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# Statutory Treatment of Directors and Officers Under the Kentucky Business Corporation Act

C. Kent Hatfield  
*University of Kentucky*

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# STATUTORY TREATMENT OF DIRECTORS AND OFFICERS UNDER THE KENTUCKY BUSINESS CORPORATION ACT

## INTRODUCTION

The new corporation act provides, often for the first time, a measure of statutory guidance for the significant area of corporate law dealing with directors and officers. The act does not attempt to include within its sections all of the law pertaining to directors and officers. Accordingly, a number of judicial doctrines developed over the years will remain unaffected by its provisions.

Most significantly, the act provides a legal framework for the structure and operation of the basic management bodies of the corporation. The general approach of the new law attempts to find an appropriate balance between the interests of shareholders and directors, directors and officers, majorities and minorities, and large and small corporations. Consistent with the Model Act, the Kentucky version is sympathetic to directors and majority interests, although several provisions have been modified to strike a more equitable balance for the rights of all parties.

This note will discuss the application of the new act to directors and officers under six major topics: (1) the board of directors and its members, (2) meetings of the board of directors, (3) directors' management functions, (4) directors' fiduciary duties, (5) officers, and (6) indemnification. Legislative history, previous statutes, and existing case law will be cited where appropriate in an attempt to make this note of benefit to the practitioner.

## I. THE BOARD OF DIRECTORS AND ITS MEMBERS

### A. *Board of Directors—KRSA § 271A.175*

#### 1. *Powers*

Like the prior statute,<sup>1</sup> the new section provides that the management of the corporation shall be vested in a board of directors. However, as in the prior act, this grant of authority is not necessarily one to be exercised exclusively by the board of directors. The new act provides:<sup>2</sup>

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<sup>1</sup> KY. REV. STAT. § 271.345(1) (1971) [hereinafter cited as KRS].

<sup>2</sup> KY. REV. STAT. ANN. § 271A.175 (Supp. 1972) [hereinafter cited as KRSA].

The business and affairs of a corporation shall be managed<sup>3</sup> by a board of directors except as may be otherwise provided in the articles of incorporation. If any such provision is made in the articles of incorporation, the powers and duties conferred or imposed upon the board of directors by this Act shall be exercised or performed to such extent and by such person or persons as shall be provided in the articles of incorporation.

The act, therefore, expressly permits an initial grant of authority to persons or bodies other than the board, if such a provision is included in the articles of incorporation.<sup>4</sup> As this authority is included in the articles, it appears to be an original structuring of power by the incorporators rather than a delegation of power by the board.<sup>5</sup>

The statute is somewhat unclear in its use of the term "powers and duties" as to whether the recipient of this authority will be allowed to escape traditional director liability, or will be limited in his exercise of director powers. However, the clear import of this sentence is that the powers and duties are those "conferred or imposed upon the board of directors by this Act," a phrase which is devoid of any inherent limitations. The only limitations involved are those that may be found in the articles that confer this authority. Thus, if the provision in the articles confers or imposes less than the total powers and duties of the board, there may be a portion of such power remaining vested in the board. For this reason, if it is desirable to use this device to confer authority on others besides the board, the practitioner should be certain to make the article provision specific enough to prevent a duality of function and broad enough to vest all such power in the desired body.

The scope of this pre-structured grant of power should logically follow the boundaries that exist in setting the limits on the powers of the board of directors. Any function that could properly be exercised by the board could likewise be exercised by the recipient

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<sup>3</sup> It should be noted that the word "managed" is not defined in the statute. This is in line with the philosophy of leaving the definition of management to the courts to be applied in the context of specific factual situations and within the framework of the traditional management functions. MODEL BUS. CORP. ACT ANN. 2D § 35 ¶ 2 (1971).

<sup>4</sup> The reasoning behind this provision is discussed in MODEL BUS. CORP. ACT ANN. 2D § 35 ¶ 2 (1971). The primary purpose is to permit close corporations to do under the law what they have been commonly doing in practice. The generality of the provision permits almost complete flexibility in patterns of management, with imposition of such controls as may be desired in individual cases. This provision will be useful not only to family-owned corporations but also to corporate joint ventures. Note that the power of shareholders to assume managerial functions in the close corporation is greatly enhanced.

<sup>5</sup> Compare with KRSA § 271A.210 which is clearly a delegation of power by the board to executive and other committees.

of the power conferred by the articles.<sup>6</sup> Existing case law on proper director functions should retain its validity in this context.<sup>7</sup> Thus, it would appear to be possible to impose the total board powers upon one designated in the articles.<sup>8</sup> In such a case, while the board would function as a "dummy," without powers, it would still be a statutorily-required body.

The principal change from the prior law is that under the new act, management duties can be conferred upon those who are not directors, while previously, under KRS § 271.345(4)(d), the board could only appoint executive committees of its own members to perform management tasks. Furthermore, under the new act, the dichotomy between discretionary and ministerial duties is not important where the actual board power has been granted to others. The grant is, or can be, a total grant of power, thus encompassing both discretionary and ministerial functions.

## 2. Qualifications

KRSA § 271A.175 further provides: "Directors need not be residents of this state or shareholders of the corporation unless the articles of

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<sup>6</sup> The committee hearings generally expressed the view that one exercising director functions would not be insulated from traditional director liability. More important, liability under the federal law was felt to be certain. KENTUCKY LEGISLATIVE RESEARCH COMMISSION, INFORMATIONAL BULL. NO. 88, LEGISLATIVE HEARING: CORPORATION LAW 66, 67 (1971) (comment of Mr. Shaikun) [hereinafter cited as LEGISLATIVE HEARING].

<sup>7</sup> See *e.g.*, *Chicago City Ry. v. Allerton*, 85 U.S. (18 Wall.) 233 (1874), where the charter stated that the capital might be increased "at the pleasure of the corporation" and that all corporate powers were vested in the board of directors. Without consulting the shareholders, the board of directors voted to increase the capital stock beyond the limit fixed by the charter. In a shareholder suit to enjoin the increase, it was held that the change contemplated was so fundamental that it could not be made by the directors alone. The court stated that the general power to perform all corporate acts refers to ordinary business transactions of the corporation, and that such fundamental change cannot be made in the absence of express or implied shareholder consent. See generally *Taylor v. Axton-Fischer Tobacco Co.*, 173 S.W.2d 377 (Ky. 1943), holding that when the board made a resolution to retire all of the class A stock, what were potential rights in class B stockholders became vested rights, and the board could not modify the resolution to make class A retirement optional instead of mandatory, thereby prejudicing the rights of class B stockholders. *Kozy Theater Co. v. Love*, 231 S.W. 249 (Ky. 1921), holding that where directors constitute the only stockholders and they informally authorize the president to sell all of the corporate assets, the corporation is bound by the president's act; *Caddy Oil Co. v. Sommer*, 218 S.W. 288 (Ky. 1920); *Haldeman v. Haldeman*, 197 S.W. 376 (Ky. 1917), stating that the legality of the acts of directors does not depend upon the motive inducing them; *Pittsburgh C.C. & S.L. Ry. v. Dodd*, 72 S.W. 822 (Ky. 1903). In *Burt v. The Irvine Co.*, 224 Cal. App.2d 50, 36 Cal. Rptr. 270 (1964), the court held that under West Virginia law the board of directors could regulate the presence of strangers at a board meeting, including barring a director's attorney. Note further collection of cases in MODEL BUS. CORP. ACT ANN. 2D § 35 ¶ 4.01(2) (1971).

<sup>8</sup> See LEGISLATIVE HEARING, *supra* note 6, at 65 (comment of Mr. Shaikun).

incorporation or by-laws so require. The articles of incorporation or by-laws may prescribe other qualifications for directors." This provision represents no significant change from prior Kentucky law. It is identical to the Model Act and in line with the majority of jurisdictions, particularly those that have revised their corporation acts in recent years.<sup>9</sup> Residency and shareownership requirements are now thought to be of only marginal benefit to the modern corporation. However, where such qualifications are deemed important, the new act, like the old, provides considerable flexibility by allowing insertion of these requirements into either the articles or the by-laws.

Significant by its absence from the act is the requirement that directors must be either natural persons or of the age of legal majority. Despite specific proposals to this effect at the public hearings, the legislature has consciously decided to omit such a requirement from the act.<sup>10</sup> This policy decision is in harmony with the premise that qualifications for directors are matters to be determined by the shareholders and incorporators as the specific situation may dictate, and not by the legislature in the form of blanket prohibitions on director qualifications. Accordingly, other qualifications may be set forth in the articles or by-laws; however, they will most certainly be subject to judicial construction for possible unreasonable or discriminatory restrictions.<sup>11</sup>

### 3. *Compensation of Directors*

The last sentence of KRSA § 271A.175 provides: "The board of directors shall have authority to fix the compensation of directors unless otherwise provided in the articles of incorporation." This

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<sup>9</sup> For a case where the articles or by-laws do prescribe a shareownership requirement, see *Kaye v. Kentucky Pub. Elevator Co.*, 175 S.W.2d 142 (Ky. 1943); accord, *Schmidt v. Mitchell*, 41 S.W. 929 (Ky. 1897), holding that a director may hold his stock as a trustee or have only legal title thereto, even for the express and sole purpose of making him eligible, unless the situation was brought about in furtherance of a dishonest scheme concerning the management or control of the corporation. See generally MODEL BUS. CORP. ACT ANN. 2D § 35 ¶ 3.03 for a list of those states still retaining shareownership and residency requirements for directors.

<sup>10</sup> See LEGISLATIVE HEARING, *supra* note 6, at 68, for a discussion of the effect of having a minor on the board of directors where a member of a large corporate law firm and a corporate attorney for a large public-issue corporation proposed that directors should be natural persons of 18 years of age or older. Note also that the requirement that incorporators must be natural persons of 18 years or more under KRS § 271.025 is no longer applicable.

<sup>11</sup> See *e.g.*, *Hempstead v. Atchison, Topeka & Santa Fe Hosp. Ass'n*, 210 P. 482 (Kan. 1922), 30 A.L.R. 243, upholding a by-law provision that all trustees must be of good moral character and invalidating the election of a man who had been convicted of embezzlement and prosecuted for forgery.

provision should alleviate the problems caused by the early common law view that directors would be assumed to receive their compensation in the form of dividends and need not be separately compensated for their duties as directors.<sup>12</sup> Note again the flexible approach toward balancing the rights of directors and shareholders by the phrase "unless otherwise provided in the articles." Even without statutory authorization in Kentucky under the old law, the fixing of their own salaries by directors has certainly been a common occurrence in practice. Thus, the new act represents express authority for action that may have been unlawful in the past.

It is not to be doubted, however, that the concept of the director as a fiduciary will operate as a meaningful check on the fairness and reasonableness of the compensation.<sup>13</sup> The traditional problems in this area have centered around director compensation for services rendered outside the scope of the director's office,<sup>14</sup> the reasonableness and burden of proof of the reasonableness of salaries of directors who are officers,<sup>15</sup> the voting by directors on their own salaries,<sup>16</sup> and

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<sup>12</sup> For an excellent statement of the common law rule see *Nat'l Loan & Inv. Co. v. Rockland Co.*, 94 F. 335, 337 (8th Cir. 1899); *Lofland v. Cahall*, 118 A. 1 (Del. 1922); *Godley v. Crandall & Godley*, 212 N.Y. 121, 105 N.E. 818 (1914).

<sup>13</sup> See *Sagalyn v. Meekins, Packare & Wheat, Inc.*, 195 N.E. 769 (Mass. 1935). See generally Klaus, *Corporate Quandry: Search for an Adequate Method of Executive Compensation*, 4 TULSA L.J. 197 (1967); Brodsky, *What Is Reasonable Compensation?* 14 TUL. TAX INST. 389 (1965); Edwards, *Directors' Remuneration*, 117 NEW L.J. 147 (1967).

<sup>14</sup> See *Paine v. Ky. Ref. Co.*, 167 S.W. 375 (Ky. 1914), holding that unless compensation is provided for in the charter or by-laws, directors are not entitled to compensation for services within the line of their official duties. But, where the services are not within the line of their official duties and it may be inferred from the circumstances that both parties understood the directors were to be compensated, this rule does not apply. A director acting as an arbitrator in a dispute between the corporation and its general manager is performing services outside his regular duties and is entitled to reasonable compensation. Compare *Winberg v. Camp Taylor Dev. Co.*, 95 S.W.2d 261 (Ky. 1936); *Johnson v. Tri-Union Oil & Gas Co.*, 129 S.W.2d 111 (Ky. 1939). Note further collection of cases in 3 P-H CORP. (Ky.) ¶ 35 (1972).

<sup>15</sup> See *Beha v. Martin*, 171 S.W. 393 (Ky. 1914), holding that where the directors own a majority of the stock and vote salaries for themselves as officers, the salaries must be reasonable according to the services performed. The objecting minority stockholders bear the burden of proving that the salaries are unreasonable. *Richardson v. Blue Grass Mining Co.*, 29 F. Supp. 658 (E.D. Ky. 1939), *cert. denied*, 317 U.S. 639 (1942), stated that the court will determine and allow reasonable compensation for services for which shareholders have benefited, despite proof of dereliction of fiduciary duty. The court will compel restitution of previously paid excessive amounts. *Contra, Santarelli v. Katz*, 270 F.2d 762 (7th Cir. 1959), which places the burden of proof on the directors.

<sup>16</sup> See *Beha v. Martin*, 171 S.W. 393 (Ky. 1914), stating that each director must refrain from voting on his compensation and his presence cannot be counted in determining a quorum. The Court suggested that the split-resolution technique is a proper means for granting director compensation, while the single resolution will be held invalid. Note that these requirements are now of doubtful validity in light of the new provision, KRSA § 271A.205.

the right of the corporation to commissions paid to directors.<sup>17</sup> It now appears that the distinction between services rendered in the regular line of duty and those rendered outside the scope of the director's normal functions is of slight significance in determining the director's right to compensation.<sup>18</sup> The distinction may still be useful, however, in determining the reasonableness of such compensation.

As KRSA § 271A.205<sup>19</sup> now removes most of the procedural obstacles concerning transactions with the corporation in which directors are interested parties, the director compensation section should be read in light of this new section for both substantive and procedural guidance. Read collectively, these sections allow directors to be compensated without the previous technical restrictions, but such compensation must be reasonable. Since KRSA § 271A.175 merely gives the directors power to fix their own compensation without specifically treating the self-dealing problem, it is important in order to preserve the comprehensive nature of the act that the substantive spirit of KRSA § 271A.205 be construed to encompass the director compensation section. Accordingly, the function of the courts in this area will be of no small significance.

## B. Number, Election, and Term of Directors—KRSA § 271A.180

### 1. Number of Directors

The new act provides that "the board of directors of a corporation shall consist of one or more members."<sup>20</sup> This provision, like the whole section, is identical to that of the Model Act,<sup>21</sup> and identical in substance to the prior law.<sup>22</sup> As of 1969, Kentucky was one of several states allowing the minimum number of directors to be one or more.<sup>23</sup> The new Kentucky statute, like the previous one, is consistent with the trend away from the minimum-of-three requirement.

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<sup>17</sup> See *Paducah Land, Coal & Iron Co. v. Hayes*, 24 S.W. 237 (Ky. 1893), holding that where the vendor of land to a corporation in return for corporate stock gave back to the directors a part of the consideration, the corporation was entitled to the benefits of this stock.

<sup>18</sup> But see *Hurt v. Cotton States Fertilizer Co.*, 159 F.2d 52 (5th Cir. 1947), where the court after first stating the general rule that "retroactive" compensation to directors is invalid as a gift of corporate assets, upheld a payment of retroactive compensation that bore a reasonable relation to extra services rendered and was approved by a majority of the shareholders.

<sup>19</sup> This is the section concerning director conflicts of interest. See text and accompanying notes, *infra*, for a full discussion of this provision.

<sup>20</sup> KRSA § 271A.180.

<sup>21</sup> ABA-ALI MODEL BUS. CORP. ACT § 36 (rev. ed. 1969).

<sup>22</sup> KRS § 271.345(1).

<sup>23</sup> For a list of the states and their required minimum number of directors, see MODEL BUS. CORP. ACT ANN. 2D § 36 ¶ 3.03 (1971).

A growing number of states are adopting the Model Act approach while others are following a similar approach which allows less than three directors where there are fewer than three shareholders.<sup>24</sup> Kentucky has wisely decided that it is more advantageous to all concerned to recognize the common practice of "one-man" management in close corporations than to insist that a sole stockholder in a close corporation find two friends to serve nominatively as "dummies" on the board.

Some concern has arisen in the past over the conflict between KRS § 271.345(1), which required a minimum of one director, and KRS § 271.345(4)(c), which listed the requirements for a quorum at a board meeting. The latter statute provided that a majority of the board constituted a quorum which, *inter alia*, could not be less than two directors.<sup>25</sup> This inconsistency has been resolved by the quorum provision of the new act.<sup>26</sup>

It is further provided by KRSA § 271A.180 that "the number of directors shall be fixed by, or in the manner provided in, the articles of incorporation or the by-laws, except as to the number constituting the initial board of directors, which number shall be fixed by the articles of incorporation." The flexibility in this approach is apparent; no maximum number of directors is prescribed, and ample opportunity exists for granting power to either the board or the shareholders, with additional room for checks and balances between the two holders of power.

The shareholders may retain the power to set the number of directors by providing for a specific number in the articles. As only the shareholders may amend the articles,<sup>27</sup> they thereby can maintain absolute control over the number of directors. For those corporations desiring a more flexible approach, the articles may provide the manner in which the number is determined, without stating a specific number. This would allow the board to set the number but would require it to do so in the manner set out in the articles. One variation would prescribe a range or sliding scale for the number of directors, yet allow the board to operate freely within that range.<sup>28</sup>

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<sup>24</sup> *Id.*

<sup>25</sup> It is generally felt that the "nor less than two" requirement of the prior statute was simply an error that was not corrected when the minimum number of directors was reduced from three to one. LEGISLATIVE HEARING, *supra* note 6, at 69 (comment of Mr. Shaikun).

<sup>26</sup> See generally the quorum provision, KRSA § 271A.200.

<sup>27</sup> However, where no shares have been issued, the board may by resolution amend the articles without a shareholder vote. KRSA § 271A.295.

<sup>28</sup> Such a system could adversely affect the cumulative voting rights of minority stockholders in some circumstances. See, e.g., *Stone v. Auslander*, 28 Misc. 2d 384, 212 N.Y.S.2d 277 (Sup. Ct. 1961).



On the other hand, the power to fix the number may be vested largely in the board subject to certain restrictions for the protection of shareholders. Where the number is fixed in the by-laws,<sup>29</sup> the power of the board will be enhanced. This conclusion follows naturally from the right of the board to adopt the initial by-laws and to amend or repeal existing by-laws.<sup>30</sup> However, the fact that board action is subject to repeal or change by action of the shareholders,<sup>31</sup> operates as an effective check on arbitrary or irresponsible acts of the board. Note also that the power to amend or repeal by-laws may be reserved completely to the shareholders at the outset by so providing in the articles. One possibility would be to set a maximum and minimum number in the articles, permitting the board to operate freely within this range in the framework of amending the by-laws, with the action of the board subject to change or repeal by the shareholders. Numerous other hybrids are possible, subject only to the needs of the situation and the ingenuity of corporate counsel.<sup>32</sup>

The act additionally makes it clear that proceedings under this section are not proper for the removal of existing directors, by providing that "no decrease shall have the effect of shortening the term of any incumbent director." The procedures for removal of a director are expressly set forth in a subsequent section of the act.<sup>33</sup>

While KRSA § 271A.180 does not represent a significant departure from prior law,<sup>34</sup> a greater flexibility of approach is indicated, especially for the close corporation. For a proper understanding of the possibilities and limitations in this area, the interrelation of this section and the sections on amending the articles<sup>35</sup> and by-laws<sup>36</sup> must be considered.

## 2. *Initial Board of Directors*

The number of members of the first board of directors must be fixed in the articles of incorporation. This represents only a slight change from prior law which allowed the number to be fixed either in the articles or the by-laws.<sup>37</sup> In addition, the names and addresses of the first board must be stated in the articles. This is somewhat

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<sup>29</sup> It is generally considered cheaper and easier to amend the by-laws than the articles.

<sup>30</sup> KRSA § 271A.135.

<sup>31</sup> *Id.*

<sup>32</sup> See generally P-H CORP. ¶ 1503 (1972).

<sup>33</sup> KRSA § 271A.195.

<sup>34</sup> KRS § 271.345(1), (4).

<sup>35</sup> KRSA § 271A.295.

<sup>36</sup> KRSA § 271A.135.

<sup>37</sup> KRS § 271.345(4).

different from prior law in that the role of the incorporators is now greatly diminished. The corporation will have a fixed number of directors from its inception, and the persons constituting the board will be ascertained and vested with power from the outset. Previously, there was no board until it was elected at the first meeting of shareholders, a situation which could give rise to problems.<sup>38</sup>

The term of the initial directors will last until the first annual shareholder meeting, and until their successors have been elected and qualified. During this period, the initial board will hold the same powers, rights, and duties as the subsequently elected boards.

### 3. *Election*

At the first annual meeting of shareholders and at each annual meeting thereafter the shareholders shall elect directors to hold office until the next succeeding annual meeting, except in case of the classification of directors as permitted by this Act.<sup>39</sup>

It is, of course, a longstanding rule that stockholders have the inherent power to elect the members of the board by a majority vote,<sup>40</sup> and the above section represents no change from prior law. Like the prior law, the new act is silent on certain areas that have given rise to litigation in the past. Existing case law developed under the prior statute may still retain some validity with respect to interpretation of the new section. In this regard, litigation has arisen in Kentucky pertaining to the time when a director accepts his election and begins his duties;<sup>41</sup> the failure to elect the required number of directors;<sup>42</sup> the formality required for director elections;<sup>43</sup> the effect

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<sup>38</sup> See, e.g., *Lebus v. Stansifer*, 157 S.W. 727 (Ky. 1913), holding that the articles could not allow the incorporators to act as the board of directors for a limited time without any action of the shareholders.

<sup>39</sup> KRSA § 271A.180.

<sup>40</sup> See *Beardsley v. Johnson*, 121 N.Y. 224, 24 N.E. 380 (1890), and other cases cited in P-H CORP. ¶ 1504 (1972).

<sup>41</sup> See *Cumberland Publishing Co. v. Adams Real Estate Corp.*, 432 S.W.2d 808 (Ky. 1968), holding that a duly elected director accepts his office by the simple act of serving; cf. *Bramblet v. Commonwealth Land & Lumber Co.*, 83 S.W. 599 (Ky. 1904).

<sup>42</sup> See *Gilchrist v. Collopy*, 82 S.W. 1018 (Ky. 1904), holding that where the ownership of stock is evenly divided and the two interests have a working agreement whereby in alternate years one elects two and the other, three directors, an election attended by only one of the interests will not be held void because it resulted in the election of only two directors pursuant to the agreement. Note that the case cited here and those cited in the succeeding six footnotes are collected in P-H CORP. ¶ 1504 (1972) and 3 P-H CORP. (Ky.) § 36 (1972). See also *Drake v. Herndon*, 91 S.W. 674 (Ky. 1906).

<sup>43</sup> See *Beha v. Martin*, 171 S.W. 393 (Ky. 1914) holding that where the stockholders elected persons to offices to which they were eligible only if directors, and the affairs of the corporation were generally conducted informally, such action indicated that they elected such persons as directors also.

of the election of ineligible candidates and the status and effect of de facto directors.<sup>44</sup> Litigation arising in other states which may be of help in interpreting the new act involves the postponement of a stockholders' meeting by directors for an indefinite period;<sup>45</sup> the power of a president to adjourn a stockholders' meeting before the election of directors;<sup>46</sup> and the validity of stockholder agreements to elect certain persons as directors<sup>47</sup> or to elect only "dummy" directors.<sup>48</sup>

#### 4. *Term*

The term of office set forth by the act is clearly one year, as it runs from election until the next succeeding annual meeting, except where directors are classified. This represents no change from the prior statute. The director's term extends "until his successor shall have been elected and qualified." Therefore, litigation may arise where the new directors are not elected on time or are not qualified.<sup>49</sup>

### C. *Classification of Directors—KRSA § 271A.185*

#### 1. *The Staggered Board*

Like the previous statute,<sup>50</sup> the new act<sup>51</sup> permits classification of directors by the use of what is commonly called the staggered board. Here also, the Model Act has been adopted in its entirety. The principal change from prior law is that classification is not permitted unless the board consists of nine or more members. This requirement

<sup>44</sup> See *Schmidt v. Mitchell*, 41 S.W. 929 (Ky. 1897), holding that where an ineligible candidate is elected, he is not a de facto director, nor are the votes cast for him deemed lost so as to cause the election of one who received a minority of votes. *Contra*, *Porter's Adm'r. v. Dulin Oil Co.*, 45 S.W.2d 495 (Ky. 1932), holding that even if there is some question about eligibility, the directors become de facto directors and their acts while in office cannot be attacked in a collateral proceeding. *Cf.* *O'Hara v. Williamstown Cemetery Co.*, 119 S.W. 234 (Ky. 1909), holding that where there were no de jure directors, the Court could require the corporation to call a meeting for electing directors.

<sup>45</sup> See *Silverman v. Gilbert*, 185 So.2d 373 (La. 1966).

<sup>46</sup> See *In re Dollinger Corp.*, 51 Misc.2d 802, 274 N.Y.S.2d 285 (Sup. Ct. 1966).

<sup>47</sup> See *Clark v. Dodge*, 269 N.Y. 410, 199 N.E. 641 (1936).

<sup>48</sup> See *Ford v. Magee*, 160 F.2d 457 (2d Cir. 1947), invalidating such an agreement.

<sup>49</sup> See *Lincoln Court Realty Co. v. Kentucky Title Sav. Bank & Trust Co.*, 185 S.W. 156 (Ky. 1916), holding that where the resignations of directors, effective upon acceptance, were not accepted, the men remained as directors; *La Rue v. Bank of Columbus*, 178 S.W. 1033 (Ky. 1915), holding that where the new directors had not been elected and qualified, the acts of the old directors were valid.

<sup>50</sup> KRS § 271.345(4).

<sup>51</sup> KRSA § 271A.185.

will effectively negate the possibility of a small corporation's using classification because most small corporations neither need nor desire a board of this size.<sup>52</sup> However, the effect of this requirement on the large or public issue corporation should be minimal.

Classification under the new act must be provided for in the articles of incorporation, while previously a provision in either the articles or by-laws would have been sufficient authorization. As the board generally has the power to amend the by-laws, the new section will prevent the board from authorizing classification where there is no provision in the articles allowing classification. Theoretically, this is a sound restriction consistent with the inherent power of the shareholders to elect directors.

Directors may be divided into either two or three classes, with each class to be as nearly equal in number as possible. Classification is not permitted before the first annual meeting of shareholders. At the first annual meeting, the directors are divided into two classes; the term of the first class will expire at the next annual meeting while the term of the second class will expire at the second annual meeting. The same terms are set where there are three classes, except that the term of the third class will expire at the third annual meeting. At each annual meeting following the first meeting, the shareholders will elect the same number of directors as there are directors with terms expiring. Directors elected after the first meeting will serve two-year terms if there are two classes, or three-year terms if there are three classes. Three years is thus the maximum term for any director, but, of course, he may be re-elected.

The theory behind the staggered board is that holdovers from the existing board can assure a continuity of management that is vital for a successful corporation. Additionally, there may be some merit to the premise that a staggered board will protect against sudden, irresponsible changes by dissident groups.<sup>53</sup> On the other hand, several criticisms may be directed against this device. The most common is that this technique is used to perpetuate the control of present management because it takes two or three years for a whole new board to be elected;<sup>54</sup> the "ins" can effectively use this extra time to get back into favor with the shareholders. Another objection is that management will be insulated from shareholder control and not responsive to shareholder demands.

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<sup>52</sup> See LEGISLATIVE HEARING, *supra* note 6, at 65.

<sup>53</sup> MODEL BUS. CORP. ACT ANN. 2D § 37 ¶ 2 (1971).

<sup>54</sup> Note, however, that the whole board can be removed without cause at one time under KRSA § 271A.195, a fact which may tend to blunt this criticism.

## 2. *Effect on Cumulative Voting*

The objection that a staggered board defeats the guarantee of cumulative voting is certainly a matter of proper concern in Kentucky. Cumulative voting is guaranteed by the Kentucky Constitution,<sup>55</sup> and consequently, and statute abrogating this right will be invalid. There are cumulative voting provisions in both the prior<sup>56</sup> and present<sup>57</sup> statutes, but as of now, the Kentucky Court of Appeals has not considered the effect of a staggered board on cumulative voting. Accordingly, the decisions of other jurisdictions may be relevant in determining the constitutionality of the staggered board.

Two lines of cases have emerged. In *Wolfson v. Avery*,<sup>58</sup> an Illinois statute similar to the new Kentucky classification statute was declared unconstitutional as repugnant to the Illinois constitutional guarantee of cumulative voting. In this case, the court looked to the intent of the framers and found that the purpose of cumulative voting was to guarantee a greater proportional representation to minority interests. Thus, the statute could not stand.

However, in *Janney v. Philadelphia Transportation Co.*,<sup>59</sup> a classification statute was found by the Pennsylvania court not to be inconsistent with the constitutional guarantee of cumulative voting. The court admitted that the staggered board device could affect cumulative voting, but suggested that other devices were available to minority interests which could be used to dilute the voting control of the majority. The court construed the constitutional phrase "distribute them upon two or more *candidates*" (emphasis added) to mean that the framers did not intend to insure the success of cumulative voting, but only to give minority interests the *opportunity* for greater

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<sup>55</sup> Ky. Const. § 207 provides:

In all elections for directors or managers of any corporation, each shareholder shall have the right to cast as many votes in the aggregate as he shall be entitled to vote in said company under its charter, multiplied by the number of directors or managers to be elected at such election; and each shareholder may cast the whole number of votes, either in person or by proxy, for one candidate, or distribute such votes among two or more candidates, and such directors or managers shall not be elected in any other manner.

However, see *Farmers No. 4, Inc. v. Lexington Tobacco Board of Trade*, 461 S.W.2d 926 (Ky. 1971), where cumulative voting was not extended to members of a non-stock, non-profit corporation. See also *In re Am. Elevator & Machine Co.*, 73 F. Supp. 473 (W.D. Ky. 1947), allowing a corporation to issue non-voting preferred stock.

<sup>56</sup> KRS § 271.315(2).

<sup>57</sup> KRSA § 271A.165(4).

<sup>58</sup> 126 N.E.2d 701 (Ill. 1955). *Accord*, *People ex rel. Syphers v. McCune*, 101 S.E.2d 834 (W. Va. 1958).

<sup>59</sup> 128 A.2d 76 (Pa. 1956).

proportional representation. The court distinguished the *Wolfson* case on these grounds.

The Kentucky constitutional provision also uses the term "candidate" which was important in the analysis of the *Janney* case. Note that the intent of the framers in their debates and discussions was a highly significant factor in both cases. One writer suggests that the debates on this section of our constitution reveal that the framers intended only to provide an opportunity for, and not a guarantee of, greater proportional representation.<sup>60</sup> If so, the new statute would probably be constitutional. It may also be significant that since staggered boards must have at least nine members, and at least three will be elected at one time, cumulative voting is not affected as much as it would be where fewer directors are elected. However, we must await a court of appeals decision to this effect before the matter is resolved.<sup>61</sup>

#### D. Vacancies on the Board of Directors—KRSA § 271A.190

As the prior statute<sup>62</sup> specifically vested the power to fill vacancies in the remaining members of the board, the new statute<sup>63</sup> does not effect a great substantive change in this area. As before, this power may not be limited by provisions in either the articles or the by-laws but rests principally with the board of directors.<sup>64</sup> However, under close statutory scrutiny, the use of the word "may" in the new section pertaining to the directors' power to fill vacancies, should be contrasted with the word "shall" in the prior act. The word "shall" confers sole authority on the board, while the word "may" implies a sharing of this power with the shareholders even in the absence of a provision in the articles or by-laws. Therefore, in those jurisdictions holding that the shareholders have inherent authority to elect directors, the new act may not preclude the possibility of a special shareholder meeting to fill vacancies on the board.<sup>65</sup> Of course,

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<sup>60</sup> See Comment, *Cumulative Voting—Removal, Reduction and Classification of Corporate Boards*, 22 U. CHI. L. REV. 751, 758 (1955); see generally Ham, *The Close Corporation Under Kentucky Law*, 50 KY. L.J. 125, 136 (1961).

<sup>61</sup> For prior rulings of the Court of Appeals on cumulative voting, see *Proctor Coal Co. v. Finley*, 33 S.W. 188 (Ky. 1895), holding that where cumulative voting was not used in previous elections, it was not precluded in subsequent elections; *Schmidt v. Mitchell*, 41 S.W. 929 (Ky. 1897), stating that cumulative voting was optional with the stockholders as long as they were not denied that right.

<sup>62</sup> KRS § 271.345(4)(a).

<sup>63</sup> KRSA § 271A.190.

<sup>64</sup> MODEL BUS. CORP. ACT ANN. 2D § 38 ¶ 2 (1971).

<sup>65</sup> See *Campbell v. Loew's Inc.*, 134 A.2d 852 (Del. Ch. 1957).

without such a special meeting the remaining board members will fill the vacancy.<sup>66</sup>

The new section eliminates the procedural requirement that a quorum of the entire board be present at any meeting to fill vacancies by providing that a vacancy may be filled "by the affirmative vote of a majority of the remaining directors though less than a quorum of the board of directors." This has been a troublesome area in the past where courts have held that a majority of the remaining members did not constitute a quorum and that elections to fill vacancies by less than a quorum of the entire board were invalid.<sup>67</sup> Now, hypothetically, two of the three remaining members of a five-man board, would constitute a quorum for filling the two vacancies. The purpose of this provision is to allow the corporation to operate with a full board without the expense and delay incident to holding a special meeting of shareholders.<sup>68</sup>

Previously, the term of the director elected to fill the vacancy continued until his successor was elected by the shareholders at the annual meeting or at a special meeting called for that purpose. Under the new act, the term continues for the unexpired portion of the previous director's term. In most cases, the result will be the same under either statute, with the maximum term one year. However, under the new provision, where there is a staggered board with terms of three years, the newly elected director in serving his predecessor's term, could serve up to the three-year maximum. This result was not possible under the previous statute.

The most significant change from prior law is that under the new section the directors are able to create vacancies by expanding the size of the board and then filling these vacancies. Previously, no specific authorization existed for this practice, which gave substantial doubt to its legality. The new section has the dual effect of enhancing the director's management function while diminishing the control of the corporation by the shareholders. This is characteristic of the type of provision which provides the brand of flexibility that appears attractive to corporations deciding whether to incorporate in Kentucky or another state. The practice may seem fraught with opportunity

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<sup>66</sup> Note that the special meeting was also available under the prior law, but such action was to elect a successor to the member elected by the board, and did not infringe upon the board's right to fill the vacancy until the shareholders acted, either at an annual or special meeting.

<sup>67</sup> See *McCleary's v. John S. McCleary, Inc.*, 119 A. 551 (Del. Ch. 1923); *Tomlinson v. Loew's Inc.*, 134 A.2d 518 (Del. Ch. 1957), *aff'd*, 135 A.2d 136 (Del. 1957); and further collection of cases cited in MODEL BUS. CORP. ACT ANN. 2D § 38 ¶ 4.03(2) (1971).

<sup>68</sup> MODEL BUS. CORP. ACT ANN. 2D § 38 ¶ 2 (1971).

for abuse, but this contingency is counterbalanced to some extent by a restriction of the terms of these newly created directorships to the next election by the shareholders.

The act does not deal specifically with the problems resulting from unfilled directorships,<sup>69</sup> removal vacancies,<sup>70</sup> and resignations,<sup>71</sup> but such events are probably included within the general scope of the section. Hopefully the courts will not be long in clearing up the ambiguities remaining.

#### E. *Removal of Directors*—KRSA § 271A.195

This section of the new act<sup>72</sup> delineates a substantial change from prior law. Previously, Kentucky had no provision relating to the removal of directors either with or without cause. It is arguable whether the former section stating that officers and directors stood in a fiduciary relationship to the corporation<sup>73</sup> also carried the implication that directors could be removed for breach of this duty.<sup>74</sup> However, most courts have consistently held that shareholders have the inherent power to remove directors for cause.<sup>75</sup> The real problems arose where a director was removed by the shareholders without cause or when a suit sought to have the court remove a director.

The above problems are now largely eliminated by KRSA § 271A.195(1) which provides:

At a meeting of shareholders called expressly for that purpose, directors may be removed in the manner provided in this section. Any director or the entire board of directors may be removed, *with*

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<sup>69</sup> See *Harris v. Brown*, 6 F.2d 922 (W.D. Ky. 1925) holding that where the shareholders had failed to fill two directorships on the board, the board had no right to fill them even though the articles gave the board the right to fill vacancies until the next annual election.

<sup>70</sup> Note that while the shareholders have the right to elect directors, the removal section, KRSA § 271A.195, is silent upon whether the shareholders may elect the successor to a removed director. It may be that the shareholders have the right to do so, but in the absence of such action, a vacancy is created within the meaning of the principle section, allowing the board to fill this vacancy. Of course, where the whole board is removed, the shareholders will have to fill the vacancies.

<sup>71</sup> See *Seal of Gold Mining Co. v. Slater*, 161 Cal. 621, 120 P. 15 (1911), holding the board had the power to accept a director's resignation and elect his successor. See also *Mayo v. Interment Properties, Inc.*, 53 Cal. App.2d 654, 128 P.2d 417 (1942).

<sup>72</sup> KRSA § 271A.195. This is substantially similar to the Model Act section.

<sup>73</sup> KRS § 271.365 (1971).

<sup>74</sup> See LEGISLATIVE HEARING, *supra* note 6, at 66 (remark of Mr. Shaikun suggesting this possibility).

<sup>75</sup> See *Auer v. Dressel*, 306 N.Y. 427, 118 N.E.2d 590, 48 A.L.R.2d 604 (1954); *Campbell v. Loew's Inc.*, 134 A.2d 852 (Del. Ch. 1957).



*or without cause*, by a vote of the holders of a majority of the shares then entitled to vote at an election of directors (emphasis added).

Cause is thus no longer a requirement for removal in accordance with the theory that, as the shareholders are the owners of the corporation, they should have complete power to determine who will manage the corporation. The propriety of a director's conduct is unimportant. The sole determining factor is whether a majority of the shareholders desire to remove the director.<sup>76</sup>

Most courts have held that where a director is to be removed for cause he must be given notice of the charges, a reasonable time to prepare his defense, and an opportunity to be heard before the vote.<sup>77</sup> The new act does not specifically deal with a director's right to a hearing, but as cause is no longer required, it may be fairly implied that this right has been abrogated. Since this power is vested solely in the shareholders, such a conclusion would be consistent with the nature of the power.

The question of removal may be presented for action by the shareholders only at a meeting called for that purpose. Taken literally, this would appear to preclude removal at the regular annual meetings, but it may be possible to circumvent this restriction by specifically calling a meeting for the purpose of removal, which either precedes or follows the annual meeting.

The entire board or any member thereof may be removed in this fashion. This provision is highly significant in that it strongly preserves the ability of the shareholders to act swiftly and decisively in bringing about changes in management. It also facilitates an effective shift in control when all or a controlling block of stock is sold to third parties. The new owners may assume almost immediate control without the bother of the previous technical obstacles. A simple majority vote is all that is required.

The only apparent restrictions upon the removal power are found in subsections (2) and (3) of KRSA § 271A.195. Subsection (2) protects the right of cumulative voting, and is probably necessary to prevent any constitutionally proscribed abuse of the cumulative voting right. Where less than the entire board is to be removed, this subsection operates to insure that "no one of the directors may be removed if the votes cast against his removal would be sufficient to elect him if then cumulatively voted at an election of the entire board

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<sup>76</sup> MODEL BUS. CORP. ACT ANN. 2D § 39 ¶ 2 (1971).

<sup>77</sup> See, e.g., *State v. Brast*, 127 S.E. 507 (W. Va. 1925).

of directors, or, if there be classes of directors, at an election of the class of directors of which he is a part." This provision does not apply if the entire board is to be removed, but it is effective in preventing the majority from removing a minority director and frustrating the constitutional guarantee of cumulative voting. Subsection (3) applies where directors are classified by the classification of shares, as opposed to classification by term which is covered in subsection (2). Subsection (3) logically restricts the removal power to the holders of the class of shares from which the particular director is elected, rather than allowing shares of all classes to be voted. Thus, Class A shareholders cannot participate in a vote to remove a Class B director. The Class B director can be removed only by a majority vote of the outstanding Class B shares.

## II. MEETINGS OF THE BOARD OF DIRECTORS

### A. *Quorum of Directors*—KRSA § 271A.200

#### 1. *Number*

The new act<sup>78</sup> provides that a majority of the directors fixed in the by-laws or articles constitutes a quorum for the transaction of business unless a greater number is required by the articles or by-laws. With some modification, the traditional common law requirement that a majority of the directors shall constitute a quorum<sup>79</sup> has been retained. The majority provision was also the basic guideline to be followed in the previous statute.<sup>80</sup> However, the principal differences between the new act and the old are found in the qualifying phrases of this general guideline.

The prior law stated that a majority of the directors constituted a quorum unless the by-laws provided a different number, which in no case could be less than one-third the total number of directors, nor less than two directors. As previously stated, the "nor less than two" requirement was generally felt to be an error that was not corrected when the minimum number of directors was decreased from three to one.<sup>81</sup> The significant feature of the prior act that is absent from the new law is the provision allowing less than a majority to constitute a quorum if so provided in the by-laws, subject to the one-third minimum. Thus, the less-than-majority-quorum provision

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<sup>78</sup> KRSA § 271A.200. This section is identical to ABA-ALI MODEL BUS. CORP. ACT § 40 (rev. ed. 1969).

<sup>79</sup> See *Caddy Oil Co. v. Sommer*, 218 S.W. 288 (Ky. 1920).

<sup>80</sup> KRS § 271.345(4)(c).

<sup>81</sup> See LEGISLATIVE HEARING, *supra* note 6, at 69 (remark of Mr. Shaikun).

has been consciously omitted from the new section, despite a proposal at the public hearings to retain this feature of the previous act.<sup>82</sup> The minimum number of directors now required for a quorum is a majority of the total number, with no downward adjustment allowed in either the articles or by-laws. This is one of the few sections of the new act to be criticized as taking away some of the flexibility that existed under the previous law.

It is quite conceivable that the seeming rigidity of this requirement may provide an obstacle to prompt and effective board action where several of the directors live at distant places or are simply unable to attend a meeting for any number of legitimate reasons. However, consistent with the comprehensive nature of the Model Act, there are adequate remedies for this situation. These remedies may be found in the sections authorizing the designation of executive committees<sup>83</sup> and allowing action to be taken informally without a meeting.<sup>84</sup>

With regard to upward revision of the quorum number, there is no similar limitation. Either the articles or the by-laws may provide for a greater than majority quorum requirement under the new act. The number may range anywhere from a majority to unanimous attendance. While the previous statute did not expressly authorize such an upward revision, it did allow a number other than a majority to be specified in the by-laws, with upward revision generally thought to be included within the scope of the provision. This part of the new statute is of special significance to the close corporation where the articles may be constructed to extend substantial protection to minority interests.<sup>85</sup> A unanimous quorum requirement coupled with the constitutional guarantee of cumulative voting could provide tremendous leverage for the minority interest in a close corporation.

The drafters of the Model Act have construed "number of directors" to mean the total authorized number of directors as fixed by the by-laws or by the articles if there is no by-law provision.<sup>86</sup> This could present a potential problem if one or several of the directors were not presently in office and a quorum could not be obtained. However, this undesirable situation was prudently anticipated by the drafters in the vacancy section, KRSA § 271A.190, which permits a majority of the remaining directors to fill vacancies though less than

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<sup>82</sup> *Id.* at 69 (proposals of Mr. Shaikun and Mr. Greenebaum).

<sup>83</sup> KRSA § 271A.210.

<sup>84</sup> KRSA § 271A.220.

<sup>85</sup> See MODEL BUS. CORP. ACT ANN. 2D § 40 ¶ 2 (1971).

<sup>86</sup> *Id.*

a quorum exists. Nevertheless, these vacancies must be filled to allow the board to act if a quorum is otherwise unobtainable.

## 2. *Vote to Constitute an Act of the Board*

KRSA § 271A.200 further provides: "The act of a majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors, unless the act of a greater number is required by the articles of incorporation or the by-laws." Thus, an act of the board is accomplished by a majority vote of the quorum present.<sup>87</sup> This is consistent with the previous statute.<sup>88</sup> It is possible to provide in either the articles or by-laws a specified voting requirement greater than a majority, including unanimous voting, on all or any specified questions. This represents an additional device for the potential use of minority interests in the close corporation.<sup>89</sup>

Existing case law in certain areas not specifically treated by the new act may retain part or all of its prior validity. Some examples pertaining at least tangentially to this section are: the prohibition against directors voting by proxy;<sup>90</sup> the area of business judgment and discretion traditionally allowed the board;<sup>91</sup> and the usual reluctance of the courts to interfere with the board's management function.<sup>92</sup>

## B. *Organizational Meeting of Directors—KRSA § 271A.285*

Previously, two organizational meetings were required of every newly formed corporation. First, there was the initial meeting of the shareholders who elected the first board of directors, adopted the by-laws unless this function was granted to the directors by the articles, and transacted such other business as was stated in the notice of the meeting.<sup>93</sup> Then followed a meeting of the first board of

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<sup>87</sup> See *Paducah & Ill. Ferry Co. v. Robertson*, 171 S.W. 171 (Ky. 1914), holding that the act of less than a quorum at a meeting of the board cannot bind the corporation.

<sup>88</sup> KRS § 271.345(4)(c).

<sup>89</sup> This section relegates to merely historical significance cases such as *Benintendi v. Kenton Hotel*, 294 N.Y. 112, 60 N.E.2d 829, 159 A.L.R. 280 (1945), holding invalid a unanimous vote-requirement for director action.

<sup>90</sup> See *Haldeman v. Haldeman*, 197 S.W. 376 (Ky. 1917), stating that directory could not vote by proxy.

<sup>91</sup> See *Pittsburgh, C.C. & St. L. Ry. Co. v. Dodd*, 72 S.W. 822 (Ky. 1903), stating that the management of the affairs of the corporation, involving the exercise of judgment and policy, is committed to the board of directors by law; *accord*, *Caddy Oil Co. v. Sommer*, 218 S.W. 288 (Ky. 1920).

<sup>92</sup> See *Taylor v. Axton-Fisher Tobacco Co.*, 173 S.W.2d 377 (Ky. 1943), holding that the action of the board when exercised in good faith and not in fraud of the rights of stockholders would not be interfered with by the courts; *accord*, *Graham v. McAdoo*, 123 S.W. 260 (Ky. 1909).

<sup>93</sup> KRS § 271.345(2).

directors who adopted the by-laws if the articles so provided, elected officers, and transacted such other business as properly came before the meeting.<sup>94</sup> Under the new act,<sup>95</sup> only one such organizational meeting is required, the initial meeting of the board of directors.

After the issuance of the certificate of incorporation, the directors are prepared to proceed with all facets of the management of the corporation.<sup>96</sup> This result is principally due to the sections of the new act providing that the first directors are named in the articles<sup>97</sup> and empowering the board of directors to adopt the initial by-laws.<sup>98</sup> Thus, at the organizational meeting, the board will adopt the by-laws, elect officers, and transact such other business as may come before the meeting.<sup>99</sup>

The meeting will be held at the call of a majority of the directors named in the articles. The directors calling this meeting must give at least three days' notice by mail to all named directors, stating the time and place of the meeting. Previously, only one day's notice was required. Such notice, however, may be waived if a written waiver is signed either before or after the time stated in the notice by the person or persons entitled to such notice.<sup>100</sup> The prior statute simply stated that "such call and notice shall not be necessary if all directors are shown by the minutes of such meeting to have been present thereat."<sup>101</sup>

### C. *Place and Notice of Directors' Meeting—KRSA § 271A.215*

KRSA § 271A.215(1)<sup>102</sup> is substantially similar to previous law<sup>103</sup> in providing that either regular or special meetings of the board of directors may be held either within or without this state. No statutory limitation is put upon the designation of the place for directors'

<sup>94</sup> KRS § 271.345(3).

<sup>95</sup> KRSA § 271A.285. This section is identical to ABA-ALI MODEL BUS. CORP. ACT § 57 (rev. ed. 1969).

<sup>96</sup> Where for convenience, secrecy, or other reasons, "dummy" directors are named in the articles, the latter may act upon routine matters such as adoption of by-laws or election of officers, but basic questions such as the authorization of employment contracts or the valuation of property or services to be accepted as consideration for the issuance of shares should not be made the responsibility of such directors. MODEL BUS. CORP. ACT ANN. 2D § 57 ¶ 2 (1971).

<sup>97</sup> KRSA § 271A.270(1)(j).

<sup>98</sup> KRSA § 271A.135(1).

<sup>99</sup> With regard to the actual conduct of the meeting, note that Roberts Rules of Order do not apply unless the corporation adopts them, usually in a by-law provision. LEGISLATIVE HEARING, *supra* note 6, at 78.

<sup>100</sup> See KRSA § 271A.660.

<sup>101</sup> KRS § 271.345(3).

<sup>102</sup> This provision is identical to ABA-ALI MODEL BUS. CORP. ACT § 43 (rev. ed. 1969).

<sup>103</sup> KRS § 271.345(4)(b).

meetings,<sup>104</sup> but it may be helpful to designate a particular place for regular meetings in a by-law provision to provide some measure of consistency for this important procedural matter. The statute likewise makes no attempt to regulate the time when the regular meeting should be held, but this also should be incorporated into a by-law provision which can accommodate the convenient attendance of all directors.

KRSA § 271A.215(2) deals generally with notice and waiver of notice for both regular and special meetings of the board. Regular meetings may be held with or without notice as provided in the by-laws. Thus, the act specifically defers the questions of whether notice is desirable, and if so, how much, to the drafters of the by-laws who in most cases will be the board of directors. However, for special meetings, notice is required;<sup>105</sup> but here also the specifics are left to the by-law provision.

In a fairly austere sentence that is somewhat ambiguous in its effect, KRSA § 271A.215(2) further provides that "attendance of a director at a meeting shall constitute a waiver of notice of such meeting, except where a director attends a meeting for the express purpose of objecting to the transaction of any business because the meeting is not lawfully called or convened." This provision should apply to either a regular meeting at which notice is required by a by-law or to a special meeting since notice is statutorily required. Therefore, notice may be waived by attendance at the meeting, as well as by a written waiver under the general section on waiver of notice.<sup>106</sup>

In the limited situation where a director attends only for the purpose of objecting to the transaction of business because the meeting was not lawfully called or convened, the director preserves his position of not having received notice. This should have the effect of making at least the special meeting an illegally convened meeting;<sup>107</sup> although the statute is silent on the effect of such events. One important matter apparently left to the interpretation of the courts is whether a director's presence under these circumstances

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<sup>104</sup> This section eliminates the validity of the early common law distinction between "corporate acts" and "business acts," where courts held that the former could be done only at a meeting held within the state while the latter could be done outside the state. MODEL BUS. CORP. ACT ANN. 2D § 43 ¶ 2 (1971).

<sup>105</sup> *Id.*

<sup>106</sup> See generally KRSA § 271A.660.

<sup>107</sup> In general, the courts tend to be broad-minded in reviewing actual omissions in the absence of specific harm. MODEL BUS. CORP. ACT ANN. 2D § 43 ¶ 2 (1971).

can be counted for the purposes of establishing a quorum.<sup>108</sup> The logical result would be that if a director attends and immediately announces his objection to the convening of the meeting, his presence could not be used in establishing a quorum. However, if he either stays and participates in the meeting or subsequently changes his mind and revokes his prior objection, his presence may be used to establish the quorum.

The act further provides that neither the business to be transacted, nor the purpose of any regular or special meeting need be specified in either the notice or waiver unless the by-laws so require. This provision is at least somewhat incongruous with the provision permitting a director to attend only for the purpose of objecting. One may wonder how a director could attend only for the purpose of objecting if he has no idea what is to come before the meeting and nothing in the notice, if any, informs him of the agenda.<sup>109</sup> The answer must lie in the fact that, as a matter of general practice, the purposes for which most special meetings are called are usually communicated informally to the directors. To be added to this reasoning is the strong policy argument that the board should not be limited to matters specified in the notice, but should be free to act on any matter that is properly within the scope of board action.

#### D. *Waiver of Notice—KRSA § 271A.660*

The new act contains a general waiver of notice provision applicable to both shareholders and directors whenever notice is required under any provision of the act, the articles, or the by-laws.<sup>110</sup> This section provides that a waiver "in writing signed by the person or persons entitled to such notice, whether before or after the time stated therein, shall be equivalent to the giving of such notice." Previously, the corporate statute contained a substantially similar provision, but it was applicable only to shareholders,<sup>111</sup> while the new section extends the waiver privilege to directors as well.<sup>112</sup> In addition, the scope of the privilege is now applied to notice provisions

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<sup>108</sup> See generally LEGISLATIVE HEARING, *supra* note 6, at 74-78.

<sup>109</sup> *Id.*

<sup>110</sup> KRSA § 271A.660. This section is identical to ABA-ALI MODEL BUS. CORP. ACT § 144 (rev. ed. 1969).

<sup>111</sup> KRS § 271.295(4).

<sup>112</sup> At common law the prevailing view was that only shareholders could waive notice, either before or after the event. This distinction resulted from the significance attached to the "consultative function" of directors. Such a distinction is now thought to be outmoded due to the prominence of statutes allowing for board action without a meeting, as well as to the effectiveness of modern communication. MODEL BUS. CORP. ACT ANN. 2D § 144 ¶ 2 (1971).

in the articles, the by-laws, and any section of the act itself. This general section is complemented by the more specific section providing that attendance of a director at a board meeting shall constitute waiver of notice, except when he attends only for the purpose of objecting to the transaction of business.<sup>113</sup>

E. *Action by Directors Without a Meeting*—KRSA § 271A.220

Action by the board of directors may be taken informally, without a meeting, under the new act.<sup>114</sup> Informal action by the board was also permitted under the previous statute;<sup>115</sup> however, there are important procedural and substantive differences in the new law.

The new section basically provides that, subject to contrary provisions in the articles or by-laws, any action to be taken at a board or committee meeting "may be taken without a meeting if a consent in writing, setting forth the action so taken, shall be signed by all of the directors, or all of the members of the committee, as the case may be. Such consent shall have the same effect as a unanimous vote." This provision, like the previous one, substantially dilutes the traditional "board action" rule which required that the board meet and act only as a body.<sup>116</sup>

Flexibility in the performance of the board's management function is the principal purpose of this section. Statutory approval for the often necessary and common practice of informal action in the close corporation is another purpose for the provision.<sup>117</sup> Minority interests are protected by the requirement that the consent must be unanimous, although opportunity for abuse may still exist, especially in dealings with third parties.

The underlying principle behind this section is ratification. The board, acting through all of its members, may now subsequently ratify prior informal action.<sup>118</sup> This differs from the previous statute where consent had to be given before the action was taken. The new section does not specifically mention a prior grant of consent for subsequent action, a practice which is not based on the ratification principle. However, this type of action should be interpreted to be

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<sup>113</sup> KRSA § 271A.215(2).

<sup>114</sup> KRSA § 271A.220. This section is identical to ABA-ALI MODEL BUS. CORP. ACT § 44 (rev. ed. 1969).

<sup>115</sup> KRS § 271.345(4)(e).

<sup>116</sup> For cases generally following the board action rule see *Caddy Oil Co. v. Sommer*, 218 S.W. 288 (Ky. 1920); *Haldeman v. Haldeman*, 197 S.W. 376 (Ky. 1917); *Paducah & Ill. Ferry Co. v. Robertson*, 171 S.W. 171 (Ky. 1914); *American Wire-Nail Co. v. Gedge*, 29 S.W. 353 (Ky. 1895).

<sup>117</sup> MODEL BUS. CORP. ACT ANN. 2D § 44 ¶ 2 (1971).

<sup>118</sup> LEGISLATIVE HEARING, *supra* note 6, at 157.



within the scope of the provision, especially since it was authorized by the prior statute and is, thus, not alien to Kentucky law.

### III. DIRECTORS' MANAGEMENT FUNCTION

#### A. *Executive and Other Committees*—KRSA § 271A.210

Kentucky has long recognized the power of the board of directors to delegate part of its management functions to an executive committee.<sup>119</sup> This right was codified in the previous statute<sup>120</sup> that permitted a majority of the whole board, by resolution, to designate two or more of the directors to constitute an executive committee, which to the extent provided in the resolution, could exercise the authority of the board *in the management of the corporation*.

The new act<sup>121</sup> also recognizes this right although there are important substantive differences between the two provisions. The new section states in part that if the articles or by-laws so provide, the directors, by resolution adopted by a majority of the full board, may designate from among its members an executive committee and one or more other committees each of which, to the extent provided in the resolution or articles or by-laws, shall have and may exercise *all* the authority of the board. This section is dependent upon an enabling provision in the articles or by-laws, and designates no minimum number of committee members. These features are changes from the previous statute.

However, the most significant change from prior law is in the scope of the authority that may be delegated. The new section expressly provides that *all* the authority of the board may be delegated, but only to the extent provided in a resolution, the articles, or the by-laws. The extent of the powers so delegated is limited only by a specific enumeration of actions the committee may not take,<sup>122</sup>

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<sup>119</sup> See *Haldeman v. Haldeman*, 197 S.W. 376 (Ky. 1917), upholding the power of the board of directors to delegate part of their authority to an executive committee.

<sup>120</sup> KRS § 271.345(4)(d).

<sup>121</sup> KRSA § 271A.210. This provision is in large part patterned after ABA-ALI MODEL BUS. CORP. ACT § 42 (rev. ed. 1969).

<sup>122</sup> KRSA § 271A.210 provides:

. . . but no such committee shall have the authority of the board of directors in reference to amending the articles of incorporation, adopting a plan of merger or consolidation, recommending to the shareholders the sale, lease, exchange or other disposition of all or substantially all the property and assets of the corporation otherwise than the usual and regular course of its business, recommending to the shareholders a voluntary dissolution of the corporation or a revocation thereof, or amending the by-laws of the corporation.

all of which are of a fundamental or structural nature and remain vested in the full board. The previous statute allowed the committee to exercise board authority *in the management of the corporation*, a phrase which is cognizant of the traditional distinction between ministerial functions and discretionary functions, the former being delegable and the latter non-delegable.<sup>123</sup> This distinction is not made in the new statute, as all powers may be delegated subject to those powers specifically made non-delegable.<sup>124</sup>

This new section will be of special benefit to the large corporation where overly centralized management may be an obstacle to prompt decision-making in corporate affairs. More significantly, it may also provide a loophole, enabling the majority interest on the board to designate members of its faction to constitute committees that can effectively control substantially all of the management functions. Further, since committee action is subject, in most cases, to the same rules that govern action by the board,<sup>125</sup> a majority of the committee, if a quorum is present, may act with little interference from minority board or committee members.

The section is also significant in what it does not say. Deleted from the House-passed version of the bill was a sentence providing that the designation of a committee shall not operate to relieve the board of directors, or any member thereof, of any responsibility imposed by law.<sup>126</sup> The underlying question is, of course, whether board members who are not committee members and did not participate in actions of the committee, may nevertheless be held liable for negligent or fraudulent actions of the committee. Several participants in the public hearings on the proposed act felt that such a provision would be unjust to innocent board members and would, as a practical matter, require the board to consider and ratify every action of the committee.<sup>127</sup> In any event, the conscious deletion of this part of the Model Act section could be interpreted as establishing a legislative intent to excuse nonparticipating board members from liability for committee actions.<sup>128</sup>

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<sup>123</sup> See LEGISLATIVE HEARING, *supra* note 6, at 71-74. For a collection of cases distinguishing between ministerial and discretionary powers, see MODEL BUS. CORP. ACT ANN. 2D § 42 ¶ 4.02 (1971).

<sup>124</sup> See MODEL BUS. CORP. ACT ANN 2D § 42 (1971).

<sup>125</sup> See *Canada-Atlantic & Plant S.S. Co. v. Flanders*, 145 F. 875 (1st Cir. 1906); *McNeil v. Boston Chamber of Commerce*, 28 N.E. 245 (Mass. 1891); and further cases cited in MODEL BUS. CORP. ACT ANN. 2D § 42 ¶ 4.06 (1971).

<sup>126</sup> See KY. ACTS ch. 274 § 42 (1972).

<sup>127</sup> See LEGISLATIVE HEARING, *supra* note 6, at 73-74 (1971) (comments of Messrs. Shaikun, Ward, Caldwell, and Greenebaum).

<sup>128</sup> Note the liability under the federal laws may be a different matter indeed.

B. *Dividends and Distributions from Capital Surplus—*  
 KRSA §§ 271A.225, 271A.230

The new act, like the previous one,<sup>129</sup> vests the board of directors with discretion to declare dividends<sup>130</sup> and make distributions from capital surplus,<sup>131</sup> subject to certain limitations. Within broad limits, the board of directors has discretion in determining whether dividends or other distributions will be made, and if so, in setting the amount of such distributions. It is usually difficult for a shareholder to prevail in his claim that the board has improperly exercised its discretion not to declare dividends or has declared dividends which are too small.<sup>132</sup> Existing case law on proper exercise of this discretion,<sup>133</sup> abuse of discretion,<sup>134</sup> and limitations on discretion<sup>135</sup> may be useful in dealing with these questions under the new law.

For a detailed treatment of when dividends and distributions may legally be declared and the maximum limits on the amount of these distributions, consult the section of this symposium concerning corporate finance. Director liability for improper payment of dividends or other distributions is treated in KRS § 271A.240.

#### IV. FIDUCIARY DUTIES OF DIRECTORATE

##### *Introductory Note*

Standards of conduct to which directors are held accountable are encompassed in a variety of doctrines and theories, but can usually

<sup>129</sup> KRS § 271.265.

<sup>130</sup> KRSA § 271A.225. This section is identical to ABA-ALI MODEL BUS. CORP. ACT § 45 (rev. ed. 1969). Note, however, that in subsection (a) the alternative provision provided by the Model Act has been adopted in place of the regular provision.

<sup>131</sup> KRSA § 271A.230. This section is identical to ABA-ALI MODEL BUS. CORP. ACT § 46 (rev. ed. 1969).

<sup>132</sup> See MODEL BUS. CORP. ACT ANN. 2D § 45 ¶ 2 (1971).

<sup>133</sup> See *Gearhart v. Lee-Clay Products Co.*, 152 S.W.2d 1003 (Ky. 1941), stating that in a stockholder's petition to compel declaration of a stock dividend the existence of surplus out of which a dividend can be paid must be alleged; *Westerfield-Bonte Co. v. Burnett*, 195 S.W. 477 (Ky. 1917), stating that unless the directors are guilty of bad faith or a willful abuse of discretion, the courts will not interfere; *Smith v. Southern Foundry Co.*, 179 S.W. 205 (Ky. 1915), stating that dividends are payable as the directors in the exercise of their discretion may declare. For a further collection of cases, see 3 P-H CORP. (Ky.) ¶ 45 (1972).

<sup>134</sup> See *Louisville & St. L. Ry. Co. v. U.S.*, 20 F. Supp. 483 (W.D. Ky. 1937), holding that a corporation has no right to exclude some stockholders of the same class from receiving dividends; *Patton v. Nicholas*, 302 S.W.2d 441 (Tex. Civ. App. 1957); *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919); and further collection of cases in MODEL BUS. CORP. ACT ANN. 2D § 45(a) ¶ 4.06(2) (1971).

<sup>135</sup> See *Crocker v. Waltham Watch Co.*, 53 N.E.2d 230 (Mass. 1944); *Cannon v. Wiscasset Mills Co.*, 141 S.E. 344 (N.C. 1928); and other cases in MODEL BUS. CORP. ACT ANN. 2D § 45(a) ¶ 4.06(3) (1971).

be classified into three broad areas: (1) duty of care, (2) duty of loyalty, and (3) conduct under federal statutes, especially the securities laws. Contrary to the previous act,<sup>136</sup> the present act does not specifically deal with the duty of care, as this area is presumably left to the courts.<sup>137</sup> Of course, director conduct under federal statutes is a matter independent of, and not affected by, the Kentucky corporation law.<sup>138</sup> However, the present act does treat some situations in the duty-of-loyalty area which are discussed below.

#### A. *Director Conflicts of Interest—KRSA § 271A.205*

Statutory regulation of director conflicts of interest is new to Kentucky law, although it appears to have been a common practice to include regulatory standards in the articles of incorporation through KRS § 271.035(2) of the prior act.<sup>139</sup> However, the standards regarding most director conflicts are now prescribed by statute<sup>140</sup> with no specific allowance made for provisions in the articles.

KRSA § 271A.205(1) essentially provides that no transaction between a corporation and a director or any other entity in which one or more of its directors are directors or officers or are financially interested, shall be void or voidable solely because of such relationship or interest, or because such director or directors are present at the meeting of the board or a committee thereof which authorizes, approves or ratifies such contract or transaction or because his or their votes are counted for such purpose, if one of three conditions is met: (a) the contract or transaction is not manifestly unfair to

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<sup>136</sup> KRS § 271.365 provided:

Officers and directors shall be deemed to stand in a fiduciary relation to the corporation, and shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.

<sup>137</sup> While the standard for the duty of care is no longer prescribed by statute, there is little reason to conclude that this standard or a similar one, as well as the related "business judgment rule," will not continue to be imposed by judicial decision. See *Urban J. Alexander Co. v. Trinkle*, 224 S.W.2d 923 (Ky. 1949); *Richardson v. Blue Grass Mining Co.*, 29 F. Supp. 658 (1939), cert. denied, 317 U.S. 639 (1952); *People's State Bank v. Jacksonian Hotel Co.*, 87 S.W.2d 111 (Ky. 1935); *Reinhardt v. Owensboro Planing Mill Co.*, 215 S.W. 523 (Ky. 1919); *Graham v. McAdoo*, 123 S.W. 260 (Ky. 1909) (applying business judgment rule).

<sup>138</sup> See *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968). See generally *Ruder, Wheat, & Loss, Standards of Conduct under the Federal Securities Acts*, 27 BUS. LAW 75 (Feb. 1972); *McLaren & Bicks, Standards of Conduct under the Antitrust Acts*, 27 BUS. LAW. 95 (Feb. 1972).

<sup>139</sup> See LEGISLATIVE HEARING, *supra* note 6, at 69 (comment of Mr. Shaikun).

<sup>140</sup> KRSA § 271A.205. This provision, for the most part, is identical to ABA-ALI MODEL BUS. CORP. ACT § 41 (rev. ed. 1969).

the corporation and the relationship or interest is disclosed to the board or committee approving the transaction without counting the vote of the interested director, or (b) the contract or transaction is not manifestly unfair to the corporation and the relationship is disclosed to the shareholders and they approve the transaction, or (c) the contract or transaction is fair and reasonable to the corporation.

Thus, if any one of these three conditions is met, the contract or transaction may stand.<sup>141</sup> The first two conditions combine fairness with disclosure, while the last focuses only on fairness and reasonableness, no disclosure being necessary. It is obvious that any of the three, especially the latter, presents considerable liberality for treating such contracts or transactions. The only variation in this section from the Model Act section is that in (a) and (b) the phrase, "The contract or transaction is not manifestly unfair to the corporation" has been added to the Kentucky provision. Consequently, the Model Act treatment of director conflicts of interest has been tightened in Kentucky by adding a standard of fairness to what was mere disclosure. Despite this change, the provision remains as one of the least restrictive in any jurisdiction.

Procedural obstacles are removed in KRSA § 271A.205(2) which allows interested directors to be counted in determining the presence of a quorum at a board or committee meeting that approves or ratifies the transaction. Coupled with the provisions of KRSA § 271A.205(1) that permit interested directors to be present at the meeting and even vote for the approval of the transaction, only one procedural requirement remains. In option (a) of the three conditions, the vote of the board or committee approving the transaction must be sufficient to pass without counting the vote of the interested director. There is no prohibition against the interested director voting his shares on this matter at a shareholders' meeting, and, of course, under option (c) neither disclosure nor the approval of any corporate body is necessary if the contract is fair and reasonable.

Some concern surfaced at the public hearings that a literal reading of the act would require disclosure of either relationship or interest, but not necessarily both. The following situation was suggested:<sup>142</sup> if a director of a corporation is financially interested in one of the

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<sup>141</sup> The function of this section is not to provide a basis for validating for all purposes a contract or transaction between an interested director and his corporation, but simply to establish that such a transaction is not automatically void or voidable solely by reason of the director's interest. In addition, the courts retain their full powers to deal with such matters under general equitable principles. MODEL BUS. CORP. ACT ANN. 2D § 41 ¶ 2 (1971).

<sup>142</sup> LEGISLATIVE HEARING, *supra* note 6, at 70 (comments of Mr. Caldwell).

corporation's major suppliers and the fact of his relationship to the supplier is disclosed, but the fact that this other corporation is a major supplier is not disclosed, then there would be a disclosure of relationship but not interest. Taken literally, this would satisfy the disclosure requirement of the new act. One participant in the hearing expressed the view that the act requires "full disclosure" which includes both relationship and interest, but at least in large corporations, the whole matter is largely pre-empted by the federal proxy rules which require disclosure of all possible areas of conflict of interest.<sup>143</sup> In the small corporation, however, the question apparently remains open.

The application of this section is limited to conflicts of interest in transactions directly between the director and the corporation itself, or between the corporation and another corporation where there is a common director, or between the corporation and another entity in which the director has a financial interest.<sup>144</sup> Other sections of the new act cover corporate loans to employees and directors,<sup>145</sup> the right of the board of directors to fix the compensation of its members,<sup>146</sup> liability of directors for declaring illegal dividends or making illegal distributions, and illegal purchases of treasury stock.<sup>147</sup> Not specifically covered by the new act, but usually falling within the concept of the fiduciary duty of loyalty, are situations of usurping a corporate opportunity<sup>148</sup> and acquiring a competing business. The law on these situations is left to development through the case-by-case method of judicial decision.

#### B. *Loans to Employees and Directors—KRSA § 271A.235*

Statutory regulation of loans to directors, officers, and employees is also new to Kentucky law. The above section, which attempts

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<sup>143</sup> *Id.* at 71 (comment of Mr. Greenebaum). The federal proxy rules are applicable to any corporation whose shares are listed on a national securities exchange and also to corporations whose shares are traded over the counter if the latter corporations have more than 500 shareholders and \$1,000,000 in assets. The proxy rules may be found in 17 C.F.R. § 240.14 (Supp. 1972).

<sup>144</sup> See MODEL BUS. CORP. ACT ANN. 2D § 41 ¶ 2 (1971).

<sup>145</sup> KRSA § 271A.235.

<sup>146</sup> KRSA § 271A.175.

<sup>147</sup> KRSA § 271A.240.

<sup>148</sup> For cases involving the corporate opportunity and other loyalty doctrines, see *Pepper v. Litton*, 308 U.S. 295 (1939); *Urban J. Alexander Co. v. Trinkle*, 224 S.W.2d 923 (Ky. 1949), stating that a director or officer breaches no fiduciary duty to the corporation in taking advantage of a business opportunity which the corporation is financially and legally unable to engage in, and the director is not compelled to account to the corporation for any profits realized; *Reutlinger v. Reiss*, 183 S.W.2d 488 (Ky. 1944); *Coleman v. Hanger*, 275 S.W. 784 (Ky. 1925); *Jasper v. Appalachian Gas Co.*, 153 S.W. 50 (Ky. 1913).

to set safe but flexible standards for regulating such conduct, is identical to the Model Act section,<sup>149</sup> except for a sentence exempting certain types of businesses from part of the section.

The statute basically provides: "A corporation shall not lend money to or use its credit to assist its directors without authorization in the particular case by its shareholders. . . ." Inserted into the Model Act section by the legislature was the exempting provision that the above sentence does not apply to transactions in the ordinary and usual course of business of any bank, trust company, combined bank and trust company, insurance company, savings and loan association, credit union or industrial loan corporation. The section then qualifies the initial sentence:

A corporation may lend money to and use its credit to assist any employe of the corporation or of a subsidiary, including any such employe who is a director of the corporation, if the board of directors decides that such loan or assistance may benefit the corporation.

Consequently, loans may be made (1) to any employee if the board decides that such assistance may benefit the corporation; (2) to any employee who is also a director, under the same condition as employee loans; and (3) to any director who is not an employee, only where there is shareholder approval. The proximate result of this section is that inside directors, due to their dual capacity as director and employee, may receive assistance from the corporation while outside directors may not. Such a result is not entirely logical since the inside directors are the ones who are in positions allowing the greatest opportunity for self-dealing.<sup>150</sup> In contrast, the outside directors are not usually in such a position, but nevertheless, must still obtain shareholder approval. The provision has been criticized for thus discriminating against outside directors, especially since the SEC proxy rules permit loans of up to \$30,000 to directors without requiring public disclosure.<sup>151</sup> The reasoning here is that if even the usually restrictive proxy rules would not interfere with such loans, at least those less than \$30,000, then a supposedly liberal state corporation statute should likewise not interfere. Of course, this reasoning would not be applicable for the smaller corporation where \$30,000 may constitute the entire capital of the corporation.

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<sup>149</sup> Compare KRSA § 271A.235 with ABA-ALI MODEL BUS. CORP. ACT § 47 (rev. ed. 1969).

<sup>150</sup> One possible method to circumvent this restriction would be to employ the director in some minor consultant position and proceed with the loan. LEGISLATIVE HEARING, *supra* note 6, at 115 (comments of Mr. Shaikun).

<sup>151</sup> *Id.*

Regarding loans to both employees and director-employees, the sole criterion for the propriety of such assistance is a determination by the board of directors that the loan may benefit the corporation. No standards or guidelines for such a determination are prescribed by the act, although presumably a business purpose is required.<sup>152</sup> Likewise, the board has complete discretion, subject to the benefit test, to determine what security, if any, will be required for the loan. It may be advantageous to the corporation in a particular case to make a loan without security. However, this should occur infrequently since the board is responsible for making improvident loans and may be held liable for waste of corporate assets.<sup>153</sup>

Absent also from the section is any mention of what rate of interest, if any, the loan should carry. The lack of statutory guidance here may logically be interpreted as leaving this matter also to the discretion of the board. However, one test of the adequacy of the interest rate would be to balance the expected benefit to the corporation to be derived from granting the loan against a reasonable return achievable by the corporation had the funds been invested elsewhere.<sup>154</sup> A similar standard could be used to test the adequacy of the security for the loan by balancing the expected benefit and likelihood of timely repayment against reasonable investment returns available elsewhere to the corporation.

### C. *Liability of Directors in Certain Cases—KRSA § 271A.240*

This section<sup>155</sup> is similar to the prior statute<sup>156</sup> in imposing liability upon directors for declaring improper dividends or making other unlawful distributions, for allowing improper purchases by a corporation of its own stock, and for agreeing to improper distributions

<sup>152</sup> The comment to the Model Act section states:

Use of corporate funds for other than corporate purposes is improper. Even the sole stockholder is not entitled to use corporate funds for his individual purposes. Unless creditors' rights are involved, there may be no one to complain about such acts but nevertheless there may be tax consequences. For instance, the funds used might, for tax purposes, be considered a dividend to the stockholder.

MODEL BUS. CORP. ACT ANN. 2D § 47 ¶ 2, Comment (1971).

<sup>153</sup> *Id.*

<sup>154</sup> Cf. *Tovrea Land & Cattle Co. v. Linsenmeyer*, 412 P.2d 47 (Ariz. 1966) (en banc), upholding loans made by a corporation to its dominant directors without the required majority vote of the board of directors, for less than the legal interest rate, where there was no fraud or unfairness and no showing that funds could have been invested at a more substantial interest yield, and the loans were repaid in full with interest. See further collection of cases in MODEL BUS. CORP. ACT ANN. 2D § 47 ¶ 4 (1971).

<sup>155</sup> This provision is patterned substantially after ABA-ALI MODEL BUS. CORP. ACT § 48 (rev. ed. 1969), with several important changes.

<sup>156</sup> KRS § 271.275.



of corporate assets during liquidation. It also deals with the time when a director is deemed to have assented to such action, good faith defenses, and the right of contribution from shareholders and other directors.

KRSA § 271A.240(1) begins with the phrase "In addition to any other liabilities imposed by law upon directors of a corporation," and then proceeds to state the three liability provisions mentioned above. The significance of this initial phrase deserves some comment. Such "other liabilities" are, in general, correlative of the broad powers placed upon directors by this act to manage the business and affairs of the corporation.<sup>157</sup> However, liability resulting from common law or judicial doctrines not specifically covered by the act, as well as liability under federal statutes, may also be included. This determination may be particularly relevant in clarifying a director's right to contribution from other directors under KRSA § 271A.240(5).

KRSA § 271A.240(1)(a) provides that directors who vote for or assent to the declaration of any dividend or other distribution of assets to the shareholders, contrary to the provisions of the act<sup>158</sup> or any restriction contained in the articles of incorporation, shall be jointly and severally liable to the corporation for the amount of such dividend or distribution paid or distributed in excess of the amount which could have been paid or distributed without a violation of the act or the restrictions in the articles. Note that the liability is joint and several and runs to the corporation. The amount of liability is only for the illegal part of the dividend or distribution, not the full amount.

KRSA § 271A.240(1)(b) provides generally that directors who vote for or assent to the purchase of the corporation's own shares contrary to the provisions of the act<sup>159</sup> shall be jointly and severally liable to the corporation for the amount of consideration paid which is in excess of the maximum amount which could lawfully have been paid.

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<sup>157</sup> MODEL BUS. CORP. ACT ANN. 2D § 48 ¶ 2 (1971).

<sup>158</sup> For what constitutes a proper dividend or distribution under this act, see KRSA § 271A.225 concerning dividends and KRSA § 271A.230 concerning distributions from capital surplus.

<sup>159</sup> As to when a corporation may properly purchase its own shares, see KRSA § 271A.030. See also *Reilly v. Segert*, 201 N.E.2d 444 (Ill. 1964), where judgment had been entered against the directors for a distribution by purchase of shares where the corporation was insolvent when the payment was made. The court held liable the shareholders who had received the corporate funds for their shares, further holding that a statutory provision for director liability did not negate the common law liability of shareholders. Note the additional cases digested in MODEL BUS. CORP. ACT ANN. 2D § 48 ¶ 4 (1971). See generally Ruder, *Dangers in a Corporation's Purchases of Its Own Shares*, 13 PRAC. LAW. 75, 76 (May 1967).

KRSA § 271A.240(1)(c) provides that directors who vote for or assent to any distribution of assets to the shareholders during liquidation of the corporation, without payment and discharge of or adequate provision for all known debts and liabilities of the corporation, shall be jointly and severally liable to the corporation for the value of the assets distributed to the extent that such debts are not thereafter paid and discharged.

KRSA § 271A.240(2) states that any director present at a board meeting at which action described in KRSA § 271A.240(1)<sup>160</sup> is taken, shall be presumed to have "assented to"<sup>161</sup> the action unless he does one of three things: (1) enters his dissent in the minutes of the meeting, or (2) files his written dissent with the secretary of the meeting before adjournment, or (3) forwards his dissent to the secretary of the corporation by registered mail within 60 days after adjournment but not later than three days after he has learned of such action.<sup>162</sup> The right to dissent does not apply to a director who voted in favor of the action. It has been suggested that to escape the burdens of this provision, the board should meet as a committee of the whole since the provision is applicable only to meetings of the board of directors.<sup>163</sup> Whether the courts would agree with such a literal reading of the provision remains for determination.

KRSA § 271A.240(3) deals with a good faith defense.<sup>164</sup> A director will not be held liable under KRSA § 271A.240(1)(a), (b), or (c) if he relied and acted in good faith upon financial statements of the corporation represented to him to be correct by the president or officer in charge of the books of account, or stated in a written report by an independent public or certified public accountant fairly to reflect the financial condition of the corporation. The director may also

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<sup>160</sup> The Model Act makes this subsection applicable to "any corporate matter," rather than only to those actions described in KRSA § 271A.240(1).

<sup>161</sup> See *Aiken v. Insull*, 122 F.2d 746 (7th Cir. 1941), *cert. denied*, 315 U.S. 806 (1942), decided under a statute which provided that directors "declaring or assenting to" illegal dividends were liable, where it was held that the word "assenting" includes the approval and ratification of a dividend after it has been declared by the executive committee. In this case the directors adopted a resolution approving the executive committee's declaration of an unlawful dividend. See also *Cunningham v. Shellman*, 175 S.W. 1045 (Ky. 1915). Note the further collection of cases in MODEL BUS. CORP. ACT ANN. 2d § 48 ¶ 4.02 (1971).

<sup>162</sup> Here again the legislature has broadened the Model Act to make the section more flexible to the director. The 60-day provision was added by the legislature.

<sup>163</sup> See LEGISLATIVE HEARING, *supra* note 6, at 79-80 (comments of Mr. Shaikun).

<sup>164</sup> For cases applying the common law defense of good faith with regard to improper dividends, see *Cunningham v. Shellman*, 175 S.W. 1045 (Ky. 1915); *City of Franklin v. Caldwell*, 96 S.W. 605 (Ky. 1906); *Lexington & Ohio R.R. v. Bridges*, 46 Ky. 556 (1847).

escape liability in determining the amount available for a dividend or distribution if in good faith he considered the assets to be of their book value. Unlike the prior statute, reliance upon the representations of an "employee" having charge of the books of account is not included in the good faith defense.<sup>165</sup> Regarding the independent accountant, reliance is allowed only on those statements where the opinion is given that the statements fairly reflect the financial condition of the corporation. Thus, on its face, good faith reliance is not a defense where the independent accountant does not express the opinion that the statements fairly reflect the financial condition of the corporation.

KRSA § 271A.240(4) gives any director held liable under this section the right of contribution from shareholders who accepted or received the dividend or distribution, knowing it to have been made in violation of the act, in proportion to the amounts received by them.<sup>166</sup> This differs from the previous statute where shareholders were liable only if no director were liable, or the directors liable were unable to pay the judgment.<sup>167</sup> To this extent, the new section represents a broadening of shareholder liability.

The director's right to contribution from other directors is set forth in KRSA § 271A.240(5). A director is entitled to contribution from the other directors who voted for or assented to the action upon which the claim is asserted.

Unlike the previous statute,<sup>168</sup> the new provision contains no internal statute of limitations on either director or shareholder liability. Formerly, there was a two-year statute of limitations on these types of actions, and despite a proposal to insert such a provision into the new section,<sup>169</sup> the act as approved contains no such provision. The

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<sup>165</sup> The absence of the word "employee" in this section prompted some discussion at the public hearings on the bill. The view was expressed that permitting reliance upon employee representations could open the door to certain fraudulent practices, due to the less than independent nature of the director-employee relationship. See LEGISLATIVE HEARING, *supra* note 6, at 82 (comment of Chairman Lewis).

<sup>166</sup> See *Grant v. Ross*, 37 S.W. 263 (Ky. 1896), stating that the corporation can recover dividends illegally declared under a mistake or misapprehension as to the right to declare them; cf. *First Nat'l Bank & Trust Co. v. Glenn*, 36 F. Supp. 552 (W.D. Ky. 1941), stating that dividends accrue to the stockholder on the date they are declared although payable at a later date to stockholders of record on an intermediate date; *Lobaco Co. v. Chaffin*, 235 S.W. 993 (Ky. 1921). Note further collection of cases in 3 P-H CORP. (Ky.) ¶¶ 45, 48 (1972).

<sup>167</sup> KRS § 271.275(2). However, under the previous statute, shareholders could be liable even if they did not know that the dividend or distribution was illegal. Thus, innocent shareholders have a defense under the new law that was not previously available.

<sup>168</sup> KRS § 271.275(3).

<sup>169</sup> See LEGISLATIVE HEARING, *supra* note 6, at 81-82 (1971) (proposal of Mr. Shaikun).

opinion was expressed that this section may be subject to the general five-year statute applicable when there is no other statute specified.<sup>170</sup>

D. *Penalties Imposed Upon Officers and Directors—KRSA § 271A.640*

The previous statute<sup>171</sup> regarding penalties imposed upon officers and directors has been retained almost in its entirety by the new act with a corresponding rejection of the Model Act section. KRSA § 271A.640(1) provides that any foreign corporation transacting business in this state without complying with the provisions of this chapter that require certain things to be done before transacting business, and any officer, director, or agent of the corporation who knowingly participates in such activity, shall be fined from \$100 to \$1,000 for each offense. KRSA § 271A.640(2) provides an identical fine for any corporation<sup>172</sup> that violates any provision of this chapter, as well as for any officer, director, or agent who knowingly participates therein. For violations of this section, the commonwealth's attorney of the county where the corporation is domiciled—and not the attorney general—has the responsibility of instituting the suit.<sup>173</sup>

V. OFFICERS

A. *Number and Authority of Officers—KRSA § 271A.250*

The present enactment<sup>174</sup> concerning officers contains only minor deviations from the previous statute.<sup>175</sup> "The officers of a corporation shall consist of a president, a secretary, and a treasurer, each of whom shall be elected by the board of directors" in the manner prescribed by the by-laws. Contrary to both the Model Act and the prior statute, no mention is made of the vice-president. Therefore, this position is not statutorily required, but may be created and filled in accordance with the sentence of subsection (1) allowing election or appointment of "such officers and assistant officers and agents as may be deemed necessary." These other officers, of course, are discretionary with the board of directors and are governed by the regulatory provisions of the by-laws.

The act expressly allows one person to hold any two or more

<sup>170</sup> *Id.*

<sup>171</sup> KRS § 271.990.

<sup>172</sup> See *Kentucky Straight Creek Coal Co. v. Commonwealth*, 200 S.W.2d 470 (Ky. 1947).

<sup>173</sup> See *Commonwealth ex rel. Breckinridge v. Monroe Co.*, 378 S.W.2d 809 (Ky. 1964).

<sup>174</sup> KRSA § 271A.250(1). This provision is substantially similar to ABA-ALI MODEL BUS. CORP. ACT § 50 (rev. ed. 1969).

<sup>175</sup> KRS § 271.355(1).

offices except that the same person cannot hold both the offices of president and secretary if the corporation has more than one shareholder. Thus, all corporations are required to have a president, secretary, and treasurer, but only two persons are required to hold these three offices if the corporation has more than one shareholder. If the corporation has only one shareholder, the act implies that all three offices may be held by one person. In this regard, the provision is specially tailored to meet the needs of the close corporation and is more liberal than either the prior law or the Model Act.

KRSA § 271A.250(2) outlines in the broadest terms the duties and authority of officers and agents of the corporation. It is identical to the Model Act and substantially similar to the previous provision.<sup>176</sup> The new provision states that all officers and agents shall have such authority and perform such duties in the management of the corporation as may be provided in the by-laws or by resolution of the board not inconsistent with the by-laws. It is important to note that this authority is express authority, derived from the statute, the by-laws, and resolutions of the board.<sup>177</sup> The provision does not encompass the more troublesome apparent authority, authority flowing from ratification, or implied authority.

Implied authority may be called "inherent" or "presumptive" authority or authority "by virtue of office" and often results from general custom or past practices or as incidental to express authority. Implied authority is found in the general manager of the corporation who has authority to make any contract or perform any act in the ordinary course of business. When the president acts as general manager, he enjoys these implied powers.<sup>178</sup> However, other officers are rarely considered to possess implied authority.

Problems concerning apparent authority and principles of estoppel usually arise in third-party situations. When a corporation cloaks an officer or agent with apparent authority, and a third party in good faith reasonably relies on such authority, the corporation is estopped from denying the authority.<sup>179</sup> The board of directors can subsequently ratify prior unauthorized acts of officers, if these acts could have been previously authorized by the board. Ratification creates an equivalent to prior authority and may be express or implied. Acceptance of the benefits of unauthorized acts of officers, with knowledge of the facts, will constitute an implied ratification.<sup>180</sup>

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<sup>176</sup> KRS § 271.355(2).

<sup>177</sup> MODEL BUS. CORP. ACT ANN. 2D § 50 ¶ 2 (1971).

<sup>178</sup> *Id.*

<sup>179</sup> *Id.*

<sup>180</sup> *Id.*

Kentucky courts have recognized generally the distinctions between authority that may be express, implied, apparent, or resulting from ratification. As the new section deals only with express authority, existing case law on the other sources of authority may be particularly relevant in determining the full scope of the powers and duties of corporate officers. Litigation has arisen in the past regarding the following: the express authority of the president;<sup>181</sup> the implied authority of the president,<sup>182</sup> vice-president,<sup>183</sup> secretary,<sup>184</sup> agent,<sup>185</sup> stockholder,<sup>186</sup> and bookkeeper;<sup>187</sup> the apparent authority of all officers

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<sup>181</sup> See *Davis v. Pendennis Club*, 19 S.W.2d 1078 (Ky. 1929) (holding that if the president is authorized to make a contract and does so, it is binding on the corporation); *Liebowitz v. Allied Brewing & Distilling Co.*, 134 S.W.2d 994 (Ky. 1939) (contract binding on third party). See generally 3 P-H CORP. (Ky.) § 50 (1972) for digest of cases found in this and the ten succeeding footnotes.

<sup>182</sup> See *Southeastern Land Co. v. Jonnard*, 249 S.W. 789 (Ky. 1923), holding that the president of a real estate corporation may authorize an agent to sell some corporate property as part of the regular business of the corporation; *In re Fed. Coal Co.*, 31 F.2d 375 (E.D. Ky. 1927), holding that the president as general manager has the power to secure an indebtedness of the corporation by pledging the bonds of the company; *Bramblet v. Commonwealth Land & Lumber Co.*, 83 S.W. 599 (Ky. 1904), holding that the president may not purchase debts of the corporation at a discount and enforce them against it for full value; *Harbel Coal Co. v. Asher Coal Mining Co.*, 414 S.W.2d 128 (Ky. 1967), holding that the president has no general authority to execute contracts concerning lease of coal lands.

<sup>183</sup> See *Clay v. Mt. Holly Dev. Co.*, 464 S.W.2d 621 (Ky. 1971), where the vice-president had no authority to issue checks to himself for alleged services rendered, when there was no board resolution granting this authority; however, he is entitled to reasonable compensation for work performed beyond the scope of his duties; *Union Motor Co. v. Taylor*, 267 S.W. 170 (Ky. 1924), which held that when a corporation has permitted its vice-president to make the corporation's employment contracts it is bound thereby; *Empire Coal Mining Co. v. Empire Coal Co.*, 210 S.W. 474 (Ky. 1919), holding that it is not within the ordinary and apparent authority of the vice-president and general manager to sell all the corporation's assets. See also *Kentucky-Pennsylvania Oil & Gas Corp. v. Clark*, 57 S.W.2d 65 (Ky. 1933); *Elk Valley Coal Co. v. Thompson*, 150 S.W. 817 (Ky. 1912).

<sup>184</sup> See *Citizens' Dev. Co. v. Kypawva Oil Co.*, 229 S.W. 88 (Ky. 1921), which held that the secretary is generally a mere ministerial officer who keeps books and records, and in the absence of express authority has no power to buy property for the corporation; *Main St. Warehouse Co. v. Bain Moore Tobacco Co.*, 250 S.W. 98 (Ky. 1923).

<sup>185</sup> See *Am. Oil Pump & Tank Co. v. Sizemore*, 276 S.W. 558 (Ky. 1925), where the court held that in order for the act of an agent to bind the company, it must appear that he was acting within the actual or apparent scope of his authority; see also *Commonwealth v. Aetna Life Ins. Co.*, 93 S.W.2d 840 (Ky. 1936); *Harlan Fuel Co. v. Wiggington*, 262 S.W. 957 (Ky. 1924).

<sup>186</sup> See *Paducah & Ill. Ferry Co. v. Robertson*, 171 S.W. 171 (Ky. 1914), which held that where the chairman of the board acquiesces in the employment of an agent by a stockholder, the corporation is bound by the contract of employment.

<sup>187</sup> See *Main St. Tobacco Warehouse Co. v. Bain Moore Tobacco Co.*, 250 S.W. 98 (Ky. 1923), holding that a bookkeeper is a mere clerical employee of the corporation, and without special authority given to him, may not bind the corporation by his promise or agreement.

and agents;<sup>188</sup> and the ratification of unauthorized acts<sup>189</sup> including the related principles of estoppel<sup>190</sup> and laches.<sup>191</sup>

### B. *Removal of Officers*—KRSA § 271A.255

The new section<sup>192</sup> concerning removal of officers represents no significant changes from prior law.<sup>193</sup> The present statute allows the removal of any officer or agent by the board of directors, whenever in its judgment the best interests of the corporation will be served thereby. It further provides that such removal shall be without prejudice to the contract rights, if any, of the person so removed, but the election or appointment of an officer or agent shall not of itself create contract rights.

Removal of officers is entirely discretionary with the board of directors, and therefore, may be with or without cause.<sup>194</sup> Usually the courts will not interfere with the exercise of this discretion.<sup>195</sup> However, an officer employed under a contract of employment will have an action for damages if he is removed without cause before his term

<sup>188</sup> See *Preece v. Burns' Adm'r*, 81 S.W.2d 881 (Ky. 1935), holding that a corporation is bound by the acts of its officers and agents who have been held out as having the authority which they exercise, or by its custom of dealing; *Caddy Oil Co. v. Sommer*, 218 S.W. 288 (Ky. 1920), holding that apparent authority of an officer is based upon his past acts on the company's behalf of which it had, or should have had, knowledge, and such apparent authority is limited by the character of the business. See also *R. H. Kyle Furniture Co. v. Russell Dry Goods Co.*, 340 S.W.2d 220 (Ky. 1960); *Enterprise Foundry & Machine Works v. Miners' Elkhorn Coal Co.*, 45 S.W.2d 470 (Ky. 1931).

<sup>189</sup> See *City of Whitesburg v. Whitesburg Water Co.*, 78 S.W.2d 330 (Ky. 1935) and cases cited therein; the unauthorized acts of officers or agents may be ratified by the corporation by acquiescence, or by accepting and retaining the benefits of the acts; *Kentucky-Pennsylvania Oil & Gas Corp. v. Clark*, 57 S.W.2d 65 (Ky. 1933), holding that unless the corporation has full knowledge of the acts of its agents, it cannot be bound by ratification. See also *Coldiron v. Good Coal Co.*, 125 S.W.2d 757 (Ky. 1939). *Contra*, *Kentucky By-Product Coal Co. v. Cline*, 265 S.W. 306 (Ky. 1924).

<sup>190</sup> See *McDowell v. Bauman*, 224 S.W. 641 (Ky. 1920), which held that although it has authorized an officer to sign checks, a corporation is not estopped to deny his authority when the person receiving the check is charged with notice that it was given in payment of an obligation of a third person. See also *Montgomery Coal Corp. v. Riddle*, 276 S.W. 975 (Ky. 1925).

<sup>191</sup> See *McDowell v. Bauman*, 224 S.W. 641 (Ky. 1920), which held that a corporation which delays for nearly three years before denying the authority of an officer to sign a certain check is not guilty of laches unless the delay operates to the disadvantage of others.

<sup>192</sup> KRSA § 271A.255. This provision is identical to ABA-ALI MODEL BUS. CORP. ACT § 51 (rev. ed. 1969).

<sup>193</sup> KRS § 271.355(3).

<sup>194</sup> See *O'Neal v. F. A. Neider Co.*, 80 S.W. 451 (Ky. 1904), which held that, in the absence of a contract, the board could remove an officer at any time without cause.

<sup>195</sup> See *Harris v. Brown*, 6 F.2d 922 (W.D. Ky. 1925), holding that a court of equity cannot interfere with the board's removal of the president no matter how harmful such action may be to the corporation.

expires.<sup>196</sup> Mere appointment or election by itself will not support such an action, as there must be a valid contract in existence before contract rights are created.

## VI. INDEMNIFICATION

### A. *Indemnification of Officers, Directors, Employees, and Agents—KRSA § 271A.025*

The indemnification provision of the new act<sup>197</sup> presents several highly significant changes from the previous statute.<sup>198</sup> These provisions place Kentucky among the most liberal of all jurisdictions with regard to indemnification of officers and directors.

#### 1. *Third-Party Suits*

The new provision readily distinguishes between liability resulting from actions brought by third parties and actions by or in the right of the corporation, commonly called derivative suits. KRSA § 271A.025(1) applies only to third-party actions in "any threatened, pending, or completed action, suit or proceeding, whether civil, criminal, administrative or investigative." Accordingly, indemnification may be allowed at any stage of any type of third-party action.

The requirement of standing for persons allowed indemnification is easily satisfied. Any person may be indemnified who was or is a party to any of the above named actions,

by reason of the fact that he is or was a director, officer, employe [*sic*] or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employe [*sic*] or agent of another corporation, partnership, joint venture, trust or other enterprise. . . .

The scope of indemnification in third-party actions is the broadest possible, extending to expenses (including attorneys' fees), judgments, fines, and amounts paid in settlement actually and reasonably incurred in connection with the action. It is significant that compromise settlements are included and that no court approval is required by the statute.

Indemnification is permitted only where the person involved can satisfy the standard-of-conduct requirements of this subsection. For

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<sup>196</sup> See MODEL BUS. CORP. ACT ANN. 2D § 51 ¶ 2 (1971).

<sup>197</sup> KRSA § 271A.025. This provision is almost entirely identical to ABA-ALI MODEL BUS. CORP. ACT § 5 (rev. ed. 1969) and DEL. CODE ANN. tit. 8 § 145 (Supp. 1968).

<sup>198</sup> KRS § 271.375.



civil or administrative proceedings, the person must have "acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation." The phrase "or not opposed to" is designed to cover actions arising out of acts done other than in the capacity of officer or director, but arising by reason of status as an officer or director. Thus, proceedings under the federal securities acts for such things as violations of Rule 10b-5 or § 16(b), or under state law for usurpation of a corporate opportunity, are included within the scope of indemnification.<sup>199</sup> However, an extensive debate presently exists concerning whether indemnification for federal securities acts violations is permissible, or whether such indemnification would frustrate the public policy behind the securities laws.<sup>200</sup> At least one recent case has refused indemnification for an underwriter found liable for knowing violations of the federal securities laws,<sup>201</sup> but there may be an implication here that indemnification is permissible for mere negligent or careless securities acts violations.

Regarding criminal actions, the standard of conduct requires that the person "had no reasonable cause to believe his conduct was unlawful." The act further provides that the termination of any action by judgment, order, settlement, conviction, or upon a plea of *nolo contendere*, shall not, of itself, create a presumption that the person did not act in accordance with the standards of conduct required by this subsection. This provision is applicable to all actions whether civil, criminal, administrative, or investigative.

## 2. *Derivative Actions*

KRSA § 271A.025(2) grants the power of indemnification to the corporation for actions by and in the right of the corporation. Any threatened, pending, or completed action is included, and the same persons are covered in derivative actions who are covered in third-party actions. Indemnification in derivative suits extends only to "expenses (including attorneys' fees) actually and reasonably incurred by him in connection with the defense or settlement of such action or suit." Thus, indemnification of any amount of a judgment or

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<sup>199</sup> See MODEL BUS. CORP. ACT ANN. 2D § 5 ¶ 2 (1971).

<sup>200</sup> See generally, Bishop & Arsht, *Liabilities Which Can Be Covered Under State Statutes and Corporate By-Laws*, 27 BUS. LAW. 120, 125 (Feb. 1972); Applebaum & McDowell, *Indemnification Against Securities Acts Liabilities*, 27 BUS. LAW. 131, 134 (Feb. 1972).

<sup>201</sup> See *Globus v. Law Research Service, Inc.*, 418 F.2d 1276 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970).

compromise settlement is not permitted. This is an important change from the prior statute which permitted indemnification for such amounts in derivative suits.<sup>202</sup>

The standard of conduct required here is the same as that required in third-party civil actions, *i.e.*, conduct in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the corporation. However, there is one large exception. Indemnification is not permitted where the person has been "adjudged to be liable for negligence or misconduct in the performance of his duty to the corporation. . . ." Thus, where the expense of defending a derivative suit represents a significant amount, it would seem to be wise for the director or officer to reach a compromise settlement if there is a good chance he would be found liable for negligence or misconduct. If he is so adjudged, the court in which the suit is brought may determine that in view of all the circumstances of the case, the "person is fairly and reasonably entitled to indemnity for such expenses which such court shall deem proper." There is, of course, no assurance that the court will do this.

### 3. *Successful Defenses*

Where the director or officer is "successful on the merits or otherwise" in defense of any action referred to in subsections (1) or (2), he must be indemnified for his expenses (including attorneys' fees) actually and reasonably incurred. Indemnification under this provision, subsection (3), is "mandatory," as the corporation enjoys no discretion in deciding whether or not to indemnify the officer or director for his expenses. In contrast, subsections (1) and (2) are "permissive," as the person possesses no legal right to indemnification unless it is ordered by the court under subsection (2).<sup>203</sup>

The phrase "or otherwise" in this subsection could present some difficulty of interpretation as to what types of successful defenses, other than on the merits, are included. Logically this would include technical defenses such as the statute of limitations. However, other defenses such as unclean hands of the plaintiff,<sup>204</sup> and partial successes

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<sup>202</sup> KRS § 271.375(2). This section of the previous act has been roundly criticized. Consider Professor Hornstein's comment: "A unique law passed the Kentucky legislature: it provides for repaying to the director not only his expenses, but 'any amount paid in compromise.' Can one imagine a more warped concept of fiduciary responsibility!" Hornstein, *New Aspects of Stockholders' Derivative Suits*, 47 COLUM. L. REV. 1, 10 (1947).

<sup>203</sup> See MODEL BUS. CORP. ACT ANN. 2D § 5 ¶ 2 (1971).

<sup>204</sup> See *Diamond v. Diamond*, 120 N.E.2d 819 (N.Y. 1954).

such as dismissal of several counts of a criminal indictment but conviction on other counts,<sup>205</sup> have been held not to be included within the scope of allowable indemnification for expenses.

#### 4. *Procedure for Indemnification; Exclusivity; and Merged Corporations*

The new act allows indemnification under subsections (1) or (2) only where the director or officer has met the applicable standard of conduct set forth in those two subsections, unless indemnification is ordered by a court. The determination as to whether the person has met this standard of conduct is governed by subsection (4), which permits the determination to be made by (a) the board of directors by a majority vote of a quorum consisting of directors who were not parties to the action or (b) the shareholders. A third method of determination included in the Model Act but omitted from the Kentucky version, permits independent legal counsel to make the determination in a written opinion. Several writers have doubted the practical independence of such counsel,<sup>206</sup> and apparently the Kentucky legislature has agreed.

Of the two alternative methods available in this section, the board-of-directors method is probably the safer and easier one to follow. However, where the whole board is named in the suit, or where enough directors are parties so that a disinterested quorum is unobtainable, the shareholders will have to make the determination. For the larger corporation covered by the SEC proxy rules, this means a full disclosure to the shareholders of all facets of the proceeding. Surely this could prove embarrassing to the director or officer involved, but it may be the only course available.

Subsection (5) permits the corporation to advance the expenses, including attorneys' fees, to the person involved in any proceeding under this section, if authorized in the manner provided in subsection (4). The receipt of an undertaking to repay the corporation by the person involved, unless it is ultimately determined that he is entitled

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<sup>205</sup> See *Merritt-Chapman & Scott v. Wolfson*, 264 A.2d 358 (Del. Sup. Ct. 1970). Note that decisions of the Delaware courts on indemnification may have considerable application to the new Kentucky provision as the two statutes are practically identical.

<sup>206</sup> See e.g., Bishop, *Sitting Ducks and Decoy Ducks; New Trends in Indemnification of Corporate Directors and Officers*, 77 *YALE L.J.* 1078 (1968). For a more favorable view of indemnification statutes generally, see Sebring, *Recent Legislative Changes in the Law of Indemnification of Directors, Officers and Others*, 23 *BUS. LAW.* 95 (1967).

to indemnification, is a condition precedent to the advancement of expenses.

Indemnification under this section is expressly made not exclusive of any other rights of indemnification to which the person may be entitled "under any by-law, agreement, vote of shareholders or disinterested directors or otherwise. . . ." The actual effect of the non-exclusivity clause of subsection (6) is not exactly clear,<sup>207</sup> although it has been suggested that it would be proper to insert a provision into the by-laws making mandatory any permissive indemnification allowed.<sup>208</sup> Subsection (8) insures that indemnification will extend to directors and officers of merged corporations by defining "the corporation" to include all constituent corporations absorbed in a consolidation or merger.

### 5. *Liability Insurance*

In a somewhat controversial provision, subsection (7) of the new act allows a corporation to purchase and maintain insurance on behalf of covered persons ". . . against any liability asserted against him and incurred by him in any such capacity or arising out of his status as such. . . ." As previously noted, the "arising out of his status" phrase is directly aimed at Rule 10b-5 or § 16(b) violations, thus raising serious policy considerations concerning indemnification for securities acts violations. Additionally, insurance coverage is permitted ". . . whether or not the corporation would have the power to indemnify him against such liability under the provisions of this section." The previous practice of the corporation's sharing the cost of the insurance with the person covered is no longer necessary, as the corporation may now pay the full cost of such insurance.<sup>209</sup>

*C. Kent Hatfield*

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<sup>207</sup> See Bishop, *supra* note 206, at 1085 for the following excerpts: Nobody knew what the clause meant in the old statutes, and if anyone knows what it means in the new ones, he has not published the information. . . . If the few cases in which the issue has been presented are any guide, the courts will not be overly eager to find in the non-exclusive clause authority for the indemnification of executives who have breached their duty to the corporation.

<sup>208</sup> See Klink, *Liabilities Which Can Be Covered Under State Statutes and Corporate By-Laws*, 27 BUS. LAW. 109, 115 (1972).

<sup>209</sup> For articles dealing with liability insurance policies and indemnification insurance generally, see Hinsey, DeLancey, Stahl, & Kramer, *What Existing D & O Policies Cover*, 27 BUS. LAW. 147 (Feb. 1972); Hinsey and DeLancey, *Directors and Officers Liability Insurance—An Approach to Its Evaluation and a Checklist*, 23 BUS. LAW. 869 (1968); Note, *Liability Insurance for Corporate Executives*, 80 HARV. L. REV. 648 (1967); Bishop, *New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability*, 22 BUS. LAW. 92 (1966).