases has been discussed and the implications of the award for other shareholders.

Answers to the questions raised here will require a close association between two areas of law which traditionally have been considered to be

186. 96 N.J. 36, 473 A.2d 73 (1984).

187. *Id.* at 46-47, 473 A.2d at 78.

188. N.C. GEN. STAT. § 50-20(b)(2) (1984).

189. *Id.*

distinctly separate—the law of corporations and domestic relations. Also, the district court bench will increasingly find itself faced with corporate law issues with which it traditionally has had little experience.

In the *Wade* line of cases, the court of appeals set aside the corporate veil in deference to the “wedding veil” which protects the economic partnership concept of marriage. Because the corporate law issues raised here were not argued by the parties in these cases, the corporate veil lost by default. The corporate separateness doctrine and its equitable exception can accommodate the remedial objectives underlying *Wade*, *Phillips*, and *McLeod*. Use of this doctrine in the consideration of marital claims on separate property stock would avoid the potential for unfair results suggested here without sacrificing fairness to the marital partnership. The North Carolina Supreme Court has denied discretionary review of *Wade*¹⁹⁰ and *McLeod*¹⁹¹. However, a record in which the corporate law issues are fully developed may lead to a reconsideration of the rule developed in these cases.

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190. 313 N.C. 612, 330 S.E.2d 616 (1985).

191. 314 N.C. 331, 333 S.E.2d 488 (1985).