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CHANGES IN THE TREATMENT OF THE CLOSE CORPORATION UNDER THE NEW KENTUCKY BUSINESS CORPORATION ACT¹

A close corporation may be defined as one whose voting shares are held by a single shareholder or a closely-knit group of shareholders. It is usually small, though not always, and generally has no public investors. The shareholders it does have are often quite active in the management of the enterprise.² Historically the close corporation has been largely ignored by the lawmakers; its particular needs have been made subservient to those of the large, public-issue corporations. If a small group wished to form a corporation in order to take advantage of the limited liability concept or preferential tax treatment, such a group had to conform to the formalities required of large corporations. The expense and inconvenience which often resulted probably dissuaded many from donning the corporate veil.

In recent years, however, the courts and legislatures have begun to recognize the peculiar problems of the close corporation. With the adoption of the Model Business Corporation Act, Kentucky has taken a major step toward easing those problems. Throughout this discussion of changes in the Kentucky law on close corporations, one large revision in particular must be kept in mind: the first sentence of Kentucky Revised Statutes Annotated [hereinafter KRSA] § 271A.175 states, "The business and affairs of a corporation shall be managed by a board of directors *except as may be otherwise provided in the articles of incorporation*" (emphasis added). Though probably too cumbersome to be useful in a large public-issue corporation, this section permits the creators of a close corporation to split up all the functions traditionally exercised by the board of directors among the shareholders and directors and even outsiders. Aside from the new provisions on shareholder agreements, voting trusts, and the like,

¹ Constant references will be made in the footnotes to the provisions of both the old (Ky. Rev. Stat. ch. 271 (1971) [hereinafter cited as KRS]) and the new corporation law (Ky. Rev. Stat. Ann. ch. 271A. (Supp. 1972) [hereinafter cited as KRSA]) and to the ABA-ALI MODEL BUSINESS CORPORATION ACT (rev. ed. 1969). Where the Model Act provision is the same as, or similar to, the new Kentucky provision, it will be included with each reference to the new act, without explanation. Model Act references will be made to MODEL BUS. CORP. ACT ANN. 2D (1971) for easy access to the drafters' comments and the cases included therein.

² H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 257 (2d ed. 1970) [hereinafter cited as H. HENN, LAW OF CORPORATIONS].

this provision allows the members of the close corporation to structure the enterprise in almost any manner they wish. Individual members no longer need to make sure they have on their shareholder hat, or their director hat, before they act; a provision in the articles may now do away with the hats altogether.

For purposes of this discussion, the various provisions regulating close corporations have been divided into three parts: (1) those which are ancillary to the actual creation and continued existence of the corporation; (2) those which may be, but are not necessarily, integral to the creation and continued existence of the corporation; and (3) those which are fundamental to the creation and continued existence of the corporation. Both the old and new acts will be discussed and the strong and weak points of each will be analyzed.³ Hopefully, the superiority of Kentucky's new Business Corporation Act, particularly in regard to close corporations, will be apparent at the conclusion.

I. ANCILLARY DEVICES

A. *Voting Trusts*

A voting trust is created by an agreement among the shareholders of a corporation and a trustee, or by several identical agreements between individual shareholders and a common trustee, providing that, for a designated period of time, control over the stock owned by the shareholders shall be lodged in the trustee, either with or

³ The problems of the one-man corporation will not be treated in the text because the old and new acts are much the same. A one-man corporation may be defined as a corporation with a single shareholder or a single major shareholder and others who have nominal holdings in order to qualify as incorporators or directors. H. HENN, *LAW OF CORPORATIONS* § 258. The adoption of the Model Act had little effect on Kentucky's existing law concerning one-man corporations. Kentucky previously allowed one individual to form a corporation (KRS § 271.025; KRSA § 271A.265; MODEL BUS. CORP. ACT ANN. 2D § 53 (1971)); acknowledge the articles of incorporation (KRS § 271.035; KRSA § 271A.265; MODEL BUS. CORP. ACT ANN. 2D § 53 (1971)), and constitute the board of directors (KRS § 271.345(1); KRSA § 271A.180; MODEL BUS. CORP. ACT ANN. 2D § 36 (1971)). However, in the area of directors serving as officers, an important consideration for one who wishes to form a one-man close corporation, several changes have been made. The old statute declared that no officer need be a director and that any two of the offices of vice-president, secretary, and treasurer could be combined in one person. KRS § 271.355(1). Under that section, a corporation with a president, vice-president, secretary and treasurer would need three persons to fill those offices. The new act specifically provides that directors may be officers or employees (KRSA § 271A.101(15); MODEL BUS. CORP. ACT ANN. 2D § 20 (1971)), and that any two or more offices may be held by the same person in the one-man corporation (KRSA § 271A.025). The Kentucky provision in this respect seems to go even further than the Model Act, which states that "[a]ny two or more offices may be held by the same person except the offices of president and secretary." MODEL BUS. CORP. ACT ANN. 2D § 50 (1971).

without a reservation to the owners or some other person of the power to direct how the voting control shall be used. The essential feature of the voting trust is "the delegation of group voting power for the purpose of controlling corporate management."⁴ Kentucky has had a voting trust statute for many years.⁵ With the adoption of the new act, however, a number of substantive and procedural changes have been made. The old statute made voting trust certificates transferable with the same effect as certificates of stock;⁶ the new act does not. Also, the old act limited the liability of the trustee to actions for negligence or malfeasance;⁷ no such limitations are found in the new act. And finally, the new act is not limited to domestic corporations or to *two* or more shareholders.⁸ Any number of shareholders of any corporation, foreign or domestic, may now create a valid voting trust in Kentucky.⁹ The instrument creating the trust must be in writing, and a copy must be filed at the corporation's registered office;¹⁰ the trust may endure ten years only.¹¹ Additionally, under the new act the trustee must keep a record of the holders of voting trust certificates and a copy of that record must be filed at the registered office. Both the agreement and the record of trust certificate holders are to be open for inspection by shareholders *and* holders of voting trust certificates. The last difference between the old and new acts appears to be one of form rather than substance. The old act specifically declared that share certificates subject to voting trusts had to be surrendered and cancelled, with new certificates issued to the trustee;¹² the new act merely requires that the shareholder transfer his shares to the trustee.¹³ In spite of the lack of specific directions in the new act, however, it is obvious that the drafters of the Model Act contemplated some type of re-issue of certificates by the corporation to the voting trustee.¹⁴ Otherwise, it might prove quite difficult for the trustee to vote the stock in his keeping.

⁴ 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1705 (1917).

⁵ KRS § 271.325.

⁶ KRS § 271.325(5).

⁷ KRS § 271.325(7)(d).

⁸ KRS § 271.325(1).

⁹ KRSA § 271A.170(1); MODEL BUS. CORP. ACT ANN. 2D § 34 ¶ 1 (1971).

¹⁰ The old act called for a "duplicate original," while the new act requires only a "counterpart" of the agreement.

¹¹ The duration of voting trusts, limited by statute and the articles of incorporation, may not be extended by the court. *In re Elless*, 174 F.2d 925 (6th Cir. 1949).

¹² KRS § 271.325(4).

¹³ KRSA § 271A.170(1).

¹⁴ See MODEL BUS. CORP. ACT ANN. 2D § 34 ¶ 2 (1971) and H. HENN, LAW OF CORPORATIONS § 197.

Other sections of the new act affect voting trusts. Shares standing in the name of the trustee may be voted by him, in person or by proxy, but only if the shares are actually transferred to him. However, if the trustee is an administrator, guardian, executor, or committee, he may vote the shares without the transfer.¹⁵ The old act allowed "fiduciaries" to vote shares after transfer, but included nothing authorizing voting privileges before transfer.¹⁶ One provision found in the old act and preserved in the new, though not a part of the Model Business Corporation Act, relates to shares held jointly by three or more fiduciaries. Under that provision, the majority of the fiduciaries shall control the voting of the shares unless the instrument or order appointing the fiduciaries indicates otherwise. If the fiduciaries are equally divided, either a beneficiary or a fiduciary may petition the court to appoint an additional person to break the deadlock.¹⁷

Several provisions conferring rights on holders of voting trust certificates are found in the new act. Holders of these certificates may now bring derivative actions,¹⁸ inspect the books and records, making extracts therefrom,¹⁹ and receive financial statements upon request.²⁰ Combined with the looser restrictions of the voting trust provision itself, these sections make the use of the voting trust more attractive to shareholders and more adaptable to the situations it may be required to cover.²¹

¹⁵ KRSA § 271A.165(6). The Model Act section omits "conservators" from the list. MODEL BUS. CORP. ACT ANN. 2D § 33 (1971).

¹⁶ KRS § 271.315(4).

¹⁷ KRSA § 271A.165(7) is substantially the same as KRS § 271.315(4).

¹⁸ KRSA § 271A.245; MODEL BUS. CORP. ACT ANN. 2D § 49 (1971). The old Kentucky provision on derivative or "secondary" actions, KRS § 271.605, was limited to shareholders.

¹⁹ KRSA § 271A.260(2) and (3). The Kentucky act in this regard differs from the Model Business Corporation Act. KRSA § 271A.260(3) requires that the person desiring to inspect the books, be he a shareholder of record or a holder of a voting trust certificate, furnish the corporation an affidavit that, in effect, states that he does not want the information for improper purposes. The Model Act does not include this affidavit requirement. MODEL BUS. CORP. ACT ANN. 2D § 52 (1971). Both acts, however, state that if the person desiring the inspection has used corporate records for wrongful purposes in the past, such use constitutes a defense in avoiding the penalties provided for refusing to allow the inspection. The old Kentucky act, KRS § 271.396(4), limited the right of inspection to shareholders, had no affidavit requirement, and mentioned no penalties or defenses for refusing to allow inspection.

²⁰ KRSA § 271A.260(5); MODEL BUS. CORP. ACT ANN. 2D § 52 (1971).

²¹ Voting trusts are still not always upheld. See, e.g., *Grogan v. Grogan*, 322 S.W.2d 514 (Tex. 1959), where a Texas court declared void a voting trust the purposes of which were to insure the election of directors who would retain the general manager and establish the general manager's nephew as his successor. Only by declaring a trust void or by appointing a new trustee can the voting power of a voting trust be terminated. *Le Roy Sargent & Co. v. McHarg*, 174 N.W. 742 (S.D. 1919).

B. Shareholder Agreements

In many jurisdictions, shareholders have long been able to make agreements among themselves concerning the affairs of the corporation without having to meet the formal requirements of the voting trust. These shareholder, or pooling, agreements generally consist of an advance decision by a group of shareholders to exercise their voting rights in a certain manner; as long as the rights of minority shareholders are not ignored or the directors unduly deprived of their discretion in the management of the corporation, such agreements are usually valid and enforceable.²² In Kentucky, however, shareholder agreements have been looked upon with disfavor. The old act neither allowed nor disallowed such agreements, but in *Haldeman v. Haldeman*,²³ the Court of Appeals held that an agreement among three shareholders providing for the election and maintenance of two of them as officers of the corporation was invalid as contrary to public policy. The Court ruled that public policy prohibited the enforcement of an agreement by which a shareholder attempts to bargain away his right to vote according to his best judgment and in the best interests of the corporation.²⁴ Since *Haldeman*, there has been little evidence of use of shareholder agreements in Kentucky.²⁵

With the passage of the new act, Kentucky has joined the jurisdictions that *specifically* allow shareholder agreements. The act states simply and without equivocation that agreements among shareholders shall be valid and enforceable and not subject to the provisions of the act relating to voting trusts.²⁶ Corporate practitioners and shareholders of Kentucky corporations are now free to create agreements among themselves that affect their corporations, secure in the knowledge that such agreements will not be found invalid *per se* by the courts. There are limits, however; the courts may still strike particular agree-

²² H. HENN, LAW OF CORPORATIONS § 198.

²³ 197 S.W. 376 (Ky. 1917).

²⁴ *Id.* at 382.

²⁵ There is authority in Kentucky for the use of shareholder agreements, however. In *Gilchrist v. Collopy*, 82 S.W. 1018 (Ky. 1904), the Court found valid an agreement between two cities, which were the sole shareholders in a corporation whose articles provided that five directors were to constitute the board, to the effect that in alternate years one city would elect three directors and the other two. The Court stated that it was "so absolutely practical and so eminently fair" that it had to be upheld.

²⁶ KRSA § 271A.170(2). This section is substantially the same as the Model Act section, though it appears to be even more encompassing. MODEL BUS. CORP. ACT ANN. 2D § 34 ¶ 2 (1971). The last sentence of the Model Act section reads: "Such agreements shall not be subject to the provisions of *this section* regarding voting trusts" (emphasis added). The Kentucky act omits the emphasized words, and since other sections of both the Kentucky act and the Model Act affect voting trusts, it can be argued that Kentucky's law is clearer and less subject to possible entanglement with voting trusts than the Model Act provision.

ments for sufficient cause. A brief look at the treatment accorded various types of shareholder agreements in other jurisdictions may serve to outline the boundaries within which such agreements may be created.

A common purpose of shareholder agreements is to elect specific persons as directors or officers. This type of agreement has been held valid and not violative of public policy in a number of jurisdictions.²⁷ Also, an agreement between the sole shareholders of a corporation that they would act jointly in all matters and follow a single course of action in accordance with whatever decision they reached, has been held valid.²⁸ In one case, an agreement that all policies, management, and operation of the corporation would be by the unanimous consent of the board of directors was allowed.²⁹ This particular agreement involved the corporation's sole shareholders who also made up the board of directors. In *Katcher v. Ohsman*,³⁰ an agreement was upheld under which two of the three shareholders of a corporation (the two owned less than ninety per cent of the stock) promised the third that all affirmative actions would require at least ninety per cent of the vote, for both shareholder and director action. Other agreements that have been valid include one which provided that the shareholders of each faction in the corporation approve the salaries of the other faction and vote their stock in such a way that the two factions would have equal board representation;³¹ another that required one shareholder to vote for dissolution on the promise of another to pay him the amount, if any, by which the sum obtained for the sale of the corporation's assets was less than his investment;³² and a third that bound the corporation to purchase the stock of any shareholder upon his death.³³

Generally, agreements that deprive directors of their statutory authority are not valid.³⁴ In *Burnett v. Word, Inc.*, for instance, a

²⁷ *In re Evening Journal Ass'n*, 71 A.2d 158 (N.J. 1950); *In re Roosevelt Leather Hand Bag Co.*, 68 N.Y.S.2d 735 (Sup. Ct. 1947); *Hayden v. Beane*, 199 N.E. 755 (Mass. 1936); *Harris v. Magrill*, 131 Misc. 380, 226 N.Y.S. 621 (Sup. Ct. 1928); *Fitzgerald v. Christy*, 242 Ill. App. 343 (1926); *Horn v. J. O. Nesses Lumber Co.*, 236 Ill. App. 187 (1925); *Thompson v. J. D. Thompson Carnation Co.*, 116 N.E. 648 (Ill. 1917); *Weber v. Della Mt. Mining Co.*, 94 P. 441 (Idaho 1908).

²⁸ *Ringling Brothers-Barnum & Bailey Combined Shows, Inc. v. Ringling*, 53 A.2d 441 (Del. 1947).

²⁹ *Bator v. United Sausage Co.*, 81 A.2d 442 (Conn. 1951).

³⁰ 97 A.2d 180 (N.J. 1953).

³¹ *Caller v. Galler*, 238 N.E.2d 274 (Ill. 1968).

³² *Wolf v. Arant*, 77 S.E.2d 116 (Ga. 1953).

³³ *Brigham v. M & J Corp.*, 227 N.E.2d 915 (Mass. 1967).

³⁴ *Ford v. Magee*, 160 F.2d 457 (2d Cir. 1947), *cert. denied*, 332 U.S. 759 (1947); *Manson v. Curtis*, 223 N.Y. 313, 119 N.E. 559 (1918); *McQuade v. Stoneham*, 263 N.Y. 323, 189 N.E. 234 (1934); *Williams v. Fredericks*, 175 So. 642 (La. 1937); *Teich v. Kaufman*, 174 Ill. App. 306 (1912); *Harris v. Scott*, 32 A. 770 (N.H. 1893).

shareholder agreement to retain certain directors for a ten-year period and to incur no indebtedness above a certain amount was allowed, while a directors' agreement to the same effect was not, since it limited the directors' discretion.³⁵ On the other hand, in *Clark v. Dodge*³⁶ the court upheld an agreement between two shareholders, who were also directors, which provided that one of them would disclose a formula vital to the enterprise to the son of the second shareholder; in return, the other shareholder would vote, as a director, to keep the first shareholder on as general manager. The court stated that the *shareholder aspects* of the agreement were perfectly valid and legal and then allowed the *director aspects* to stand on the ground that to do so would harm no one.³⁷ Such a broad rationale might certainly be useful to shareholders in a close corporation seeking to limit the discretion of the board.

In addition to those which seek to limit the directors' powers, other types of agreements have been found invalid. A shareholder agreement that had no time limit and no provision that it was applicable to successor shareholders was held void in a recent Florida decision.³⁸ And Massachusetts has held in a number of cases that agreements not joined in by *all* the shareholders are invalid.³⁹ Also, a few jurisdictions have found agreements involving the promise of officer positions to be against public policy.⁴⁰

The fact that a court finds a particular agreement to be valid does not necessarily mean that that agreement will be enforced. In some cases the courts have denied enforcement for some reason other than the invalidity of the agreement. An agreement which included the provision that one of the members was to be president of the corporation was held valid, but the court denied enforcement.⁴¹ The court

³⁵ 412 S.W.2d 792 (Tex. 1967).

³⁶ 269 N.Y. 410, 199 N.E. 641 (1936).

³⁷ See also *Slonim v. Brodie*, 109 N.Y.S.2d 440 (Sup. Ct. 1951); *In re Kirschner*, 81 N.Y.S.2d 435 (Sup. Ct. 1948); *In re Buckley*, 183 Misc. 189, 50 N.Y.S.2d 54 (1944).

³⁸ *Berkowitz v. Firestone*, 192 So.2d 298 (Fla. 1966).

³⁹ *Odman v. Oleson*, 64 N.E.2d 439 (Mass. 1946); *Hellier v. Achorn*, 151 N.E. 305 (Mass. 1926); *Palmbaum v. Magulsky*, 104 N.E. 746 (Mass. 1914); *Woodruff v. Wentworth*, 133 Mass. 309 (1882); *Guernsey v. Cook*, 120 Mass. 501 (1876).

⁴⁰ An agreement by which another person was to control the shareholder's stock in consideration of that person's promise to obtain for the shareholder an office in the corporation was held illegal and void as against public policy. *Gage v. Fisher*, 65 N.W. 809 (N.D. 1895). An agreement under which shareholders were to vote their stock together at a directors election and were to retain their offices in the corporation was held invalid as against public policy only with respect to the part involving the offices. *Withers v. Edmonds*, 62 S.W. 795 (Tex. 1901).

⁴¹ *Fells v. Katz*, 256 N.Y. 67, 175 N.E. 516 (1931). See similar holdings in *Tremsky v. Green*, 106 N.Y.S.2d 572 (Sup. Ct. 1951); *Blum v. Oxman*, 190 Misc.

(Continued on next page)

stated that the provision was merely an obligation to keep the individuals as president only as long as he remained loyal to the corporation's interests. Since he had entered into a competing business, the other parties to the agreement were justified in refusing to retain him as president.⁴²

When relief is granted for the breach of a shareholder agreement it comes in several different forms. Some courts actually grant specific performance,⁴³ while others have merely enjoined the parties from acting in violation of the agreement.⁴⁴ In *Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling*⁴⁵ the court declared that the votes of the breaching party had no effect. And in *E. K. Buck Retail Stores v. Herkert*,⁴⁶ the court allowed damages for violation of a shareholder agreement.

The shareholder agreement is clearly a useful tool for controlling the operation of a close corporation. Whether or not the shareholders have carte blanche, though, remains to be seen. The simple pooling agreement, involving shareholders only, should present no problem under the new provision—such an agreement is clearly valid and enforceable. However, problems may arise with shareholder agreements that attempt to tie the hands of the board of directors. It is obvious that the drafters of the Model Act felt that the provisions of this voting agreement section covered *all* corporate transactions “without limit,” whether they affected shareholders or directors or both.⁴⁷ The Court of Appeals of Kentucky, however, has the final say. Consequently, shareholders contemplating the creation of a shareholder agreement would do well to keep in mind the various valid and invalid aspects of such agreements, as construed by courts of other jurisdictions discussed heretofore.

C. Restriction on Stock Transfers

In order to preserve the family or small-group form of the close corporation, the participants have resorted to the practice of placing

(Footnote continued from preceding page)

647, 75 N.Y.S.2d 177 (1947); *In re* Roosevelt Leather Hand Bag Co., 68 N.Y.S.2d 735 (Sup. Ct. 1947).

⁴² *Fells v. Katz*, 175 N.E. 516, 517 (N.Y. 1931).

⁴³ *Brigham v. M & J Corp.*, 227 N.E.2d 915 (Mass. 1967); *Katcher v. Ohsman*, 97 A.2d 180 (N.J. 1953); *Martocci v. Martocci*, 2 Misc.2d 330, 42 N.Y.S.2d 222 (1943); *Clark v. Dodge*, 269 N.Y. 410, 199 N.E. 641 (1936).

⁴⁴ *Kronenberg v. Sullivan County Steam Laundry Co.*, 91 N.Y.S.2d 144 (Sup. Ct. 1949); *Trefethen v. Amazeen*, 36 A.2d 266 (N.H. 1944); *Harris v. Magrill*, 131 Misc. 380, 226 N.Y.S. 621 (Sup. Ct. 1928); *Fitzgerald v. Christy*, 242 Ill. App. 343 (1926).

⁴⁵ 53 A.2d 441 (Del. 1947).

⁴⁶ 62 N.W.2d 288 (Neb. 1954).

⁴⁷ See MODEL BUS. CORP. ACT ANN. 2D § 35 ¶ 2 (1971).

restrictions on the transfer of the corporation's stock when it is issued. These restrictions have occasionally clashed with the principle that shares of stock are personal property and should be freely transferrable. Even then, however, most authorities have recognized that some restrictions are necessary. Fletcher, for instance, after referring to shares of stock as personal property says:

[I]t is well-settled that the owner, as in the case of other personal property, has an absolute and inherent right, as an incident of his ownership, to sell and transfer the same at will, except insofar as the right may be restricted by the charter of the corporation or the general law, or by a valid by-law, or by a valid agreement between him and the corporation, provided the transfer is in good faith, and to a person capable of assuming the obligations of a shareholder.⁴⁸

The most common transfer restriction is that which requires that any shareholder who wishes to sell his stock must first offer it to the corporation's other shareholders. The use of this particular type of restriction was sanctioned by the Kentucky Court of Appeals in *Taylor's Adm'r v. Taylor*.⁴⁹ Kentucky has also recognized the right of the shareholders in a close corporation to prearrange a particular purchase price for stock subject to a first-option restriction.⁵⁰ Despite this judicial recognition, the strict construction placed on these types of agreements has minimized their usefulness.⁵¹

The old law provided generally for transfer restrictions, either through the articles of incorporation or the by-laws.⁵² The new act is much more specific. It declares that the articles may contain "any provision, not inconsistent with the law, which the incorporators elect to set forth in the articles of incorporation for the regulation of the

⁴⁸ 6 W. FLETCHER, PRIVATE CORPORATIONS 3758 (1919).

⁴⁹ 301 S.W.2d 579 (Ky. 1957).

⁵⁰ *Krebs v. McDonald's Ex'r*, 266 S.W.2d (Ky. 1953). See also *Brigham v. M & J Corp.*, 227 N.E.2d 915 (Mass. 1967), wherein the court specifically enforced a shareholder agreement under which the corporation bound itself upon the death of any of its shareholders to purchase his stock at an agreed price, payable in ten equal annual installments to the deceased's estate. The court held that the administrator of the estate could not vote the stock, sell it elsewhere, or deal with it in any manner contrary to the agreement. And, in *Bailey v. Smith*, 107 So.2d 868 (Ala. 1959), the court allowed an agreement among the shareholders which required the estate of the first to die to sell enough shares to the survivor, at twice the book value, to give him voting control.

⁵¹ See *Ham, The Close Corporation Under Kentucky Law*, 50 Kx. L.J. 164-69 (1961).

⁵² KRS § 271.035(2); KRS § 271.225. Another statute that refers specifically to transfer restrictions is found, not in the chapter on corporations, but rather in the one regulating commerce and trade. When Kentucky adopted the Uniform Commercial Code, it contained a provision requiring that restrictions be noted conspicuously on the security in order to be effective. KRS § 355.8-204.

internal affairs of the corporation, including any provision restricting the transfer of shares" (emphasis added).⁵³ Thus, the reasonable use of transfer restrictions is another device by which Kentucky close corporations may preserve themselves.

II. DISCRETIONARY PROVISIONS

A. *Classification of Stock*

Restrictions other than those placed on the transfer of shares may be used to shape the corporation in the manner desired by its creators. The stock may be divided into two or more classes, with each class voting as a separate unit for various purposes, or perhaps not voting at all.⁵⁴ References to classification of stock are made throughout the new Kentucky Business Corporation Act, so all of them will not be mentioned here. This discussion will be limited to a treatment of the provisions specifically regulating the use of stock classification.

Under the new act corporations may create and issue the number of shares provided for in the articles. Such shares may be divided into as many classes as desired, carrying whatever rights and limitations are set forth in the articles.⁵⁵ The new act further provides that preferred or special classes may be divided into "series."⁵⁶ The rights and preferences of each series within a class, however, must be identical except with respect to dividend rates, redemption of shares, value of shares upon liquidation, sinking fund provisions, conversion of shares, and voting rights. The articles themselves may specifically provide for the issuance of stock in series or they may give the board of directors the authority to do so.⁵⁷ A full statement of the various rights and limitations, or a notation that such a statement will be furnished by the corporation upon request, must be exhibited on each certificate so issued.⁵⁸

⁵³ KRSA § 271A.270(1)(h); MODEL BUS. CORP. ACT ANN. 2D § 54(h) (1971). The language used in this statute might give rise to the question of whether the articles can be amended to include transfer restrictions. It states rather plainly that any provision which *the incorporators* elect to set forth in the articles is valid. However, the amendment provision of the new act appears to include transfer restrictions among the items subject to amendment. KRSA § 271A.135(1).

⁵⁴ H. HENN, LAW OF CORPORATIONS § 189.

⁵⁵ KRSA § 271A.075(1); MODEL BUS. CORP. ACT ANN. 2D § 15 (1971).

⁵⁶ KRSA § 271A.080; MODEL BUS. CORP. ACT ANN. 2D § 16 (1971). The provisions for classes and series under the old act are comparable to the new sections. KRS § 271.155.

⁵⁷ KRSA § 271A.080(2); MODEL BUS. CORP. ACT ANN. 2D § 16 (1971). Several additional filing requirements are necessary if the board creates a series.

⁵⁸ KRSA § 271A.115(2); MODEL BUS. CORP. ACT ANN. 2D § 23 (1971). The new act is similar in this regard to the former provision. KRS § 271.265(2)(d).

Any feature of class or series shares may be altered by amending the articles, which ordinarily may be accomplished by the vote of a majority of the shareholders.⁵⁹ At first glance, the provision appears to put the stock of a minority class in jeopardy; a closer look, however, reveals that where minority rights are involved, that particular minority is entitled to vote as a class on the amendment. A majority of the class affected plus a majority of all the other eligible shareholders is thus necessary for passage of the amendment.⁶⁰ In this respect the old and new acts are quite similar. Under the old act, though, the prerequisites for a class vote were not detailed: if the amendment would "alter or change the preferences, special rights, or powers" of a class "so as to affect the same adversely," or would increase the number or decrease the value of the shares of a class, then a class vote was required.⁶¹ The new act is much more explicit; it includes ten subsections describing particular situations that require a class vote.⁶² The effect of both the old and new provisions, of course, is to give a class of shareholders the power to veto disadvantageous amendments. The new provisions should prove more useful, however, because of the particularity with which the situations covered are enumerated.⁶³

Classification of stock may be used to create a number of different rights and limitations among shareholders of the same corporation.⁶⁴ Perhaps the most common classification of stock is that between preferred and common shares. But probably the most significant type of classification expressly authorized by the new act is that allowing non-

⁵⁹ KRSA § 271A.290; MODEL BUS. CORP. ACT ANN. 2D § 58 (1971); KRSA § 271A.295; MODEL BUS. CORP. ACT ANN. 2D § 59 (1971).

⁶⁰ KRSA § 271A.300; MODEL BUS. CORP. ACT ANN. 2D § 60 (1971); KRSA § 271A.295(1)(c); MODEL BUS. CORP. ACT ANN. 2D § 59 (1971).

⁶¹ KRS § 271.445(3).

⁶² KRSA § 271A.300; MODEL BUS. CORP. ACT ANN. 2D § 60 (1971).

⁶³ Other provisions in the new act which affect the use of classes or series are KRSA § 271A.130; MODEL BUS. CORP. ACT ANN. 2D § 26 (1971) (pre-emptive rights of class shareholders to acquire treasury shares); KRSA § 271A.270; MODEL BUS. CORP. ACT ANN. 2D § 54 (1971) (provisions in the articles); KRSA § 271A.325; MODEL BUS. CORP. ACT ANN. 2D § 65 (1971) (amendments under a plan of reorganization); KRSA § 271A.365(2); MODEL BUS. CORP. ACT ANN. 2D § 73 ¶ 2 (1971) (merger or consolidation vote); KRSA § 271A.395(3); MODEL BUS. CORP. ACT ANN. 2D § 79(c) (1971) (vote on transfer of corporate assets); and KRSA § 271A.420(3); MODEL BUS. CORP. ACT ANN. 2D § 84(c) (1971) (vote on voluntary dissolution).

⁶⁴ See generally *Hatch v. Newark Tel. Co.*, 170 N.E. 371 (Ohio 1930), *Ellington v. Raleigh Bldg. Supply Co.*, 147 S.E. 307 (N.C. 1929), and *Boyd v. Boone Nat'l Bank*, 218 N.W. 321 (Iowa 1928) (provisions giving liens on the corporate assets to the preferred shareholders); *Bunker Hill Country Club v. McElhatton*, 282 Ill. App. 221 (1935), *Murphy v. Richardson Dry Goods Co.*, 31 S.W.2d 72 (Mo. 1930), and *Gipson v. Bedard*, 217 N.W. 139 (Minn. 1927) (provisions giving preference to common stock); *Ammon v. Cushman Motor Works*, 258 N.W. 649 (Neb. 1935), *Cring v. Sheller Wood Rim Mfg. Co.*, 183 N.E. 674 (Ind. 1932), and *Koeppler v. Cocker Chair Co.*, 228 N.W. 130 (Wisc. 1930) (provisions for redemption of preferred stock during the life of the corporation).

voting stock.⁶⁵ Illinois, which has a constitutional provision on cumulative voting somewhat similar to Kentucky's, has held the use of non-voting stock unconstitutional on the ground that it violates the intent of that provision.⁶⁶ The Court of Appeals of Kentucky has upheld the use of non-voting stock in at least one instance,⁶⁷ although the constitutional argument was not made in that case. The Court stated that it was within the power of a corporation to provide in the articles or stock certificates that preferred shareholders have no vote "in the absence of constitutional or statutory provisions."⁶⁸ Even if the plaintiff had based his attack on Section 207 of the Constitution of the Commonwealth of Kentucky, which requires that cumulative voting be used in the election of directors, the result would likely have been the same. That section declares that "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" (emphasis added). If the articles provide that certain shareholders are *not* entitled to vote *at all*, the Kentucky Constitution, unlike that of Illinois, appears to be no bar to such provisions.

Stock classification is probably the most precise method by which the members of a close corporation can structure their enterprise. The new Kentucky Business Corporation Act seems to authorize broad implementation of this method.⁶⁹

B. *Informal Action*

One of the most inconvenient principles of law with which a close corporation must cope is that which prohibits the board of directors from binding the corporation unless they have acted as a body. The "board action" rule is derived from the requirement that the business of a corporation shall be managed by a board of directors.⁷⁰ With respect to the close corporation, the rule has effectively prevented one director of a three-man corporation, for instance, from acting without calling a meeting and getting the formal consent of the other director-members of the corporation. Kentucky corporations have operated under the board action rule since 1910, when it was adopted by the

⁶⁵ KRSA § 271A.075; MODEL BUS. CORP. ACT ANN. 2D § 15 (1971).

⁶⁶ See *People ex rel. Watseka Tel. Co. v. Emmerson*, 134 N.E. 707 (Ill. 1922).
But see Miller v. Ratterman, 24 N.E. 496 (Ohio 1889).

⁶⁷ *Williams v. Davis*, 180 S.W.2d 874 (Ky. 1944).

⁶⁸ *Id.* at 876.

⁶⁹ Stock classification may not always be desirable from a tax standpoint, however. For a discussion of the Subchapter S treatment of stock classes, see Ham, *supra* note 51, at 143 n. 70.

⁷⁰ See, e.g., KRS § 271.345(1).

Court of Appeals in *Star Mills v. Bailey*,⁷¹ and most recently reaffirmed in *Clay v. Mt. Holly Development Co.*⁷² Although the Court from time to time has relaxed its application of the rule,⁷³ by far the more satisfactory course as far as the close corporation is concerned would be to disregard the rule entirely. The legislature attempted to do so in 1966, when it amended the old act to allow informal board action if the written consent of all the directors (or members of a committee, if applicable) was obtained.⁷⁴ One problem remained, however—such informal action was valid only if the consent was obtained *prior* to taking action. In practice, the amendment was of little help to the close corporation, since a director who wanted to act for the corporation still had to contact the others and obtain their written consent *before* he could do so. The new act is similar to the old provision except that it includes no stipulation as to when the consent of the directors must be obtained,⁷⁵ thus removing the last obstacle to informal board action.

Kentucky has allowed informal action by shareholders for some time,⁷⁶ and the new act contains substantially the same provisions as the old one.⁷⁷ It is important to note that, unlike the provision for informal action by the board of directors, the effect of this section cannot be abrogated by the articles of incorporation or by the by-laws.⁷⁸ The board *can* eliminate its own power to act informally, but cannot bind the shareholders to act according to formal requirements by passing a by-law to that effect.

Along with other provisions in the new act, these sections relaxing the traditional restrictions on corporate action are clearly tailored for the close corporation. If properly utilized, they can help make the day-to-day management of a small business much less complex than in the past.

⁷¹ 130 S.W. 1077 (Ky. 1910). See also *Bastin v. Givens' Adm'x*, 185 S.W. 835 (Ky. 1916); *Paducah & Illinois Ferry Co. v. Robertson*, 171 S.W. 171 (Ky. 1914); *Chilton v. Bell County Coke & Improvement Co.*, 156 S.W. 889 (Ky. 1913). The Court of Appeals *has* allowed the board to delegate its powers to an executive committee whose acts may be made binding on the corporation. *Haldeman v. Haldeman*, 197 S.W. 376 (Ky. 1917).

⁷² 464 S.W.2d 621 (Ky. 1971).

⁷³ See, e.g., *Slater v. Bright*, 248 S.W.2d 915 (Ky. 1952); *Kozy Theatre Co. v. Love*, 231 S.W. 249 (Ky. 1921).

⁷⁴ KRS § 271.345(4)(e).

⁷⁵ KRSA § 271A.220; MODEL BUS. CORP. ACT ANN. 2D § 44 ¶ 1 (1971).

⁷⁶ KRS § 271.405.

⁷⁷ KRSA § 271A.665; MODEL BUS. CORP. ACT ANN. 2D § 145 ¶ 2 (1971). The new act, unlike the old, puts no limitations on the types of actions that may be taken informally.

⁷⁸ KRSA § 271A.220 begins with the phrase: "Unless otherwise provided by the articles of incorporation or by-laws. . . ." KRSA § 271A.665 contains no such language.

C. Executive Compensation

Another area of concern in Kentucky has been executive compensation—who sets the figure and how is it paid? The problem, as will be discussed in more detail later, was that the Court of Appeals has long been reluctant to allow a board of directors to make a contract for the corporation where interested directors were a part of the quorum and voting majority that approved it.⁷⁹ A board setting its own salaries would certainly come under the heading “interested,”⁸⁰ in order to overcome the problem, some jurisdictions have used the split resolution technique, wherein the salary for each director is voted on by the other directors with the “interested” director not participating, but Kentucky has never sanctioned this method.⁸¹ The old provision that regulated the powers of the board of directors said nothing specific about executive compensation.⁸² Under the new act, however, the board is given explicit authority to fix the compensation of directors, unless the articles provide otherwise.⁸³ The issue of *who* will fix the compensation for a corporation’s executives then, has been resolved. Several questions, however, still remain. What about the *amount* of compensation?—Is the board to be allowed to set whatever sum it wishes? And what about the *form* of payment?—Must it always be cash or can it be something else?

The fact that the board of directors now has explicit statutory authority to set its own salaries does not mean that the directors will have a free hand. Several Kentucky cases have held directors’ salaries excessive. In *Beha v. Martin*,⁸⁴ for instance, the Court held that where majority shareholders, as directors of a corporation, vote themselves salaries, a court of equity will review the reasonableness of such salaries upon application by a minority shareholder. If the court finds the salaries unreasonable, it will enjoin payment and order a recovery of the excess over a reasonable sum.⁸⁵ In a close corporation, presumably, the problem of the amount of compensation should not arise too often. Its members should be able to agree on the apportionment of

⁷⁹ See note 164, *infra*.

⁸⁰ There is a difference between a shareholder who is voting as a director and one who is voting as a shareholder; when voting as a shareholder he has a legal right to vote with a view toward his own benefits and represents himself only, but as a director he represents all the shareholders as a trustee and cannot use his office for his personal benefit at the shareholders’ expense. The motive prompting a shareholder’s vote, however reprehensive or malicious, is not generally relevant to judicial inquiry. See *Kirwan v. Parkway Distillery*, 148 S.W.2d 720 (Ky. 1941).

⁸¹ But see *Beha v. Martin*, 171 S.W. 393 (Ky. 1914).

⁸² KRS § 271.345.

⁸³ KRSA § 271A.175; MODEL BUS. CORP. ACT ANN. 2D § 35 (1971).

⁸⁴ 171 S.W. 393 (Ky. 1914).

⁸⁵ See also *Poutch v. Nat’l Foundry & Mach. Co.*, 143 S.W. 1003 (Ky. 1912).

the funds available (although the Internal Revenue Service might not). However, should a shareholder become disenchanted with the sum the other participants are receiving, he may apply to the courts for injunction and recovery on the ground of unreasonableness. Further, the payments complained of need not be in the form of regular compensation. Bonuses may also be scrutinized by the courts. A federal district court has held, in a decision under Kentucky law, that in order for the bonus to be valid, there must be formal action by the shareholders approving a bonus for past services, along with a valid contract providing for such payment showing a proper relationship between the amount of the bonus and the value of the services performed.⁸⁶ Otherwise, payment of the bonus will be considered an unlawful dissipation of corporate assets for which the managing officers are responsible to the corporation.

The form of executive compensation may also create difficulties. In the close corporation, cash is not always the most desirable medium, either in exchange for shares of stock or for compensation. There are numerous reasons for such a situation, including the lack of readily available funds in the initial stages of the close corporation. Also, the participants in a close corporation may affect the methods of payment; a father and son beginning business together might find transfers of cash inconvenient, if not impossible. These problems have led to the practice of using the stock itself, or some variation thereof, as compensation to the participants. The old Kentucky act sanctioned the practice by allowing labor or property actually received to serve as consideration for shares in the corporation, limiting the value of the stock so issued to the market value of the labor or property at the time it was performed or received. This allowed members of a close corporation to contribute their time to the business and receive stock as compensation.⁸⁷ Since the market price was to be set by the incorporators, shareholders, or directors, and was deemed to be prima facie correct, the members of the corporation could usually set the value at whatever figure they wished.⁸⁸ The statute did provide that if a person questioned the valuation and proved "by a clear preponderance of the evidence" that it should have been set differently, then such valuation would not be considered correct on its face.⁸⁹ The only differences between the old and new acts, in this respect, are that the new act deletes the incorporators from the list of those who can value the labor or property, and adds "fraud in the transaction"

⁸⁶ Richardson v. Blue Grass Mining Co., 29 F. Supp. 658 (E.D. Ky. 1939).

⁸⁷ KRS § 271.175(1).

⁸⁸ KRS § 271.195(1).

⁸⁹ KRS § 271.195.

as one of the limits on the conclusiveness of the valuation.⁹⁰ Fraud is not mentioned in the old act.⁹¹

An added provision in this area is the one specifically concerning stock options. The new act allows the board of directors to set up options, subject to provisions in the articles. They may be issued to *all* the shareholders, solely on the authority of the board. Where they are issued to directors, officers, or employees, and *not* to all the shareholders, however, a majority of the shareholders entitled to vote on the question must approve or subsequently ratify such options.⁹²

The use of stock option plans for executive (and employee) compensation became popular in the 1950's and early 1960's because of the favorable tax treatment accorded them,⁹³ and, although the Internal Revenue Code has tightened the requirements for qualified options,⁹⁴ they remain as viable alternatives to straight cash compensation. The popularity of the stock option, however, has led to a great deal of litigation by minority shareholders testing the validity of such arrangements. The largest single issue raised has been the necessity⁹⁵ and sufficiency⁹⁶ of the consideration offered for the option. Generally,

⁹⁰ KRSA § 271A.095. The new Kentucky provision differs from the Model Act on one point. The Model section merely states that in the absence of fraud the judgment of the board of directors or shareholders shall be conclusive. MODEL BUS. CORP. ACT ANN. 2D § 19 (1971). Kentucky retains its old provision allowing a person to prove that the valuation should have been otherwise.

⁹¹ There are limits on this type of compensation, too. In *Louisville Bldg. Ass'n v. Hegan*, 49 S.W. 796 (Ky. 1899), the Court held that a director who claimed commissions on the sale of land for the corporation could not collect where he allowed the board to close the transactions believing that they would have to pay nothing further. The case of *Paducah Land, Coal & Iron Co. v. Mulholland*, 24 S.W. 624 (Ky. 1894), presented an even more dubious situation. There, the directors purchased land for the corporation from one of their number and agreed to give him ten thousand shares of the corporation's stock as compensation. Under a prior arrangement with him, however, forty-five hundred of the shares were returned to the other directors for their personal benefit. The Court, in surprisingly mild terms, held that the forty-five hundred shares should be surrendered for cancellation, if not in the hands of bona fide purchasers for value.

⁹² KRSA § 271A.100; MODEL BUS. CORP. ACT ANN. 2D § 20 (1971). This section could have the effect of lessening the scope of the provision in KRSA § 271A.095 wherein a person could question the valuation of the consideration for stock on grounds other than fraud. Under KRSA § 271A.100, the judgment of the board (not the shareholders, too, as in KRSA § 271A.095) with regard to the value of consideration offered for stock options shall be conclusive, absent a showing of fraud. Perhaps the fact that the shareholders must vote on options that are not issued to everyone is considered a sufficient safeguard against abuse of director discretion.

⁹³ See INT. REV. CODE OF 1954, §§ 421-25.

⁹⁴ *Id.*

⁹⁵ See *Holthusen v. Edward G. Budd Mfg. Co.*, 52 F. Supp. 125 (E.D. Pa. 1943) and *Scheinman v. Nat'l Container Corp.*, 165 Misc. 267, 300 N.Y.S. 780 (Sup. Ct. 1939). *But see* *Leech v. Fuller*, 173 Misc. 543, 19 N.Y.S. 2d 98 (Sup. Ct. 1939).

⁹⁶ See *Gottlieb v. Heyden Chem. Corp.*, 90 A.2d 660 (Del. 1952) and *Rosenthal v. Burry Biscuit Corp.*, 60 A.2d 106 (Del. 1948).

granting an option to an officer or employee merely to provide him with extra incentive while carrying out his duties has not been considered sufficient consideration.⁹⁷ On the other hand, issuing an option to obtain or retain the services of personnel whose talents were needed for the success of the corporation has usually been considered valid.⁹⁸ Where the directors have acted in good faith, and there is no fraud or waste of assets, the courts rarely inquire into the reasonableness of the valuation of the services offered as consideration.⁹⁹ As with other types of compensation, however, the board does not have a free hand; mere "good faith" is not always enough. A court may question the sufficiency of the relationship between the value of the option and the value of the services obtained, even when the directors have acted in good faith. In *Gottlieb v. Heyden Chemical Corp.*,¹⁰⁰ a Delaware court held that the directors had to prove not only their good faith, but also that the fairness of the transaction would withstand an objective, penetrating analysis.¹⁰¹ This rationale, were it adopted by other jurisdictions, would appear to subject any and all option plans to the scrutiny of the courts.

Assurance that the employee receiving the option will continue in the employment of the corporation¹⁰² and self-dealing among the directors¹⁰³ are other issues raised by shareholders regarding stock options. It has generally been held that the corporation must be assured of the employee's services for a substantial time (at least for the period covered by the option) by the terms of the option or by other circumstances. In recent cases, however, the courts appear to be placing less emphasis on this requirement. In *Elster v. Beard*,¹⁰⁴ an

⁹⁷ *Rosenthal v. Burry Biscuit Corp.*, 60 A.2d 106 (Del. 1948).

⁹⁸ See *Wise v. Universal Corp.*, 93 F. Supp. 393 (D. Del. 1950); *Wyles v. Campbell*, 77 F. Supp. 343 (D. Del. 1948); *McQuillen v. Nat'l Cash Register Co.*, 27 F. Supp. 639 (D. Md. 1939); *Diamond v. Davis*, 38 N.Y.S.2d 103 (Sup. Ct. 1942); *Abrams v. Allen*, 36 N.Y.S.2d 174 (Sup. Ct. 1942).

⁹⁹ See cases cited in note 98 *supra*. A court of equity will not substitute its judgment as to internal management of a corporation at the instance of the minority shareholders, unless the actions complained of are so clearly against the interests of the minority as to wantonly destroy their rights and to constitute a clear violation thereof. *Rice v. Thomas*, 211 S.W. 428 (Ky. 1919).

¹⁰⁰ 90 A.2d 660 (Del. 1952), *motion for rehearing granted*, 91 A.2d 57 (Del. 1952), *aff'd*, 92 A.2d 594 (Del. 1952), *new trial*, 99 A.2d 507 (Del. Ch. 1953).

¹⁰¹ 90 A.2d 660, 663 (Del. 1952).

¹⁰² See *Clamitz v. Thatcher Mfg. Co.*, 158 F.2d 687 (2d Cir. 1947), *cert. denied*, 331 U.S. 825 (1947); *Wyles v. Campbell*, 77 F. Supp. 343 (D. Del. 1948); *Holthusen v. Edward G. Budd Mfg. Co.*, 52 F. Supp. 125 (E.D. Pa. 1943); *Elster v. Am. Airlines, Inc.*, 100 A.2d 219 (Del. Ch. 1953); *Eliasberg v. Standard Oil Co.*, 92 A.2d 862 (N.J. Super. 1952); *Kaufman v. Schoenberg*, 91 A.2d 786 (Del. Ch. 1952); *Kerbs v. California E. Airways, Inc.*, 90 A.2d 652 (Del. 1952).

¹⁰³ See *Wise v. Universal Corp.*, 93 F. Supp. 393 (D. Del. 1950); *Rogers v. Guar. Trust Co.*, 60 F.2d 106 (S.D.N.Y. 1932); *Kaufman v. Schoenberg*, 91 A.2d 786 (Del. Ch. 1952); *Diamond v. Davis*, 38 N.Y.S.2d 103 (Sup. Ct. 1942).

¹⁰⁴ 160 A.2d 731 (Del. Ch. 1960).

option that was immediately exercisable was upheld even though it contained no assurance that the employee would continue with the corporation. The court gave lip service to the general rule noted above, and then declared the option valid because it was created by a disinterested board and ratified by the shareholders.¹⁰⁵ The trend in this area, then, is toward allowing the directors wide latitude in the actual formation of stock options.¹⁰⁶ This in turn can lead to self-dealing among the directors, and, since the directors are usually able to obtain the approval of a majority of the shareholders, relief for director self-aggrandizement will be rare. Ratification by the shareholders places the burden of proving bad faith on the plaintiff;¹⁰⁷ in all cases, minority shareholders raising objections to the stock option plans have a great deal to overcome.

III. FUNDAMENTAL PROVISIONS

A. *Minority Rights and Representation*

Perhaps the most pervasive aspect of Kentucky's new corporation law is its meticulous attention to the rights of minority shareholders. Throughout the act, specific, detailed provisions prevent majority shareholders from riding roughshod over the minority. Although possibly of no practical value to the one or two-man close corporation, the sections on cumulative voting,¹⁰⁸ number¹⁰⁹ and classes¹¹⁰ of directors, vacancies on the board,¹¹¹ removal of directors,¹¹² and shareholder dissent¹¹³ could be significant to close corporations with several participants. Throughout this discussion it should be remembered that both the old and new acts require only a majority vote to amend the articles, unless a higher vote is provided in the articles themselves.¹¹⁴

¹⁰⁵ *Id.* at 733.

¹⁰⁶ See also *Olson Bros. v. Englehart*, 211 A.2d 610 (Del. 1965), *aff'd*, 245 A.2d 166 (Del. 1968) and *Stemerman v. Ackerman*, 184 A.2d 28 (Del. 1962).

¹⁰⁷ See *Kaufman v. Schoenberg*, 91 A.2d 786 (Del. Ch. 1952). In order to ratify a stock option plan, the shareholders must be properly informed of the details. *Kerbs v. California E. Airways, Inc.*, 91 A.2d 652 (Del. 1952). And if no consideration is involved, unanimous shareholder approval will be necessary to ratify the option. *Gottlieb v. Heyden Chem. Corp.*, 90 A.2d 660 (Del. 1952); *Rosenthal v. Burry Biscuit Corp.*, 60 A.2d 106 (Del. 1948).

¹⁰⁸ KRSA § 271A.165(4); MODEL BUS. CORP. ACT ANN. 2D § 33 (1971).

¹⁰⁹ KRSA § 271A.180 and KRSA § 271A.270(j); MODEL BUS. CORP. ACT ANN. 2D § 36 (1971) and MODEL BUS. CORP. ACT ANN. 2D § 54(j) (1971).

¹¹⁰ KRSA § 271A.185; MODEL BUS. CORP. ACT ANN. 2D § 37 (1971).

¹¹¹ KRSA § 271A.190; MODEL BUS. CORP. ACT ANN. 2D § 37 (1971).

¹¹² KRSA § 271A.195; MODEL BUS. CORP. ACT ANN. 2D § 39 (1971).

¹¹³ KRSA § 271A.400 and KRSA § 271A.405; MODEL BUS. CORP. ACT ANN. 2D § 80 (1971) and MODEL BUS. CORP. ACT ANN. 2D § 81 (1971).

¹¹⁴ In an early Kentucky case, the Court held that every shareholder contracts that the will of the majority shall govern in all matters coming within the limits of the act of incorporation. *Dudley v. Kentucky High School*, 72 Ky. (9 Bush) 576 (1873).

Kentucky is one of several jurisdictions that has a constitutional provision guaranteeing the right of cumulative voting.¹¹⁵ This procedure, which applies only to the election of directors, gives each share as many votes as there are directors to be elected, and permits the shareholder to distribute those votes in any way he chooses.¹¹⁶ Cumulative voting was conceived to give minority shareholders access to the board of directors. Besides the constitutional provision, Kentucky's old corporation law had a section calling for cumulative voting¹¹⁷ similar to the provisions of the new act.¹¹⁸ The only difference is that the new act specifically states that the cumulative votes may be cast "in person or by proxy" while the old act merely stated that "shareholders" shall cast the votes.¹¹⁹

Over the years, ingenious majority shareholders have developed a number of ploys whereby the purpose of the cumulative voting process (*i.e.*, to give minority shareholders representation on the board of directors) has been circumvented. Changing the number of directors, classifying the board, and filling board positions occurring through vacancy, removal, or an increase in directors, are examples of such methods. Under the new act, the number of directors may be increased or decreased by amending the articles or by-laws, whichever is originally used to fix that number, or by using some other procedure set out in the articles or by-laws.¹²⁰ However, no decrease in the number may be used to shorten the terms of an incumbent director;¹²¹ in other words, majority directors cannot circumvent the required removal procedure by decreasing the number of directors. The old act was not

¹¹⁵ KY. CONST. § 207.

¹¹⁶ H. HENN, LAW OF CORPORATIONS § 189.

¹¹⁷ KRS § 271.315(2). In *Proctor Coal Co. v. Finley*, 33 S.W. 188 (Ky. 1895), the Court of Appeals first recognized the validity of the cumulative voting provisions.

¹¹⁸ KRSA § 271A.165(4); MODEL BUS. CORP. ACT ANN. 2D § 33 (1971).

¹¹⁹ The other section of the new act having to do with selection of directors is KRSA § 271A.270(j), providing for the composition of the initial board of directors. MODEL BUS. CORP. ACT ANN. 2D § 54(j) (1971). The old act was quite similar to the new provision, the only difference being that it did not require the initial directors to actually be named. KRS § 271.035.

¹²⁰ KRSA § 271A.180; MODEL BUS. CORP. ACT ANN. 2D § 36 (1971). Where the articles provide for one number of directors and the by-laws another, the articles prevail. *In re Salmor Realty Corp.*, 16 Misc.2d 189, 183 N.Y.S.2d 879 (Sup. Ct. 1959). And where the by-laws set forth the number of directors and the shareholders elect more, the election is irregular and voidable. *In re Multifade Corp. of America*, 97 N.Y.S.2d 609 (Sup. Ct. 1950). But, where the shareholders elect fewer directors than called for by the by-laws, the election is valid as to the directors chosen. *State ex rel. Price v. DuBrul*, 126 N.E. 87 (Ohio 1919); *Great Falls & Teton County Ry. v. Ganong*, 136 P. 391 (Mont. 1913); *Wright v. Commonwealth*, 1 A. 794 (Pa. 1885). And it has been held that where candidates for a nine-man board tied for ninth place, the directorship was vacant. *Grip v. Burrdlen Woodworking Co.*, 437 P.2d 915 (Wash. 1968).

¹²¹ KRSA § 271A.180; MODEL BUS. CORP. ACT ANN. 2D § 36 (1971).

so solicitous of minority rights; it allowed a majority of the shareholders to increase or decrease the number of directors without regard to whether or not incumbents representing minority shareholders would be removed thereby.¹²² This, of course, could completely destroy the effect of cumulative voting—if the number were increased the minority's power was diluted; if the number were decreased their power may have been removed altogether.

In regard to classification of directors, the old act provided that the terms of office of the individual directors could be staggered, and that the terms were to be arranged so that "the terms of an equal or nearly equal number of directors [would] expire each year."¹²³ This provision apparently applied to boards with any number of directors, and, absent other provisions in the articles or by-laws,¹²⁴ gave majority shareholders the power to manipulate the terms of all directors, regardless of whom the directors represented on the board. Under the new act, there will be *no* classification of directors in most close corporations, since only a board of directors that consists of nine or more members may be classified.¹²⁵ However, even a board which is large enough to be classified may run into constitutional difficulties. Some jurisdictions whose constitutions require cumulative voting prohibit classification of directors because it interferes with the shareholders' voting rights. In *Wolfson v. Avery*,¹²⁶ a provision on director classification similar to that of the Model Act was held unconstitutional as inconsistent with Illinois' guarantee of cumulative voting. Kentucky's constitutional provision on cumulative voting is similar to that of Illinois,¹²⁷ and therefore the validity of the new provision on classification is questionable. On the other hand, Pennsylvania, whose constitution also requires cumulative voting, has held that the classification of directors with staggered terms is *not* inconsistent with the cumulative voting right.¹²⁸ Even if the Kentucky Court of Appeals agrees with

¹²² KRS § 271.345(4). It does appear, however, that unanimous consent of the shareholders to amend the articles or by-laws could have been required, thus preserving the minority voice on the board. KRS § 271.445(2) and KRS § 271.315(7).

¹²³ KRS § 271.345(4).

¹²⁴ See note 122 *supra*.

¹²⁵ KRSA § 271A.185; MODEL BUS. CORP. ACT ANN. 2D § 37 (1971). In *Humphreys v. Winous*, 133 N.E.2d 780 (Ohio 1956), a board composed of only three directors was divided into three classes. As a consequence, the holder of forty per cent of the shares was unable to elect a single director, even though he had cumulative voting rights. The Ohio court upheld the classification, but did so with the knowledge that the Ohio legislature had amended the corporation statute so as to provide that in the future no class could consist of less than three directors.

¹²⁶ 126 N.E.2d 701 (Ill. 1955).

¹²⁷ KY. CONST. § 207.

¹²⁸ *Janney v. Philadelphia Transp. Co.*, 128 A.2d 76 (Pa. 1956).

the Pennsylvania court, if and when the question is raised, the new act still circumscribes the power of the majority directors to some extent. The new provision authorizing director classification is much stricter than the one in the old act.¹²⁹ It provides (1) that the number of directors in each class must be "as nearly equal as possible," (2) that classes shall be staggered by a prescribed method, and (3) that any classification of directors before the first annual meeting shall not be effective. If classification is allowed in Kentucky, abuse of minority shareholders should still be held to a minimum.

The old Kentucky act had no provisions relating to the removal of directors. Since shareholders have generally been accorded the right to remove a director for cause,¹³⁰ and may adopt provisions in the articles or by-laws allowing removal without cause,¹³¹ majority shareholders could avoid the effect of cumulative voting through the removal power.¹³² Under the new act the power of removal is broad, but the procedure required to implement it is defined in such a manner as to preserve the rights of minority shareholders. At a shareholders' meeting called for the express purpose of removing directors, any or all of the directors may be removed, with or without cause, by a majority of the shares entitled to vote at an election of directors.¹³³ But, unless the *entire board* is to be removed, no single director can be removed if the votes against his removal would be sufficient to elect him if voted cumulatively at an election of the entire board.¹³⁴ Therefore, if a minority faction is able to attract enough votes to elect a director, that director cannot be removed without the acquiescence of part of that faction. The new act appears to effectively safeguard the intent of the cumulative voting provision from obliteration through the removal power.¹³⁵

Once a vacancy occurs, of course, whether through removal or

¹²⁹ KRSA § 271A.185; MODEL BUS. CORP. ACT ANN. 2D § 37 (1971); KRS § 271.345(4).

¹³⁰ See *Campbell v. Loew's, Inc.*, 134 A.2d 852 (Del. Ch. 1957).

¹³¹ See H. BALLANTINE, CORPORATIONS § 185 (rev. ed. 1946); R. STEVENS, PRIVATE CORPORATIONS § 163 (2d ed. 1949).

¹³² See *Laughlin v. Greer*, 121 Ill. App. 534 (1905).

¹³³ KRSA § 271A.195(1); MODEL BUS. CORP. ACT ANN. 2D § 39 (1971).

¹³⁴ KRSA § 271A.195(2); MODEL BUS. CORP. ACT ANN. 2D § 39 (1971). If there are classes of directors, only those shareholders who elect the particular class may remove a director of that class. KRSA § 271A.195(3); MODEL BUS. CORP. ACT ANN. 2D § 39 (1971).

¹³⁵ Removal of officers, however, is a different matter. The new act provides that officers or agents may be removed by the board whenever the board thinks such an action would be in the "best interests" of the corporation, such removal not to prejudice any contract rights of the person removed. In *O'Neal v. F. A. Weider Co.*, 80 S.W. 451 (Ky. 1904), the Court held that directors have the right to discharge an officer at any time, without cause, *in the absence of* a contract which guarantees that the officer is entitled to hold his office for a definite period.

death or resignation, the tyranny of the majority must be borne by the minority, for a time at least. The practical effect of both the old and new acts is to give the majority of directors the right to fill the unexpired term.¹³⁶ However, the new act does place restrictions on vacancies created due to an increase in the number of directors. Such "vacancies" may be filled only for a term of office continuing to the next election of directors by the shareholders.¹³⁷ This permits minority shareholders to exercise their cumulative voting privileges within a relatively short time after the new positions are created and gives them a chance to elect members of their own faction to the additional seats on the board.¹³⁸

If, despite all these checks on the corporation's majority faction, it still manages to commit the corporation to a course completely contrary to the wishes of the minority, the minority for the most part must grin and bear it. There are two exceptions to this general rule—where the corporation adopts a plan of merger or consolidation and where it disposes of all or most of its property and assets not "in the usual and regular course of business," any shareholder may "dissent."¹³⁹ The old act provided for shareholder dissent in these situations,¹⁴⁰ but there are a number of differences between the two in regard to implementing the dissent provisions. In these instances, "dissent" means that the shareholder wishes to surrender his shares of stock to the corporation in exchange for cash representing the "fair value" thereof.¹⁴¹ Under both the old and new acts the shareholder is required to follow certain

¹³⁶ KRS § 271.345(4)(a); KRSA § 271A.190; MODEL BUS. CORP. ACT ANN. 2D § 38 (1971). The only difference between the two acts is that the old act required the sanction of the shareholders. In *Stott v. Stott Realty Co.*, 224 N.W. 623 (Mich. 1929), the court held that the authority to fill vacancies did not permit the board to create vacancies by removal of directors.

¹³⁷ KRSA § 271A.190; MODEL BUS. CORP. ACT ANN. 2D § 38 (1971). In *In re A. A. Griffing Iron Co.*, 41 A. 931 (N.J. 1898), *aff'd*, 46 A. 1097 (N.J. 1899), the court held that the board did *not* have the power, under a statute allowing them to fill vacancies, to fill newly-created directorships. Other cases have held that "vacancy" implies a previous incumbency. *Gow v. Consol. Coppermines Corp.*, 165 A. 136 (Del. 1933); *McWhirten v. Washington Royalties Co.*, 152 A. 220 (Del. 1930); *Moon v. Moon Motor Car Co.*, 151 A. 298 (Del. 1930).

¹³⁸ And, it has been held that directors could not appoint others to fill directorships that were *not* newly-created, but had just never been filled by the shareholders. *Belle Isle Corp. v. MacBean*, 61 A.2d 699 (Del. 1948).

¹³⁹ KRSA § 271A.400; MODEL BUS. CORP. ACT ANN. 2D § 80 (1971).

¹⁴⁰ KRS § 271.415(4) and KRS § 271.490.

¹⁴¹ In *Corwin v. Shelter Island Light & Power Co.*, 199 N.Y.S.2d 866 (Sup. Ct. 1960), the court held that the right of a dissenter to appraisal of his shares was not absolute, but discretionary with the court, and should not be used either as an offensive weapon against the corporation or as the cause of unwarranted expense to the majority shareholders. And, where shareholders sought to examine the corporation's ledgers because this was the only way to obtain the prices paid for stock, the fact that they had sued to recover the fair market value of their stock did not constitute a waiver of their right to examine the corporation's books. *E.I.F.C., Inc. v. Atnip*, 454 S.W.2d 351 (Ky. 1970).

procedures. Both acts require that the shareholder object to the action to be taken in writing; the old act required that such objections be made *prior* to the vote¹⁴² whereas the new act also allows the shareholder to object at the meeting.¹⁴³ Further, under the old act, unlike the new, the shareholder had to elect between claiming payment for his shares and filing suit for a fraudulent or illegal corporate action.¹⁴⁴ Finally, the value of all dissenting shares had to be determined in one suit (if such a suit were necessary) under the old act;¹⁴⁵ no mention is made of consolidating shareholders' actions in the new act. These dissent provisions are probably more important to the close corporation than to public issue corporations. A shareholder who owns one-third of the stock of a corporation and finds himself outvoted on a merger or transfer of assets may utilize these provisions to withdraw from the venture.

B. *High Vote/High Quorum Requirements*

Another method which minority shareholders have employed to protect their interests is a requirement that quorums and votes at both shareholder and board meetings be greater than a simple majority. These provisions usually allow the minority to veto actions which the majority may desire; that, in turn, enhances the likelihood of deadlock and possible dissolution.¹⁴⁶ The new act makes several changes in the availability of high quorum/high vote provisions. Both the old and new acts require that a majority of the shareholders entitled to vote be present to constitute a quorum, unless provided otherwise in the articles,¹⁴⁷ but the section dealing with quorums at board meetings has been altered and clarified. Under the old act, a majority of the board of directors was needed for a quorum unless the by-laws required a *different* number.¹⁴⁸ This provision allowed the corporation to raise or lower its quorum requirement for board meetings easily, but it was unclear whether or not such changes could be made by the

¹⁴² KRS § 271.415(4)(a); KRS § 271.490(1).

¹⁴³ KRSA § 271A.405(1); MODEL BUS. CORP. ACT ANN. 2D § 81 (1971).

¹⁴⁴ KRS § 271.415(4)(b); KRS § 271.490(1).

¹⁴⁵ KRS § 271.415(4)(d); KRS § 271.490(1).

¹⁴⁶ H. HENN, LAW OF CORPORATIONS § 266.

¹⁴⁷ KRSA § 271A.160(1); MODEL BUS. CORP. ACT ANN. 2D § 32 (1971); KRS § 271.335(2)(a). The new act adds: "but in no event shall a quorum consist of less than one-third of the shares entitled to vote at the meeting." It has been held that, for quorum purposes and shareholder action, shares entitled to vote are those which are actually issued and outstanding and not the total number of shares authorized. *Castner v. Twitchell-Chanplin Co.*, 40 A. 558 (Me. 1898).

¹⁴⁸ KRS § 271.345(4)(c). A quorum could never be less than one-third the total number of directors nor less than two directors.

articles as well as the by-laws.¹⁴⁹ The new act states that a quorum at a meeting of the board of directors shall be a majority of the directors, unless a *greater* number is called for in the by-laws or the articles.¹⁵⁰ Thus the new provision solves any procedural questions that may have existed, and prohibits lowering of quorum requirements.¹⁵¹

Vote requirements have been substantially changed by the new act. The provision in the old statute, which apparently controlled the voting requisites for shareholder action, stated that the articles or by-laws could specify the votes necessary for the transaction of business, except in actions controlled by the statute.¹⁵² Like the quorum requirement, then, the vote requirements could be fixed at more or less than a majority. Further, there was no statutory authority to prevent the shareholders from requiring a unanimous vote if they so desired.¹⁵³ The new act allows the vote requirement for shareholder action to be raised, but it cannot be lowered.¹⁵⁴ The new act also retains the old provision, not found in the Model Business Corporation Act, which authorizes the remaining shareholders to act when others withdraw, causing the number present to fall below the quorum requirement.¹⁵⁵ Both the old and the new act provide that a majority vote of the shareholders is necessary before certain actions may be taken¹⁵⁶ and that if the articles require a greater vote than the statute,

¹⁴⁹ For a more detailed discussion of these problems, see Ham, *supra* note 51, at 162.

¹⁵⁰ KRS § 271A.200; MODEL BUS. CORP. ACT ANN. 2D § 40 (1971). Where the by-laws stated that a majority of the directors should constitute a quorum, and there were vacancies on the board at the time, only a majority of the *authorized* directors was necessary. Currie v. Matson, 33 F. Supp. 454 (W.D. La. 1940); Bruch v. Nat'l Guarantee Credit Corp., 116 A. 738 (Del. Ch. 1922); Burton v. Lithic Mfg. Co., 144 P. 1149 (Ore. 1914).

¹⁵¹ In a case where the shareholders adopted a resolution increasing the number of directors from five to nine, but no actual change in the number who served ever occurred, the number of directors remained at three for quorum purposes. Robertson v. Hartman, 57 P.2d 1310 (Cal. 1936).

¹⁵² KRS § 271.315(7).

¹⁵³ For a discussion of this possibility, see Ham, *supra* note 51, at 157.

¹⁵⁴ KRS § 271A.160(1); MODEL BUS. CORP. ACT ANN. 2D § 32 (1971).

¹⁵⁵ KRS § 271A.160(1); KRS § 271.335(2)(b). But, a shareholder present in person or by a proxy *before* a quorum is present may withdraw, and his original presence cannot be counted for quorum purposes after he leaves. Textron, Inc., v. Am. Woolen Co., 122 F. Supp. 305 (D. Mass. 1954). Where a person who holds shares and proxies is ejected from a meeting for objecting to the legality of the meeting, his shares cannot be counted when determining a quorum and the election of directors at the meeting is void for lack of a quorum. Leamy v. Sinaloa Exploration & Dev. Co., 130 A. 282 (Del. Ch. 1925).

¹⁵⁶ KRS § 271A.295(1)(c); MODEL BUS. CORP. ACT ANN. 2D § 59 (1971); KRS § 271.445(2) (amending the articles). KRS § 271A.345(1)(c); MODEL BUS. CORP. ACT ANN. 2D § 69 (1971); KRS § 271.460(1) (reduction of capital). KRS § 271A.395(3); MODEL BUS. CORP. ACT ANN. 2D § 79 (1971); KRS § 271.415(2)

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the articles control.¹⁵⁷ The new act, however, changes the procedure for approval of merger and consolidation. Apparently, under the old act, *only* a majority of the shareholders was necessary for approval;¹⁵⁸ the articles could not raise the requirement. Under the new provisions, the vote required for merger or consolidation *can* be changed by the articles.¹⁵⁹ An additional feature of the new act allows a merger with another corporation on approval of the board of directors, and not the shareholders, if 90% of the stock of the constituent corporations is already owned by the surviving corporation.¹⁶⁰

Vote requirements for board action have also been changed, to the benefit of the minority shareholders. The old act declared that the vote of a simple majority of the directors present would constitute the act of the board of directors;¹⁶¹ the new act provides that such actions require the vote of a majority of those present, unless a greater number is required by the articles or by-laws.¹⁶² One other new provision concerning actions of the board of directors allows directors who are interested in an action to be taken by the board to be counted when determining the presence of a quorum.¹⁶³ And although not as explicit as the quorum provision, this provision apparently allows interested directors to vote on the action.¹⁶⁴ The Kentucky courts have long held the opposite view.¹⁶⁵

One final area wherein changes have been made in the requisite number of directors for a quorum at a board meeting is that concerning

(Footnote continued from preceding page)

(transfer of corporate assets). KRSA § 271A.420(3); MODEL BUS. CORP. ACT ANN. 2D § 84 (1971); KRS § 271.500 (voluntary dissolution). Both acts allow revocation of voluntary dissolution proceedings by all the shareholders or by act of the corporation, in which case a majority vote is required. KRSA §§ 271A.440-271A.445 inclusive; MODEL BUS. CORP. ACT ANN. 2D §§ 88, 89(c) (1971); KRS § 271.520.

¹⁵⁷ KRSA § 271A.655; MODEL BUS. CORP. ACT ANN. 2D § 143 (1971); KRS §§ 271.415(2), 271.445(2), 271.460(1) and 271.500.

¹⁵⁸ KRS § 271.470.

¹⁵⁹ KRSA §§ 271A.365(2), 271A.655; MODEL BUS. CORP. ACT ANN. 2D § 73 (1971); MODEL BUS. CORP. ACT ANN. 2D § 143 (1971).

¹⁶⁰ KRSA § 271A.375(1); MODEL BUS. CORP. ACT ANN. 2D § 75 (1971).

¹⁶¹ KRS § 271.345(c). Though not explicitly stated, the old act may have been just as flexible in this regard as is the new act. KRS § 271.345(4).

¹⁶² KRSA § 271A.200; MODEL BUS. CORP. ACT ANN. 2D § 40 (1971).

¹⁶³ KRSA § 271A.205(2); MODEL BUS. CORP. ACT ANN. 2D § 41 (1971).

¹⁶⁴ KRSA § 271A.205(1); MODEL BUS. CORP. ACT ANN. 2D § 41 (1971). As a general rule, a director personally interested in a particular matter is disqualified from voting on it, and his vote cannot be counted in determining whether a resolution was passed by a majority of the board. *Holcomb v. Forsyth*, 113 So. 516 (Ala. 1927); *Jones v. Morrison*, 16 N.W. 854 (Minn. 1883). *But see* *South Georgia Holding Co. v. Hiatt*, 2 F. Supp. 91 (M.D. Ga. 1933); *Wheelen v. Pullman Iron & Steel Co.*, 32 N.E. 420 (Ill. 1892).

¹⁶⁵ See *Ham*, *supra* note 51, at 194 n. 260.

emergency by-laws to be operative in case of nuclear attack or some similar trouble.¹⁶⁶ The applicable sections provide that the board may adopt emergency by-laws which shall control in such situations, notwithstanding provisions in the articles or regular by-laws, and specifically set out certain areas upon which these by-laws may touch. These include (1) quorums for board meetings—apparently a quorum can be any number set forth in the emergency by-laws, and if no specific number is called for, it may be whatever number of directors attend a meeting called during the emergency¹⁶⁷ and (2) identity of directors—officers or other designated persons may be deemed directors to the extent necessary to provide a quorum as called for by the emergency by-laws.¹⁶⁸ If not otherwise provided in the emergency by-laws, certain officers shall be deemed directors to the extent necessary to obtain a quorum.¹⁶⁹

High quorum/high vote requirements are specific checks on the majority directors and shareholders. If proper provision is made, a single member of the corporation can exert his will against that of all the other members. And, whether for good or bad, a frequent result is deadlock and dissolution.

C. *Deadlock and Dissolution*

In close corporations, the possibility of deadlock due to evenly-divided directors or shareholders or veto arrangements,¹⁷⁰ is much greater than in the public issue corporations, chiefly because the close corporation has fewer participants. The problems of deadlock and dissolution, therefore, are critical ones which must be carefully considered by small groups contemplating incorporation. Like the old act, the new one provides for dissolution. The statutes concerning voluntary dissolution are similar, but the new act contains several important differences, some of which appear to make it easier to dissolve and others which may make it more difficult. Under the old act, dissolution by the incorporators had to take place within one year from the date of the issuance of the certificate of incorporation.¹⁷¹ Further, *all* the incorporators had to agree that the corporation be dis-

¹⁶⁶ KRSA § 271A.135(2); MODEL BUS. CORP. ACT ANN. 2D § 27A (1971). There were no comparable provisions in the old Kentucky act.

¹⁶⁷ KRSA § 271A.135(2)(b); MODEL BUS. CORP. ACT ANN. 2D § 27A (1971).

¹⁶⁸ KRSA § 271A.135(2)(c); MODEL BUS. CORP. ACT ANN. 2D § 27A (1971).

¹⁶⁹ KRSA § 271A.135(7); MODEL BUS. CORP. ACT ANN. 2D § 27A (1971).

¹⁷⁰ See note 146 *supra*, and accompanying text. See also Ham, *Suggestions for Modernizing the Kentucky General Corporation Law to Meet the Needs of Close Corporations*, 52 Ky. L.J. 527, 562 (1963).

¹⁷¹ KRS § 271.495.

solved.¹⁷² The new act has no time limit and requires that only a majority of the incorporators need agree on dissolution.¹⁷³

There are similar differences in the provisions for dissolution by the shareholders; only here the new act appears to make dissolution more difficult. The old act allowed dissolution upon the written consent of the holders of the total *voting power*.¹⁷⁴ Holders of shares with no voting power did not have to be consulted. Under the new act, the written consent of *all* of the shareholders is necessary for dissolution.¹⁷⁵ Thus, though perhaps more solicitous of the rights of minority (non-voting) shareholders, this particular provision creates a greater chance of deadlock.¹⁷⁶

As far as voluntary dissolution by act of the corporation is concerned, the old and new acts are substantially the same. Each requires a resolution by the board of directors and the approval of a majority of the shareholders entitled to vote.¹⁷⁷ And, just as the corporation may be voluntarily dissolved, so may the dissolution proceedings be voluntarily revoked. The new act is comparable to the old one in this regard.¹⁷⁸

While the sections in the old and new acts involving voluntary dissolution are similar, those governing involuntary dissolution are vastly different. Kentucky did not even have a statute dealing with involuntary dissolution in cases of deadlock prior to 1952, and the one enacted then has been of little solace to corporate practitioners. It made the dissolution discretionary with the circuit courts and was unclear as to what situations were covered.¹⁷⁹ The new act is a great deal more detailed and inclusive.

The new statute is framed in terms of the parties who may bring action for liquidation—shareholders, creditors, the Attorney General,

¹⁷² KRS § 271.495(1)(g).

¹⁷³ KRSA § 271A.410; MODEL BUS. CORP. ACT ANN. 2D § 82 (1971).

¹⁷⁴ KRS § 271.500.

¹⁷⁵ KRSA § 271A.415(1); MODEL BUS. CORP. ACT ANN. 2D § 83 (1971). In *Boyd v. Boone Nat'l Bank*, 218 N.W. 321 (Iowa 1928), it was held that a preferred shareholder had no legal interest in the continuation of the corporation, provided his right of priority to the assets was protected. Thus, he could not object to the dissolution of the corporation, even though all the shareholders did not agree to it.

¹⁷⁶ When they do dissolve a corporation, the shareholders must have a legitimate reason for doing so. In *W.P. Iverson & Co. v. Dunham Mfg. Co.*, 152 N.E.2d 615 (Ill. 1958), the court held that if shareholder-officers dissolve a corporation to prevent it from performing its contract, they must pay damages to the other contracting parties.

¹⁷⁷ KRSA § 271A.420; MODEL BUS. CORP. ACT ANN. 2D § 84 (1971); KRS § 271.500.

¹⁷⁸ KRSA §§ 271A.440-271A.445 inclusive; MODEL BUS. CORP. ACT ANN. 2D §§ 88-89 (1971); KRS §§ 271.525-271.535 inclusive.

¹⁷⁹ KRS § 271.570(2). For a detailed discussion of the problems involved with this statute, see Ham, *supra* note 51, at 173.

or the corporation itself (when it has already begun voluntary dissolution proceedings)—and gives the circuit courts “full power to liquidate the assets and business of a corporation” in specific situations.¹⁸⁰ When a shareholder is seeking liquidation, it must be established: (1) that the directors and shareholders are deadlocked, and that such deadlock is causing, or threatening to cause, “irreparable injury” to the corporation; (2) that the acts of the directors or those in control are fraudulent or illegal; or (3) that the shareholders are deadlocked and have been unable to elect successors to directors at two consecutive annual meetings.¹⁸¹ When a creditor is seeking liquidation it must be established that the corporation is insolvent and that the creditor’s claim against the corporation has been reduced to a judgment and execution is unsatisfied, or that the corporation has admitted its debt in writing.¹⁸² The Attorney General may seek liquidation after he has filed an action to revoke or forfeit a corporation’s charter and established that liquidation should precede the decree of revocation or forfeiture.¹⁸³ When the liquidation has been completed the court *shall* enter a decree dissolving the corporation.¹⁸⁴

¹⁸⁰ KRSA § 271A.475; MODEL BUS. CORP. ACT ANN. 2D § 97 (1971). There is some authority for the assertion that where the dissolution procedures are not fully complied with, the court does not have jurisdiction, and any dissolution order obtained must be set aside. *In re Packer City Tire & Rubber Co.*, 162 N.W. 897 (S.D. 1917).

¹⁸¹ KRSA § 271A.475(1)(a). The Kentucky act does not include the Model Act provision that a shareholder is entitled to liquidation if he establishes that the corporate assets are being wasted or misappropriated. MODEL BUS. CORP. ACT ANN. 2D § 97 (1971). Kentucky also omits the word “oppressive,” referring to acts of the directors, from the Model Act language.

¹⁸² KRSA § 271A.475(1)(b); MODEL BUS. CORP. ACT ANN. 2D § 97(b) (1971). A corporation whose assets are insufficient to pay its debts, and which has ceased to do business, or has taken or is about to take action which will incapacitate it from conducting a corporate enterprise with a reasonable prospect of success, or is so financially embarrassed that early suspension and failure must ensue, is as a matter of law “insolvent.” *Oscar C. Wright Co. v. Steenman*, 71 S.W.2d 991 (Ky. 1934). A conveyance by a corporation, when it is insolvent and has suspended its ordinary business because of lack of funds, is void, not voidable. *Ciba Co. v. Interstate Tanning Co.*, 9 F.2d 632 (D.N.J. 1925). But, a conveyance by a corporation cannot be invalidated as in fraud of creditors, even though the corporation is insolvent, as long as it has not suspended its ordinary business and the transferee, purchasing for valuable consideration, had no notice of the insolvency. *Chesher v. Shafter Lake Clay Co.*, 115 P.2d 636 (N.M. 1941). And where shareholders divide and convert to their own use corporate assets without paying the corporation’s debts, those shareholders must respond personally to the creditors to the extent of the corporate assets wrongfully received. *Wallace & Tiernan Co. v. Davis*, 11 S.W.2d 990 (Ky. 1928); *Martin v. Lexington*, 210 S.W. 483 (Ky. 1919).

¹⁸³ KRSA §§ 271A.470, 271A.475(1)(d); MODEL BUS. CORP. ACT ANN. 2D §§ 94, 97(d). Forfeiture of the charter of a private commercial corporation must rest upon grave cause and be warranted by material misconduct. *Commonwealth v. United Warehouse Co.*, 169 S.W.2d 300 (Ky. 1943).

¹⁸⁴ KRSA § 271A.500; MODEL BUS. CORP. ACT ANN. 2D § 102 (1971). The corporate existence is not always ended by the dissolution decree. A corporation

As noted before, the new provision on liquidation and dissolution are detailed and inclusive. However, should the shareholders of the close corporation wish to avoid the formal dissolution procedure provided by the statute, they still have the old remedies of arbitration¹⁸⁵ and buy-out agreements,¹⁸⁶ plus the new possibilities of the shareholder agreement.¹⁸⁷

CONCLUSION

The close corporation can no longer be considered the step-child of the multi-level conglomerate. With the adoption of the new Kentucky Business Corporation Act, the General Assembly has signalled its full acceptance of the concept that the close corporation is an entity unto itself. Several provisions in the new act, such as those specifically allowing transfer restrictions and informal board action, are of practical value only to the close corporation. And numerous others, like those relaxing the formalities of the voting trust and those allowing the use of shareholder agreements, make the operation of the close corporation much simpler than it was in the past. All of these elements are tempered by the all-inclusive effect of the provisions protecting the rights of minority shareholders; though not limited to the close corporation, these provisions should turn out to be of more value to its minority shareholders than to those of the public-issue enterprise. A minority shareholder in a close corporation knows when he is being oppressed—such a situation is not always obvious to the man who owns ten shares of General Motors.

The new act is the culmination of a long and tedious process, involving never-ending meetings, discussions, and revisions. Its final form combines an anticipation of possible problem areas with a lack of rigidity to create a viable, living business association. The General Assembly has finally modernized Kentucky's corporation law; the formation of an ever-increasing number of close corporations in the Commonwealth should not be far behind.

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dissolved in 1940 had the power to continue to settle its affairs by a suit instituted in 1948 to set aside a 1943 conveyance of realty by the corporation's debtors. *Blackerby v. Monarch Equip.*, 259 S.W.2d 683 (Ky. 1953). And a corporation, more than two years after dissolution, had the capacity to sue as a nominal party to set aside a forfeiture and sale of land which it owned at the time of forfeiture. *Smith v. Commonwealth Land & Lumber Co.*, 189 S.W. 912 (Ky. 1916).

¹⁸⁵ KRS § 417.010. For a discussion of common law arbitration, see *Ham*, *supra* note 51, at 181.

¹⁸⁶ See *Graham v. McAdoo*, 123 S.W. 260 (Ky. 1909). See also H. HENN, *LAW OF CORPORATIONS* § 269.

¹⁸⁷ KRSA § 271A.170(2); MODEL BUS. CORP. ACT ANN. 2D § 34 (1971).