Corporate Finance and Kentucky's New Business Corporation Act

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INTRODUCTION

The Kentucky Business Corporation Act, like many recent corporate law revisions, is patterned after the Model Business Corporation Act. Yet the new Kentucky Act is not a wholesale adoption of the Model Act; variations and changes are apparent, for the legislature promulgated provisions to conform with the mandates of the Kentucky Constitution and the special needs of Kentucky business.

Corporate finance concerns money—more specifically, a corporation's acquisition and distribution of money. This article undertakes to examine those statutory sections that have to do with money, i.e., the corporation's acquisition of money through the issuance of its shares, the corporations' distribution of money through the payment of dividends, and the other financial aspects that arise in the accounting treatment afforded these acquisitions and distributions. This article is not intended to encompass every facet of corporation finance law or to provide an in-depth analysis of the basis for each new statutory provision, but rather to focus on surveying the new law with emphasis on major differences from prior Kentucky statutes.

I. SHARES

A. Powers Contained in the Articles of Incorporation

Under the new act, as under the old, the corporation is given the power to create and issue the number of shares authorized in its articles of incorporation. They may be par or no par shares and may be divided into one or more classes with such preferences and limitations as are set forth in the articles of incorporation. The new section allows the corporation to provide in its articles of incorporation for the issuance of shares of preferred or special classes: (1) subject to redemption at the price fixed by the articles of incorporation, (2)
entitling holders of such shares to cumulative, noncumulative or partially cumulative dividends, (3) entitling holders of such shares to a preference in the payment of dividends, or (4) entitling holders of such shares to a preference over any other class or classes of shares upon the voluntary or involuntary liquidation of the corporation. Because a class of shares may be more attractive with a conversion privilege, the new section also allows shares of preferred or special classes to be made convertible if a conversion privilege is recognized in the articles of incorporation. This privilege may permit the holder, at his option, to convert his shares at a designated ratio into shares of another class or any other series of the same class as long as there are no "upstream" exchanges. An "upstream" exchange is the transfer of shares of one class of stock for shares of a class having prior or superior rights or preferences as to the payment of dividends or the distribution of assets upon liquidation. A "downstream" transfer is just the opposite. In other words, the conversion of a senior security to a junior security is "downstream;" the conversion of a junior security to a senior security is "upstream." Prior Kentucky law allowed both an "upstream" and "downstream" conversion privilege. Specific guidelines appear in the present statute for the conversion of no-par shares into shares with par value. Shares conveying no par value cannot be converted into shares with par value unless that part of stated capital of the corporation that is represented by the no-par shares is

8 Cumulative dividends are those accrued dividends that must be paid in full, along with the dividend for the current fiscal period, before any dividend may be distributed to classes having subordinate dividend rights. H. Henn, Handbook of the Law of Corporations and Other Business Enterprises § 124, at 209 (2d ed. 1970) [hereinafter cited as H. Henn, Law of Corporations].

9 Noncumulative dividends are dividends unpaid in the past which do not accumulate and need not be paid before a dividend distribution on other shares, as long as the dividend preference for the current fiscal period is satisfied. Id.

10 Partially cumulative dividends are of a hybrid variety, giving preference to unpaid dividends of past fiscal periods only to the extent that there were then funds available to pay such dividends. Id.

11 KRSA § 271A.075(2) (b).

12 KRSA § 271A.075(2) (c).

13 KRSA § 271A.075(2) (d).

14 KRSA § 271A.075(2) (e).


16 KRSA § 271A.075(2) (e). The reason for the upstream exchange exception is that when shares are convertible into debt securities the shift from shareholder status to creditor status could prejudice the rights of other creditors. H. Henn, Law of Corporation § 160, at 298. This has been Kentucky's common law view. In re Phoenix Hotel Co., 83 F.2d 724 (6th Cir. 1936), aff'd 13 F. Supp. 239 (D. Ky. 1935) (preferred shares convertible into mortgage bonds were denied secured creditor status and were subordinated to general creditors in a federal reorganizational proceeding).

17 KRSA § 271.155(4).

18 Id.
equal to the aggregate value of the par value shares or unless a deficit resulting from any such transaction is made up out of earned surplus.  

Under the new act a corporation retains the authority to issue preferred or special classes of shares in series, as long as provision is made therefor in the articles of incorporation. All shares of the same class must be identical except for the following permissible variations between series: (1) the rate of dividend, (2) the price, terms, and conditions of redemption, (3) the amount payable in the event of involuntary or voluntary liquidation, (4) the amount deposited in sinking funds for redemption or purchase, (5) the terms and conditions of any conversion privilege, and (6) the voting of rights of different classes. These variations are quite similar to those in the prior statute as amended in 1970. Before 1970, the Kentucky statute contained two express reservations: (1) if the articles of incorporation vested authority in the board of directors to create a sinking fund for a series, the fund could not be created unless a provision equally beneficial existed or was to be created at the same time for all outstanding shares of the same class, and (2) there was no authority to vary voting rights between series.

The ABA Model Act recognized the practical importance of flexibility in allowing the board of directors to fix the conversion rate of convertible preferred shares. Preferred stock issued in different series which vary depending on the terms set by the board of directors

20 KRSA § 271A.080(1) is substantially the same as KRS § 271.155(5) of the old.
21 KRSA § 271A.080(1)(a) of the new act is identical to KRS § 271.155(5) of the old.
22 KRSA § 271A.080(1)(b) of the new act is identical to KRS § 271.155(5) of the old.
23 KRSA § 271A.080(1)(c) of the new act is identical to KRS § 271.155(5) of the old.
24 KRSA § 271A.080(1)(d) of the new act is identical to KRS § 271.155(5).
25 KRSA § 271A.080(1)(e) is identical to KRS § 271.155(5).
26 KRSA § 271A.080(1)(f). In constructing the voting rights provision under the old law, KRS § 271.155(1), the Court of Appeals held that a provision in the articles of incorporation of a county fair and development corporation providing that each share of stock should have one vote, but that no person, organization, or association, regardless of number of shares owned, should have more than four votes in any of the business on which shareholders might be called on to vote was valid. Deskins v. Lawrence County Fair & Dev. Corp., 321 S.W.2d 408 (Ky. 1959).
28 KRS § 271.155(5). It was recommended in the hearing that the following language of KRS § 271.155(5) be included in KRSA § 271A.080(1): "Different series of the same class of shares shall not be construed to constitute different classes of shares for the purpose of voting by classes under this section." However, the legislature deleted it. See KENTUCKY LEGISLATIVE RESEARCH COMMISSION, INFORMATIONAL BULL. No. 88, LEGISLATIVE HEARING: CORPORATION LAW 94 (1971) [hereinafter cited as LEGISLATIVE HEARING].
has been referred to as "blank stock." The freedom thereby given the board in the issuance of such shares has been criticized as giving the board the power to dilute the interest of existing shareholders.\(^{30}\) Provisions granting the board this freedom were included in the Model Act, and adopted by Kentucky,\(^{31}\) because the advantage of flexibility was believed to outweigh the possibility of harmful dilution.\(^{32}\) Moreover, there appears to be no justification for denying this freedom where the shareholders are willing to grant it.\(^{33}\) There was a departure from the Model Act in one instance; it was decided that additional leeway should be given the corporation by allowing the exchange of shares of one series that had been previously redeemed or reacquired for shares of another series.\(^{34}\) The practical effect of the change is one of expediency; a corporation may re-sell redeemed shares without filing a statement of cancellation.\(^{35}\)

In order for the board to establish a series, where authority for such action is contained in the articles of incorporation, a resolution must be adopted setting forth the terms of the series together with its relative rights and preferences.\(^{36}\) To be effective, the resolution must be filed with the Secretary of State;\(^{37}\) such filing constitutes an amendment to the articles of incorporation.\(^{38}\) This changes prior law, which did not require a statement to be filed reciting that the resolution was duly adopted\(^ {39}\) and the approval by the Secretary of State did not explicitly constitute an amendment to the articles of incorporation.\(^ {40}\)

\(^{30}\) Id.

\(^{31}\) KRS § 271A.080(2).


\(^{33}\) Id.

\(^{34}\) KRS § 271A.080(2). The language allowing the exchange of one series for another series was adopted from KRS § 271.155(6). This concept was initiated to allow a corporation to reissue shares that became available through redemption without going through the mechanics of cancellation. See Legislative Hearing, supra note 28, at 95. However, KRS § 271A.335 expressly states that a statement of cancellation must be filed if redeemable shares are redeemed. Therefore, the only time a statement of cancellation does not have to be filed is when shares other than redeemable shares are reacquired (KRS § 271A.340) and this is not a statutory requirement because reacquired shares would become treasury shares. Consequently it could be contended that the statutory language is surplusage. However it does have merit, for it seems to give the corporation the ability to change shares of one series held as treasury shares into shares of another series—a questionable procedure under the Model Act.

\(^{35}\) KRS § 271A.080(2). See note 180-99 and accompanying text infra.

\(^{36}\) KRS § 271A.080(3).

\(^{37}\) KRS § 271A.080(4). The statement filed with the Secretary of State must include: (1) the name of the corporation; (2) a copy of the resolution; (3) the date of adoption; (4) the statement that the resolution was duly adopted by the board; and (5) the signature in triplicate of either the president or vice-president and secretary or assistant secretary. Id.

\(^{38}\) KRS § 271A.080(6).

\(^{39}\) KRS § 271.155(8).

\(^{40}\) KRS § 271.155(8)(c).
However, the new statute retained the requirements that the statement be filed in triplicate\textsuperscript{41} and that a copy be filed with the County Court Clerk of the county in which the registered office of the corporation is located.\textsuperscript{42}

B. The Issuance of Shares

An individual, known as a subscriber,\textsuperscript{43} may agree to buy shares in a corporation to be organized. Such a subscription is irrevocable for a period of six months unless otherwise provided in the subscription agreement or unless all the subscribers consent to the revocation.\textsuperscript{44} This provision is more lenient than the prior statute which provided for revocation only on such grounds as existed at law and equity for rescission of a contract,\textsuperscript{45} or after a waiting period of one year from the date the agreement was signed.\textsuperscript{46}

Under the new act payment for the subscribed shares, whether before or after the organization of the corporation, must be made in full at the time of the subscription, or in such installments and at such times as the board of directors may determine, unless otherwise provided in the subscription agreement.\textsuperscript{47} If the subscriber becomes delinquent in his payments and is unable to complete his installments, the corporation can confiscate the shares and resell them, giving the subscriber any excess that is generated from the sale.\textsuperscript{48} The prior law provided that a sufficient number of shares, to cover the amount due

\textsuperscript{41}KRS § 271A.080(5).
\textsuperscript{42}KRS § 271A.080(5)(c).
\textsuperscript{43}KRS § 271A.010(5). A "subscriber" is one who subscribes for shares in a corporation, whether before or after incorporation. \textit{Id.} This definition is the same as in the previous statute, KRS § 271.006(3).
\textsuperscript{44}KRS § 271A.085(1). Although the prior statute did not expressly allow revocation if the other subscribers agreed, Kentucky’s common law view was that the subscriber could be released from his stock subscription where the corporation had no debts and had done no business. E & T Coal Co. v. Rogers, 288 S.W. 342 (Ky. 1926).
\textsuperscript{45}KRS § 271.075(2). This is a codification of the Kentucky common law which held that stock subscriptions, like other contracts, can be rescinded for fraud, but to rescind the subscriber must act promptly. Hatcher Power Shoe Co. v. Bickford, 278 S.W. 615 (Ky. 1925). As fraud is always a defense in contracts, this position must be considered as implicit in the new statute.
\textsuperscript{46}KRS § 271A.085(1)(a). However, if a certificate of incorporation was issued before the passage of one year, the subscription became irrevocable. KRS § 271.075(1)(b).
\textsuperscript{47}KRS § 271A.085(2). This provision of the new act is identical to KRS § 271.075(4) of the old.
\textsuperscript{48}KRS § 271A.085(2). The only instance where there can be a forfeiture of a subscriber’s partial payment is when the by-laws (not the articles) provide for other penalties and there is a written demand made on the subscriber twenty days prior to any action taken by the corporation. \textit{Id.}

The corporation in effect has a lien on the stock to secure the subscriber’s debt and can collect in event of default in the same manner as any other debt. \textit{Model Bus. Corp. Act Ann.} 2d § 17 ¶ 1 (1971).
plus interest and expense of the sale, could be sold at public auction in the event of default by the subscriber. However, if no person present bid the amount due on the shares, or an action at law was not pursued or a judgment was not satisfied, then the shares were forfeited to the corporation.

C. Payment for Shares

The Kentucky Constitution requires that no corporation shall issue stock except for an equivalent in money paid, labor done, or property actually received. Further, neither labor nor property shall be taken in payment for an amount greater than the fair market value of the property or service at the time of delivery. This section has been construed as denying a corporation the ability to issue bonds at a discount while allowing a new issue of capital stock to be sold at a fixed price greater than par provided the existing shareholders are given the right to purchase their proportionate part of the new issue.

The only statutory section in the new act regarding payment of shares which appears contrary to the Constitution is KRS § 271A.095 which omitted the following language of the Model Act: “Neither promissory notes nor future services shall constitute payment or part payment for the issuance of shares of a corporation.” This paragraph was amended in 1969 by the drafters of the Model Act to emphasize that the prohibition against issuing shares for future consideration was directed solely at payment upon original issuance and not to subsequent sales of shares. Yet the provision was deleted from Kentucky’s statute to allow the exercise of a stock option which would otherwise have expired because of the holder’s lack of funds. The

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49 KRS § 271.235.
50 Id.
51 KY. CONST. § 193. The wording of the Constitution was incorporated into KRS § 271.175.
52 Id.
53 A corporation has no power to issue or negotiate its bonds for less than their face value. Mayfield Water & Light Co. v. Graves County Bank & Trust Co., 185 S.W. 485 (Ky. 1916).
54 McClanahan v. Hiedelberg Brewing Co., 199 S.W.2d 127 (Ky. 1947). If Mayfield Water & Light Co. v. Graves County Bank & Trust Co., 185 S.W. 485 (Ky. 1916), note 53 supra, is read in conjunction with McClanahan v. Hiedelberg Brewing Co., the Kentucky Constitution would seem to allow the issuance of stock at a greater value than par and the issuance of bonds at a premium, but deny the issuance of stock at a value less than par and the issuance of a bond at a discount. Although there were no specific mandates within the prior statutes (KRS §§ 271.175, 271.185, 271.195) this idea would appear controlling. The new statute states that shares having a par value can be issued for any price in excess of par as shall be fixed by the board. KRS § 271A.090(1).
56 MODEL BUS. CORP. ACT ANN. 2d § 19 ¶ 2 (1971).
57 LEGISLATIVE HEARING, supra note 28, at 206 provides:

(Continued on next page)
change is a radical departure from the previous statute which not only prohibited issuance of shares for promissory notes and future services but considered an uncertified check as equivalent to a note. Although the aspirations of the committee were commendable, when the statutory provision is juxtaposed with the mandate of § 198 of the Constitution, the deletion likely will have no bearing on an individual's ability to purchase stock with a promissory note.

Under the new statutory section, the consideration for par value shares must at least equal the par value of the shares to be issued. No-par shares may be issued and treasury shares may be sold for such consideration as the board of directors may determine unless the articles of incorporation expressly reserve this right to the shareholders. A specific statutory guideline is included for the accounting treatment in the event of issuance of shares upon the conversion or exchange of indebtedness or shares. The language of the Model Act requiring that the consideration received be "expressed in dollars" was deleted from the Kentucky statute; "expressed in dollars" was included in the Model Act so that the amounts received could be represented on the balance sheet of the corporation. However, this wording could be considered as surplusage because translation to the balance sheet could not be made without a valuation in dollars.

(Footnote continued from preceding page)

Regulation "G" of the Federal Reserve Board severely restricts the large corporations' ability to loan money to their employees for the purpose of purchasing stock. *Id.* at 207.

It was recommended in the hearings that appropriate safeguards be employed in the statutes to insure that there would be no abuse by the corporation concerning the issuance of its stock. One such suggestion was that a corporation could issue its shares for promissory notes provided that the unpaid principal of such notes did not exceed an amount equal to 5% of the total of the corporation's stated capital and capital surplus calculated as of such date. *Id.* However, no safeguards were incorporated into the bill which passed. See KRS § 271A.095.

58 KRS § 271.185(1).
59 KRS § 271.185(3).
60 KRS § 271A.095.
61 KRS § 271A.090.
62 KRS § 271A.090(1).
63 KRS § 271A.090(2).
64 KRS § 271A.090(5). The consideration to be received for any conversion or exchange of shares shall be:

(1) The principal sum, with accrued interest, of the stated capital of the exchanged or converted shares; and

(2) That part of capital surplus transferred to stated capital upon the issuance of the shares; and

(3) Any additional consideration received by the corporation. *Id.*

65 ABA-ALI MODEL BUS. CORP. ACT § 18 (REV. ED. 1969).
66 *Id.*

67 MODEL BUS. CORP. ACT ANN. 2b § 18 1/2 (1971).
68 Moreover, the Kentucky Act drafters detected a discrepancy in the ABA-ALI Model Act that could result in an individual asset appraisal, in the event of a "pooling of interests," if the wording were left in the statute. See notes 166-79, 217, and accompanying text *infra.*
The statutory pattern of the Model Act with regard to payment for shares is varied in KRSA § 271A.095. The Kentucky statute is based upon language in the Kentucky Constitution.\(^{60}\) The new provision requires that where payment is made by other than an equivalent in money, the market value of services or property must be measured at the time the shares are issued.\(^{70}\) Once the payment for the shares has been received by the corporation the shares are deemed to be fully paid and nonassessable.\(^{71}\) Valuation of the property and services is important to existing shares vis-à-vis new shares because overvalued property or services unfairly dilutes the interests of existing shareholders\(^{72}\) and results in "watered stock."\(^{73}\) The judgment of the board as to the market value of the consideration received for the shares shall be conclusive unless the person questioning the market price can establish by a clear preponderance of the evidence that the valuation was in error.\(^{74}\) This is quite similar to the language in the prior statute.\(^{75}\)

If the stock is deemed "watered," the holder or subscriber to the shares is under a statutory obligation to pay the full consideration for which such shares were issued, to either the corporation or its creditors.\(^{76}\) To assure that a statutory obligation was imposed in Kentucky's new statute, the following phrase was added to the language of the Model Act: "[the full consideration for which such shares were issued] in no event shall be less than the consideration for which such shares could be lawfully issued, and otherwise [must] comply with the terms of the subscription..."\(^{77}\) This means a subscriber is individually liable for the par value of the shares issued,\(^{78}\) or, in the case of no-par shares, for the value of the shares as fixed by either the board of directors or the shareholders.\(^{79}\) If stock is issued for over-
valued property or services that has an actual worth exceeding the par value or fixed value of the stock when issued, then the persons appraising the consideration (shareholders or directors)\(^8\) may become liable for the difference between the inflated value and the actual value of the asset received.\(^8\) A transferee,\(^8\) fiduciary,\(^8\) or pledgee\(^8\) is insulated from individual liability, much the same as under prior law,\(^8\) and need not respond to the "watered stock" obligation of the original stockholder. The clear and concise wording of the new statute\(^8\) allays the many doubts as to the fixing of liability that existed because of the rather ambiguous wording of the prior law in its approach toward "watered stock."\(^8\)

A new section\(^8\) has been created to cover stock rights and stock options. Patterned after § 20 of the Model Act,\(^8\) it reflects the current corporate practice of requiring shareholder approval for the issuance of such options and rights. Again, as to the adequacy of the consideration received for the rights or options, the judgment of the board shall be conclusive in the absence of fraud.\(^8\) The concept that a certificate representing a share cannot be issued unless fully paid is retained.\(^8\)

\(^{80}\) KRSA § 271A.090(2).

\(^{81}\) Relevant to this issue in Kentucky is § 193 of the Ky. Const. which provides that consideration for shares shall not be overvalued. For a general discussion of liability as it relates to issuance of shares for overvalued consideration see W. Cary, Cases and Materials on Corporation 1106-16 (4th ed. unabridged 1969).

\(^{82}\) KRSA § 271A.125(2).

\(^{83}\) KRSA § 271A.125(3).

\(^{84}\) KRSA § 271A.125(4).

\(^{85}\) KRS § 271.215.

\(^{86}\) KRS § 271A.125.

\(^{87}\) KRS § 271A.125 and KRS § 271.175(1). The statutes were not clear as to whether a statutory obligation was present or whether it would be necessary to look to common law for liability. For a discussion of the types of liability that existed for the issuance and sale of "watered stock," see H. Henn, Law of Corporations § 171. For Kentucky's common law view, see Rice v. Thomas, 211 S.W. 428 (Ky. 1919).

\(^{88}\) KRSA § 271A.100.


\(^{91}\) KRSA § 271A.115. Failure to issue the certificate cannot affect the shareholder's rights in relation to the corporation where its officers have knowledge of the facts. Harlan Nat'l Bank v. Carbon Clow Coal Co., 289 S.W.2d 200 (Ky. 1956).
Various transactions (stock splits, reverse splits, reclassifications, mergers, consolidations, and share dividends) invest a shareholder with a right to fractional shares in a ratio that, when applied to a particular holder, does not produce an even multiple. KRSA § 271A.120 allows corporations, in such circumstances, to issue fractional shares which proportionally have all the rights of full shares or alternatively, to issue scrip or warrants with no rights. The corporation can pay the fair value to those entitled to the fractional share.

D. A Corporation's Acquisition and Disposition of Its Own Shares

The corporation has the right to acquire and dispose of its own

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92 Stock splits result when one share is divided into a larger number of shares.
93 Reverse splits result when a number of shares are joined to form a smaller number of shares.
94 Reclassification is the act of a corporation redistributing its outstanding shares of one group into another, or changing the relative rights and privileges of one group to correspond with the rights and privileges of another outstanding class of stock.
95 In a merger, one or more corporations is combined into another constituent corporation, known as the surviving corporation, with the result that the former ceases to exist and the latter's corporate existence continues. H. Henn, Law of Corporations § 346, at 713.
96 In the case of a consolidation, two or more constituent corporations cease to exist and a new consolidated corporation emerges. Id.
97 Share dividends are distributions to shareholders of additional shares of stock of the corporation making the distribution and are second only to cash dividends in frequency and amount. Id. at 670.
99 Where fractions of shares are issued, the rights to dividends, net assets on liquidation, and voting, as well as the preemptive rights of the holder are the same as those of the holder of full shares. KRSA § 271A.120(2). However, the issuance of fractional shares may create bookkeeping problems. H. Henn, Law of Corporations § 163, at 298. The only importance is the carrying of uneven share amounts on the books, and the balancing effect when trying to reconcile those shares actually issued to the total amount supposed to be issued.
100 KRSA § 271A.120(2).
101 Scrip is a certificate exchangeable for shares usually before a specified date. KRSA § 271A.120(3). Sufficient scrip to represent a whole share may be exchanged for a full share and is usually transferable. KRSA § 271A.120(1)(d). See H. Henn, Law of Corporations § 161, at 298, 299.
102 Corporations may issue share options which must be supported by consideration. These options are evidenced by share warrants and give the holders the right to buy a specified number of shares from the corporation at a specified price and usually within a specified time. H. Henn, Law of Corporations § 170, at 312, 313.
103 It is odd that warrants were included in KRSA 271A.120(1)(d) when provision was made for them in KRSA § 271A.100. Further, it is difficult to conceive of a situation where warrants would be interchangeable with fractional shares or scrip. For this reason, little benefit will be derived from their inclusion.
104 KRSA § 271A.120(1)(c).
shares\textsuperscript{105} just as it did under the prior statute.\textsuperscript{106} Purchase of such shares is permitted only to the extent of unrestricted or unreserved earned surplus\textsuperscript{107} unless the articles of incorporation permit the corporation to use unrestricted or unreserved capital surplus\textsuperscript{108} for the purchase, or the use of such surplus is authorized by a vote of the holders of a majority of the stock entitled to vote thereon.\textsuperscript{109} Each disposition of cash or the equivalent for the acquisition of shares must be reflected by a restriction on earned or capital surplus\textsuperscript{110} and must remain until the treasury shares\textsuperscript{111} are cancelled or resold.\textsuperscript{112} However, despite these restrictions, purchases may be made out of capital if the purchase or acquisition of the shares is for the purpose of: (1) eliminating fractional shares,\textsuperscript{113} (2) collecting or compromising indebtedness of the corporation,\textsuperscript{114} (3) paying dissenting shareholders entitled to payment for their shares under the provisions of KRSA Chapter 217A,\textsuperscript{115} and (4) effecting the retirement of its redeemable shares by purchase or redemption.\textsuperscript{116} The foregoing exceptions are subject to a qualification that no purchase or payment for its own shares shall be made by a corporation when it is insolvent\textsuperscript{117} or when the purchase or payment would make it insolvent.\textsuperscript{118} The basic test

\textsuperscript{105}KRSA § 271A.030(1).
\textsuperscript{106}KRSA § 271.135.
\textsuperscript{107}KRSA § 271A.010(12) provides:
' Earned surplus' means the portion of the surplus of a corporation equal to the balance of its net profits, income, gains and losses from the date of incorporation, or from the latest date when a deficit was eliminated by an application if its capital surplus or stated capital or otherwise, after deducting subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus. Earned surplus shall include also any portion of surplus allocated to earned surplus in mergers, consolidations, or acquisitions of all or substantially all of the outstanding shares or of the property and assets of another corporation, domestic or foreign. . .
\textsuperscript{108}KRSA § 271A.010(13). ''Capital surplus' means the entire surplus of a corporation other than its earned surplus.'’ \textit{Id.}
\textsuperscript{109}KRSA § 271A.030(1).
\textsuperscript{110}See note \textsuperscript{107}supra.
\textsuperscript{111}KRSA § 271A.010(8) provides:
' Treasury shares means shares of a corporation which have been issued, have been subsequently acquired by and belong to the corporation, and have not, either by reason of the acquisition or thereafter, been cancelled or restored to the status of authorized but unissued shares. Treasury shares shall be deemed to be 'issued’ shares, but not 'outstanding’ shares."
\textsuperscript{112}KRSA § 271A.030(1).
\textsuperscript{113}KRSA § 271A.030(2).
\textsuperscript{114}KRSA § 271A.030(3)(a).
\textsuperscript{115}KRSA § 271A.030(3)(b).
\textsuperscript{116}KRSA § 271A.030(3)(c).
\textsuperscript{117}KRSA § 271A.030(3)(d).
\textsuperscript{118}KRSA § 271A.080(4).
of prior law was whether the corporation’s capital would be impaired by the acquisition of its own stock. However, three exceptions were granted, allowing the corporation to acquire its own shares, regardless of capital impairment, if the purpose was to: (1) eliminate fractional shares, (2) collect or compromise claims of the corporation, or (3) pay dissenting shareholders entitled to payment for their shares in the event of a sale or exchange of assets. Moreover, if shares were to be retired, the “impairment of capital” test was to be replaced by a liquidity test, i.e., would the corporation be rendered incapable of paying its debts in the ordinary course of business? When a comparison is made between the new statute and the old, it becomes apparent that the new statute is more prohibitive. Now, a corporation can purchase its stock only from “unrestricted or unreserved” surplus unless the acquisition falls within one of the enumerated exceptions, and even then the corporation is subject to an “insolvency” test. Whereas prior law used the ambiguous “impairment of capital” standard, it granted the same exceptions as current law but only applied the “insolvency” test to transactions resulting in the retirement of its shares by redemption. The changes will allow the courts to apply a more objective standard but will restrict somewhat the ability of a corporation to purchase its own shares. The limitations are factual, current, and absolute, with the directors being held personally liable for violation.

II. Dividends

Profits are the objective of corporations and dividends are the means of distributing those profits to the shareholders. The board of directors has the responsibility for determining the timing, the amount, and the form of dividends. There are no criteria regarding when dividends must be paid, but there are general limits on the amount of and time when dividends may be paid: if there is no

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119 KRS § 271.135.
120 KRS § 271.135(1).
121 KRS § 271.135(2).
122 KRS § 271.135(3).
123 KRS § 271.135(4).
124 KRSA § 271A.030(1).
125 KRSA § 271A.030(2).
126 KRSA § 271A.030(3).
127 KRS § 271.135.
128 KRS § 271.135(1)-(3).
129 KRS § 271.135(4).
130 KRSA § 271A.240(1)(b).
132 KRSA § 271A.225(1).
"unreserved" or "unrestricted" earned surplus or if the payment will render the corporation insolvent\(^1\) then disbursement is prohibited to such extent.\(^2\) Historically, the term "dividend" implied division of profits with the payment coming from earned surplus;\(^3\) however, the new statute\(^4\) has relaxed this concept to a certain extent. An exception has been granted, allowing corporations to pay dividends not only out of "unreserved and unrestricted" earned surplus but also out of "unreserved and unrestricted" net earnings of the current fiscal year and the next preceding fiscal year taken as a single unit.\(^5\) This permits the payment of dividends even though there is no historical earned surplus.\(^6\) The prior law denied the board the ability to declare dividends if the payment would render the corporation insolvent or if the payment would "impair" the capital of the corporation.\(^7\)

Another interesting feature of the new Kentucky statute is that dividends may be paid out of a corporation's depletion reserves\(^8\) if the articles so provide.\(^9\) This applies only to corporations whose principal business is the exploitation of natural resources and recognizes to some extent the practice which developed among mining companies of not charging depletion against their profits;\(^10\) this treatment resulted in an overstatement of income for purposes of financial statement presentation to shareholders. The new statute\(^11\) does not permit profits to be portrayed without a charge for depletion but does not permit profits to be portrayed without a charge for depletion but does

\(^1\) KRSA § 271A.010(14). See note 117 supra. Under prior law, KRS § 271.265, the board of directors could declare dividends in cash or property unless: (1) the corporation was insolvent, (2) the payment would render the corporation insolvent, or (3) the payment would "impair" the capital of the corporation. Insolvency was determined by comparing the assets to the liabilities from both a balance sheet and fair market value standpoint. See Legislative Hearing, supra note 28, at 108.

\(^2\) KRSA § 271A.225(1).

\(^3\) KRSA § 271.265.


\(^5\) KRSA § 271.265.


\(^7\) KRSA § 271.265.

\(^8\) Depletion is the accounting process of allocating against periodic revenue the cost expiration of an asset represented by a natural resource. The depletion reserve is the accumulation of the periodic charge against the revenue. The corporate practice of paying dividends from the depletion reserves is common when there are no plans to replace the natural resource in kind and operations are to cease upon exhaustion of the deposit. The payment of the dividend from the reserves would be treated as a return of capital to the stockholders and would be reported as a deduction in the owners' equity section of the balance sheet. G. Welsch, C. Zlatkovich & J. White, Intermediate Accounting 510, 543-45 (5th ed. 1972).

\(^9\) KRSA § 271A.225(1)(b). Kentucky had no previous statutory provision allowing such payment.


\(^11\) KRSA § 271A.225.
acknowledge that depletion is a non-cash expense that in no way influences a corporation's ability to pay a cash dividend. Payment from the reserve is unlimited so long as the disbursement does not render the corporation insolvent. When dividends are paid from the reserve, notice must be given to the shareholders of the amount and source of all depletion distributions.\footnote{KRSA § 271A.225(1)(b).}

Unrealized appreciation\footnote{Unrealized appreciation exists when property, plant and equipment are written up by an entity to reflect appraisal, market or current values which are above cost. See RAPPAPORT, SEC ACCOUNTING AND PROCEDURE 3.9-3.16 (1963).} of fixed and permanent assets is not to enter into the measurement of funds available for dividends. To make certain this is apparent in the new act the following sentence was added to the Model Act's definition of earned surplus:\footnote{ABA-ALI MODEL BUS. CORP. ACT § 2(1) (rev. ed. 1969).} "Unrealized appreciation of assets is not included in earned surplus."\footnote{KRSA § 271A.010(12). See note 107 supra.} Under prior law,\footnote{KRSA § 271A.010(12) and KRSA § 271A.225(1).} using the "impairment of capital" test, dividends could be paid out of any surplus and any surplus created by a write-up of assets was available for distribution in the form of dividends as long as the corporation was not rendered "insolvent" thereby. When the results obtainable under the new\footnote{KRSA § 271A.225(1)(d)1.} and prior\footnote{KRSA § 271A.225(1)(d)2.} statutes are juxtaposed, it is apparent the new act is more stringent in application.

Rather than paying a dividend in cash, many corporations find it advantageous to distribute their own shares of stock (either unissued or treasury shares) to shareholders in a ratio commensurate with their ownership. Such a dividend is called a "stock dividend."\footnote{KRSA § 271A.010(12). See note 97 supra.} If the distribution is payable in shares having a par value then the aggregate par amount of all shares issued must be transferred to stated capital.\footnote{KRSA § 271A.225(1)(d)1.} In the event no par shares are issued, the board of directors must fix a value for the shares at the time the dividend is declared, and this amount must be transferred to stated capital with notification to the shareholders of the value assigned.\footnote{KRSA § 271A.010(12) and KRSA § 271A.225(1).} If treasury shares\footnote{KRSA § 271A.010(12) and KRSA § 271A.225(1).} are distributed to shareholders, the restriction on surplus is removed.\footnote{KRSA § 271A.225(1)(d)2.} No stock dividend can be paid in shares of one class to holders of any other class without approval of the shareholders.\footnote{KRSA § 271A.030(2).} This prohibits a
change in the relative rights of the shareholders without authorization.\textsuperscript{157}

While dividends generally may be paid only from earned surplus,\textsuperscript{158} distribution of cash or property to the extent of capital surplus may be made if: (1) the corporation is solvent and such distribution will not render it insolvent;\textsuperscript{159} (2) the articles permit or the distribution is authorized by a majority of shareholders;\textsuperscript{160} (3) all cumulative dividends have been paid;\textsuperscript{161} (4) the distribution will not reduce the net assets of the corporation below the aggregate amount necessary to pay the holders of preferential shares in the event of involuntary liquidation;\textsuperscript{162} and (5) the distribution of capital surplus is disclosed to the shareholders.\textsuperscript{163} The board of directors may also make distributions from capital surplus to holders of stock having cumulative dividend rights in order to keep arrearages from arising when there is no earned surplus available.\textsuperscript{164} To avoid any misconception in the event of such a distribution, the corporation must reveal the source of payment to the shareholder.\textsuperscript{165}

III. \textit{Other Financial Aspects}

\subsection*{A. Accounting Aspects}

Of all the statutory enactments within House Bill 178 relating to financial matters, KRSA § 271A.105 is the most comprehensive and will have the most far-reaching effect on Kentucky corporations. If a corporation issues par value shares, the consideration received constitutes stated capital to the extent of the par value of the shares and any excess constitutes capital surplus;\textsuperscript{168} if a corporation issues no par shares, the entire consideration constitutes stated capital unless within 60 days the board allocates a portion to capital surplus.\textsuperscript{167} Stated capital can be increased by action of the board of directors in making

\begin{itemize}
\item \textsuperscript{157} \textit{Model Bus. Corp. Act Ann.} 2d § 45(c)-(e) \& 2 (1971).
\item \textsuperscript{158} KRSA § 271A.225(1)(a). However, there is an exception in KRSA § 271A.225(1)(b) that allows the payment of dividends out of depletion reserves.
\item \textsuperscript{159} KRSA § 271A.230(1)(a).
\item \textsuperscript{160} KRSA § 271A.230(1)(b).
\item \textsuperscript{161} KRSA § 271A.230(1)(c).
\item \textsuperscript{162} KRSA § 271A.230(1)(d).
\item \textsuperscript{163} KRSA § 271A.230(1)(e).
\item \textsuperscript{164} KRSA § 271A.230(2).
\item \textsuperscript{165} \textit{Id.}
\item \textsuperscript{166} KRSA § 271A.105(1).
\item \textsuperscript{167} KRSA § 271A.105(2). The allocation to surplus is limited to the consideration received for the shares in excess of any preference in the assets of the corporation in the event of involuntary liquidation.
\end{itemize}
a transfer from either earned or capital surplus.\textsuperscript{168} These concepts are simple and are quite similar to the prior statutory provision.\textsuperscript{169} However, a problem arises in determining what figure is assigned to stated capital, as well as in valuing the constituent corporations' assets and liabilities in the event of a merger, a consolidation, or an acquisition: the valuation being dependent upon generally accepted accounting principles.\textsuperscript{170} This means that any combination of two or more corporations that meets the guidelines for pooling of interests \textit{must} be treated and valued by the pooling of interests method of accounting and that any combination that does not meet these guidelines \textit{must} be treated as a purchase and valued by the purchase method of accounting.\textsuperscript{171} As this is a statutory mandate, it is advisable for the attorney to be aware of the heterogeneous results obtainable under the different theories—the purchase method of accounting is the antithesis of the pooling of interests method. Both methods are acceptable in accounting for two distinct business combinations, although not as alternative accounting procedures for the same business combination. To elaborate more fully upon the requirements necessary for proper accounting treatment of the resulting combination as well as the valuations accorded the assets of the transferring corporation, the following synopsis of \textit{Accounting Principles Board Opinion Number 16} is presented.

1. \textit{Conditions for Pooling of Interests Methods}\textsuperscript{172}

The pooling of interests method of accounting is intended to present as a single interest two or more common stockholders' interests which were previously independent and the combined rights and risks represented by those interests. This method reflects only an exchange of voting stock in a ratio of the respective shareholders' ownership in

\textsuperscript{168} KRS § 271A.105(4). The prior act also provided for a "pooling of interests." After any merger, consolidation, or acquisition of substantially all the outstanding shares or the property and assets of another corporation, the amount of earned surplus of the surviving corporation could equal but not exceed the aggregate net earned surplus of the component corporations. In the event no par shares were issued, the consideration received constituted capital, but the board of directors had one year after the issue to allocate a portion of the consideration to be paid in surplus or earned surplus. KRS § 271.258. Prior to 1970, the Kentucky statute did not expressly provide for a "pooling of interests" accounting method. KRS § 271.266. See notes 172-79 and accompanying text infra.

\textsuperscript{169} KRS § 271.258.

\textsuperscript{170} KRS § 271A.105(3).

\textsuperscript{171} \textit{APB Accounting Principles, APB Opinion No. 16, Business Combinations (August 1970)} [hereinafter cited as APB Opinion No. 16]

\textsuperscript{172} The discussion that follows concerning the purchase and pooling of interests methods of accounting for various corporate combinations was to a great extent taken from APB Opinion No. 16, supra note 171, at §§ 1091.45-1091.69.
the combined corporations and recognizes that there is neither a withdrawal nor an investment of other assets. In order to use this accounting method certain requirements must be met relating to (1) the attributes of the combining companies, (2) the manner of combining the interests, and (3) the absence of planned transactions.

a. Attributes of Combining Companies

First, in examination of the attributes of the combining companies, a dual criterion emerges—in coalescence, the corporations must be both autonomous and independent. For a corporation to be autonomous it must not have been a subsidiary or division of another corporation within two years before the plan of combination was initiated. A plan of combination is considered "initiated" on the earlier of (1) the date the major terms of the plan are announced publicly or formally to the shareholders of one of the combining companies, or (2) the date the shareholders of a combining company are notified in writing of an exchange offer. Independence, on the other hand, looks to the interrelated stockholdings of the corporations—at the date the plan of combination is initiated, the combining companies can hold no more than 10% of the outstanding voting common stock of any combining company as an intercorporate investment.

b. Combining of Interests

Second, the combination must be effected in a single transaction or completed in accordance with a specified plan within one year after the plan is initiated. As the separate shareholder interests lose their identities and all share mutually in the combined risks and rights of the surviving corporation, there must be no alteration giving preferential rights or claims to specific shareholder groups. The transaction qualifies for a "pooling of interests" only if the corporation offers and issues common stock with rights identical to those of the majority of its outstanding voting stock in exchange for substantially all of the voting common stock of another company at the date the plan of combination is consummated. Substantially all of the voting common stock means 90% or more. In order to fulfill this condition the issuing corporation must issue voting common stock in exchange for at least 90% of the voting common stock of another combining company that is outstanding at the date the combination is consummated. Significant problems may be encountered concerning the treatment of intercompany investments and combinations. For example, one may find that even though 90% or more of the outstanding common shares of an
issuing corporation are exchanged, the 90% test will still not be satisfied because of required adjustments to the shares.173

c. Absence of Planned Transaction

Finally, certain terms dealing with future transactions are prohibited as inconsistent with the combination of the entire existing interests of common stockholders. In any negotiations the combined corporation must not: (1) agree directly or indirectly to retire or reacquire all or part of the common stock issued to effect the combination, (2) enter into other financial arrangements for the benefit of the former stockholders of a combining company, such as a guaranty of loans secured by stock issued in the combination, which in effect negates the exchange of equity securities, and (2) intend or plan to dispose of a significant part of the assets of the combining companies within two years after the combination, other than disposals in the ordinary course of business of the formerly separate companies and elimination of duplicate facilities or excess capacity.

2. Application of Purchase Method

If the transaction does not meet the requirements of the “pooling of interests” method then it must be accounted for by the “purchase” method. The applicable principles are dependent upon the nature of the transactions: (1) an asset acquired by exchanging cash or other assets is recorded at cost; (2) an asset acquired by incurring liabilities is recorded at cost; and (3) an asset acquired by issuing shares of stock of the acquiring corporation is recorded at the fair value of the asset. A practical supplement to these general principles is that assets acquired for other than cash, including shares of stock issued, should be stated at cost when they are acquired and cost may be determined either by the fair value of the consideration given or by the fair value of the property acquired, whichever is the more clearly evident. Assets acquired in groups require not only ascertainment of the cost of the assets as a group but also allocation of the cost among the individual assets which comprise the group. The difference between the sum of the net assigned costs of the acquired assets and the consideration given constitutes goodwill.

3. A Comparison of the Methods

Although there are numerous complexities in the application of the “purchase” method and “pooling of interests” method of accounting, their general characteristics are listed seriatim:

173 See note 176 and accompanying text infra.
a. **Purchase Method**\(^{174}\)

(1) The assets and liabilities of the acquired corporation are reported by the acquiring corporation at cost at date of acquisition, with cost being the price paid for the acquired corporation and equaling the *fair market value* at that date.

(2) Individual assets acquired are reported at their *fair market value* at date of acquisition and liabilities are reported at their present "debt" values.

(3) The difference between the total purchase cost and the *fair market value* of the assets received is "goodwill."

(4) The earned surplus balance of the acquired corporation is eliminated; it is not carried forward to the surviving corporation.

b. **Pooling of Interests**\(^{175}\)

(1) The assets and liabilities of the combining corporations are reported at the previously established *book values* of each.

(2) No goodwill results from the combining of the corporations.

(3) The earned surplus balances of the combining corporations are added to determine the earned surplus balance of the combined corporations at date of acquisition.

To illustrate the ramifications of the purchase and pooling methods, consider the following hypothetical case: Corporations X and Y are planning a merger. Corporation X is going to issue its stock in a ratio of 1:2 for all of corporation Y's outstanding stock. Each company has an investment in the other company constituting 1,000 shares of common stock. Both corporations have 20,000 shares of common stock outstanding with a $10 par value. The following balance sheets portray the holdings of the two corporations (Table 1):

<table>
<thead>
<tr>
<th>TABLE No. 1</th>
<th>X</th>
<th>Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>$200,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Plant and Equipment</td>
<td>375,000</td>
<td>250,000</td>
</tr>
<tr>
<td>Investments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1,000 Shares of X Corporation</td>
<td>25,000</td>
<td>50,000</td>
</tr>
<tr>
<td>1,000 Shares of Y Corporation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Investments</td>
<td>$600,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>50,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Common Stock—$10 Par With</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20,000 Shares Outstanding</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Stated Capital</td>
<td>150,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Earned Surplus</td>
<td>200,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Total</td>
<td>$600,000</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

---


\(^{175}\) Id.
Is this a pooling of interest or a purchase? The statute states that if substantially all the assets of a corporation are acquired by the issuance of shares the transaction will be treated as a “pooling of interests” if the transaction meets generally accepted accounting principles.\textsuperscript{176} Generally accepted accounting principles define “substantially” as requiring that one corporation issue voting common stock in exchange for at least 90\% of the voting common stock of another combining company that is outstanding at the date the combination is consummated. At first glance, the hypothetical transaction appears to satisfy the “substantially” test; however, certain adjustments must be made because each corporation has an investment in the common stock of the other. These adjustments are illustrated in the following passage from \textit{Accounting Principles Board Opinion Number 16}:

\textit{Reduction for Intercorporate Investments.} The number of issued shares of voting common stock applicable to the voting common stock interests of the transferor combining company (Corporation Y) is reduced by the sum of (1) the number of shares of voting common stock of the issuing corporation (Corporation X) held by the transferor combining company (Corporation Y) at the date the plan of combination is initiated plus shares it acquired after that date and (2) the number of shares of voting common stock of the transferor combining company (Corporation Y) held by the issuing corporation (Corporation X) at the date the plan of combination is initiated plus shares it acquired after that date.\textsuperscript{177}

This would mean that the 20,000 issued shares of Corporation Y would be reduced by 3,000 shares (1,000 shares held by Corporation X and 2,000 equivalent shares held by Corporation Y as an investment in Corporation X at a 2:1 ratio), leaving only 17,000 shares on which to base the 90\% factor. When the 20,000 total issued shares is multiplied by the 90\% factor, the “pooling of interest” requirements are not met and the transaction must be treated as a purchase. The costs are allocated among the assets and liabilities with the following results:

\begin{table}
\begin{tabular}{|l|c|c|c|c|}
\hline
\textbf{Balances Per} & \textbf{Eliminations} & \textbf{Credit} & \textbf{Consolidated} \\
\textbf{Books of} & \textbf{Debit} & & \\
\textbf{Corp. X} & \textbf{Corp. Y} & & \\
\hline
\textbf{Current Assets} & \$200,000 & \$100,000 & $ & \$10,000 & \$290,000 \\
\hline
\textbf{Plant and Equipment} & \$375,000 & \$250,000 & (2) & \$100,000 & \$725,000 \\
\hline
\textbf{Investments} & & & & & \\
\textbf{1,000 sh.-X} & \$50,000 & (2) & 50,000 & (Continued on next page) \\
\textbf{1,000 sh.-Y} & \$25,000 & (1) & 25,000 & \\
\hline
\end{tabular}
\end{table}

\textsuperscript{176} KSRA § 271A.105(3).
\textsuperscript{177} APB OPINION No. 16 § 1091.68, \textit{supra} note 171, at 931.
**TABLE No. 2 (Continued)**

<table>
<thead>
<tr>
<th>Balances Per Books of</th>
<th>Eliminations and Adjustments</th>
<th>Debit</th>
<th>Credit</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corp. X</td>
<td>Corp. Y</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$600,000</td>
<td>$400,000</td>
<td>100,000</td>
<td></td>
<td>$1,115,000</td>
</tr>
</tbody>
</table>

- **Differential Liabilities**
  - $50,000

- **Common Stock—$10 Par**
  - Co. X: 20,000 sh. @ $200,000
  - Co. Y: 20,000 sh. @ $200,000

- **Stated Capital**
  - Co. X: $150,000
  - Co. Y: $50,000

- **Earned Surplus**
  - Co. X: $200,000
  - Co. Y: $50,000

- **Treasury Stock**
  - $100,000

---

1. Consideration given for purchase of Y—100% interest.
2. To apportion the differential on the basis of fair values at date of acquisition.

**Computation of Goodwill**

- **Purchase Price**
  - 9,500 shares at $50 (FMV)
  - Investment in Y Corporation: $475,000
  - Total: $500,000

- **Book Value**
  - $300,000

- **Differential**
  - $200,000

**Allocation (Market value minus book value)**

- Current Assets ($60,000-$100,000) = $(10,000)
- Property and Equipment ($350,000-$250,000) = $100,000
- Liabilities ($90,000-$100,000) = $10,000

**Balance to Goodwill**

- $100,000

---

**The journal entries for the transaction are as follows:**

1. **Common stock (Co. Y)** $200,000
   - Stated Capital (Co. Y) 50,000
   - Earned Surplus (Co. Y) 50,000
   - Differential $200,000

2. **Current liabilities** $10,000
   - Plant and Equipment 100,000
   - Goodwill 100,000
   - Treasury stock $50,000
   - Investment $50,000
   - Current Assets 10,000
   - Differential $200,000

To record the fair values of the assets and liabilities transferred at date of acquisition.

---

**Notes:**

- The differential on the basis of fair values at date of acquisition.
- The journal entries for the transaction are as follows:
  1. **Common stock (Co. Y)** $200,000
  2. **Current liabilities** $10,000

---

**178** The journal entries for the transaction are as follows:

1. **Common stock (Co. Y)** $200,000
   - Stated Capital (Co. Y) 50,000
   - Earned Surplus (Co. Y) 50,000
   - Differential $200,000

2. **Current liabilities** $10,000
   - Plant and Equipment 100,000
   - Goodwill 100,000
   - Treasury stock $50,000
   - Investment $50,000
   - Current Assets 10,000
   - Differential $200,000

To record the fair values of the assets and liabilities transferred at date of acquisition.
If the stock-holdings of Corporation Y had been in another corporation (Corporation Z), then the transaction would have qualified for a “pooling of interests” with the following accounting treatment resulting:

### TABLE No. 3

<table>
<thead>
<tr>
<th>Balances</th>
<th>Corp. X</th>
<th>Corp. Y</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>$200,000</td>
<td>$100,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Plant and Equipment</td>
<td>375,000</td>
<td>250,000</td>
<td>625,000</td>
</tr>
<tr>
<td>Investments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1,000 sh.-Y</td>
<td>25,000</td>
<td></td>
<td>(1) 25,000</td>
</tr>
<tr>
<td>1,000 sh.-Z</td>
<td></td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$600,000</td>
<td>$400,000</td>
<td><strong>$975,000</strong></td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common Stock—$10 Par</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Co. X-20,000 sh.</td>
<td>200,000</td>
<td></td>
<td>(1) 95,000</td>
</tr>
<tr>
<td>Co. Y-20,000 sh.</td>
<td></td>
<td>200,000</td>
<td>(1) 200,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>400,000</td>
<td>400,000</td>
<td>800,000</td>
</tr>
</tbody>
</table>

(1) Issuance of stock for pooling of interests and recordation of excess of par into stated value.

When a comparison is made of the results obtained by use of the “pooling of interests” method and the “purchase” method, a different valuation of the assets, liabilities, and stockholders’ equity is evident. The purchase method recognizes an increase in the fair market value of the assets of the combining corporation (Corporation Y) and gives a higher depreciable base. Earned surplus is attributable only to the issuing corporation and there is a restriction on the retained earnings in the amount of treasury stock obtained. The common shares issued are valued at current market value and the amount in excess of par is credited to stated capital. On the other hand, the pooling of interest concept recognizes only the book value of the assets of the transferor corporation (Corporation Y) and the par value of the exchanged com-

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179 The journal entry for the transaction is as follows:

(1) Common Stock (Co. Y) $200,000

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments</td>
<td>$25,000</td>
</tr>
<tr>
<td>Common Stock (Co. X)</td>
<td>95,000</td>
</tr>
<tr>
<td>Stated Capital (Co. X)</td>
<td>80,000</td>
</tr>
</tbody>
</table>

To record issuance of stock for pooling of interests and recordation of excess of par into stated value.
mon shares of the issuing corporation (Corporation X). The practicing attorney should be aware of the differences obtainable in valuation, and before the combination of two or more corporations is finalized he should seek the advice of a Certified Public Accountant.

B. Redemption and Cancellation of Shares

Under Kentucky’s new corporation statute, specific statutory treatment is given for the first time to the redemption and cancellation of redeemable180 and reacquired shares.181 When redeemable shares of a corporation are acquired by the corporation, the acquisition effects a cancellation of the shares:182 the redeemable shares cannot be treated as treasury stock.183 The shares are then restored to the status of authorized or unissued shares unless the articles of incorporation declare that the shares cannot be reissued.184 In either event a statement of cancellation185 must be filed quarterly186 with the Secretary of State, and must contain the following information: (1) the name of the corporation, (2) the number of redeemable shares cancelled, (3) the aggregate number of shares issued remaining after the cancellation, (4) the amount of stated capital of the corporation remaining after the cancellation, (5) the number of authorized shares of the corporation remaining after the cancellation if the articles of incorporation provide that the shares cannot be reissued.187 If the shares cannot be reissued, the statement of cancellation constitutes an amendment to the articles of incorporation.188

When non-redeemable shares are reacquired, there is no statutory requirement that they be cancelled;189 therefore the board of directors has the option to hold the shares as treasury stock.190 If the shares are cancelled, the effect is the same as in the case of redeemable shares;191

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180 KRSA § 271A.335.
181 KRSA § 271A.340.
182 KRSA § 271A.335(1).
183 KRSA § 271A.010(8). See note 111 supra.
184 KRSA § 271A.335(1).
185 KRSA § 271A.335(2) and KRSA § 271A.340(2). An example of the adverse consequences which may result from failure to file the statement of cancellation is illustrated by Kleinberg v. Schwartz, 208 A.2d 803 (N.J. 1965), which held that even though the corporation had an adequate surplus when it agreed to purchase defendant’s shares, defendant was liable to creditors for a payment he received from capital where the corporation failed to publish a certificate of reduction of capital.
186 The quarterly report frees large businesses trading in their own shares from having to make daily reports as required in the ABA-ALI MODEL BUS. CORP. ACT (rev. ed. 1969), LEGISLATIVE HEARING, supra note 28, at 106.
187 KRSA § 271A.335(2) and KRSA § 271A.340(2).
188 KRSA § 271A.335(1).
189 KRSA § 271A.340(1).
190 Compare KRSA § 271A.335(1) with KRSA § 271A.340(1).
the stated capital is reduced, thereby eliminating the restriction on earned surplus,\textsuperscript{192} and the shares are restored to the status of authorized but unissued shares.\textsuperscript{193} If the shares are held as treasury stock, the stated capital remains unchanged but a restriction is imposed upon earned surplus until the treasury shares are sold.\textsuperscript{194}

The new act contains a restriction on the authority of a corporation to redeem or purchase redeemable shares. If a corporation is insolvent or if the purchase or redemption would render it insolvent, the corporation is prohibited from making such a redemption.\textsuperscript{195} This is an outgrowth of the fundamental rule that a corporation may not transfer any asset before provision is made for creditors.\textsuperscript{196} A further restriction exists if the purchase or redemption would reduce the net assets of the corporation below the aggregate required to satisfy the holdings of the shareholders having prior or equal rights to the assets in the event of an involuntary liquidation.\textsuperscript{197} Thus, the contractual rights of equal or senior classes of shares are fully protected.\textsuperscript{198} Under prior law redemption of shares was restricted if the acquisition would render the corporation incapable of paying its debts in the ordinary course of business.\textsuperscript{199}

C. Stated Capital

The stated capital of a corporation may be reduced by cancellation of shares,\textsuperscript{200} by amendment to the articles of incorporation,\textsuperscript{201} or by a resolution adopted by the board of directors and approved by a majority of the shareholders.\textsuperscript{202} In the latter case, after such a resolution has been approved, a statement outlining the changes in stated

\textsuperscript{192} MODEL BUS. CORP. ACT ANN. 2D \S 68 \S 2 (1971).
\textsuperscript{193} KRSA \S 271A.340(4).
\textsuperscript{194} MODEL BUS. CORP. ACT ANN. 2D \S 68 \S 2 (1971). KRSA \S 271A.030(2).
\textsuperscript{195} KRSA \S 271A.330.
\textsuperscript{196} MODEL BUS. CORP. ACT ANN. 2D \S 66 \S 2 (1971).
\textsuperscript{197} KRSA \S 217A.330.
\textsuperscript{198} MODEL BUS. CORP. ACT ANN. 2D \S 66 \S 2 (1971). The charter provision in regard to the redemption or purchase is one that merely creates the privilege on the part of the corporation. Stock may be issued with a provision for a sinking fund or with a covenant to redeem either at a fixed date or on a stated contingency or on the demand of the shareholders, but such covenants, however absolute in appearance, are nevertheless subject to the two fundamental limitations expressed in this section. \textit{Id.} See KRSA \S 271A.075 (authority to create redeemable shares); KRSA \S 271A.030 (right to acquire or dispose of shares); KRSA \S 271A.335 (cancellation of redeemable shares); and KRSA \S 271A.290 (power to modify redemption provisions by charter amendment).
\textsuperscript{199} KRSA \S 271A.305(5). For the general authority to amend the articles of incorporation see KRSA \S 271A.290.
\textsuperscript{200} KRSA \S 271A.335 and KRSA \S 271A.340.
\textsuperscript{201} KRSA \S 271A.305(5).
capital must be delivered to the Secretary of State. Upon the filing of the statement by the Secretary of State, the stated capital is reduced as provided in the resolution. When stated capital is reduced, a corresponding amount of capital surplus can be created which may be distributed to the shareholders in a manner prescribed in KRSA § 271A.230; alternatively, if a deficit exists, the newly created capital surplus may be applied against such deficit by resolution of the board of directors. The only restriction on the ability of the corporation to reduce stated capital in this manner is the requirement that the remaining amount may not be less than the aggregate preferential amounts payable upon all issued shares having a preferential right in the event of involuntary liquidation plus the par value of all other issued shares having a par value. Under the prior statutory section the articles of reduction were required to state that the proposed reduction would not reduce the fair value of the assets of the corporation to an amount less than the total amount of its debts and liabilities and would not render the corporation incapable of paying its debts in the ordinary course of business.

The reduction of stated capital through the special corporate proceedings discussed above may augment the capital surplus of the corporation, but such surplus may also be increased by a resolution of the board directing the transfer of funds from earned surplus. If the board wishes to use capital surplus to reduce or eliminate a deficit the corporation must first use its earned surplus for this purpose before applying any of the capital surplus toward reduction of the deficit. This requirement is necessary to prevent a reduction of capital surplus to wipe out a deficit while retaining an illusory earned surplus. Reserves are authorized, and to the extent funds are reserved they are not available for dividends or other such distribution.

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203 KRSA § 271A.345(4).
204 KRSA § 271A.350.
205 MODEL BUS. CORP. ACT ANN. 2D § 69 f 2 (1971).
206 KRSA § 271A.345(5).
207 KRSA § 271A.460.
208 LEGISLATIVE HEARING, supra note 28, at 107.
209 KRS § 271A.345. Special corporate proceedings include a majority vote of the shareholders and a filing of a statement of reduction with the Secretary of State.
210 KRSA § 271A.350(1).
211 KRSA § 271A.350(2). This section corresponds with KRSA § 271A.105(4) which permits either earned or capital surplus to be transferred to stated capital.
212 KRSA § 271A.350(3).
213 Id.
214 MODEL BUS. CORP. ACT ANN. 2D § 70 f 2 (1971).
215 KRSA § 271A.350(4).
CONCLUSION

The corporate finance sections of the new Kentucky Corporation Act are a vast improvement over the prior statutory sections. As a whole the additions to and the deletions from the statutory model were well considered and did not destroy the continuity of the act. An illustration of the scrutiny and forethought given to the enactment of Chapter 271A is contained in KRSA § 271A.105. The legislative committee on corporations detected an inconsistency in the Model Act that did not allow corporations to effect a combination under the "pooling of interests" approach. The wording of the statutory model was then changed to encompass generally accepted accounting principles thereby insuring the availability of all alternative methods of asset valuation to Kentucky corporations. The Kentucky Act, although not achieving complete coverage for all corporate problems, does illustrate that Kentucky is keenly interested in the financial problems encountered by entities doing business in the corporate form.

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217 ABA-ALI MODEL BUS. CORP. ACT (rev. ed. 1969). The following language of § 21(c) of the Model Act was deleted from KRSA § 271A.105(3):
If shares have been or shall be issued by a corporation in merger or consolidation or in acquisition of all or substantially all of the outstanding shares or of the property and assets of another corporation, whether domestic or foreign, any amount that would otherwise constitute capital surplus under the foregoing provisions of this section may instead be allocated to earned surplus by the board of directors of the issuing corporation except that its aggregate earned surplus shall not exceed the sum of the earned surpluses as defined in this Act of the issuing corporation and of all other corporations, domestic or foreign, that were merged or consolidated or of which the shares or assets were acquired.
Also omitted from the Kentucky section, KRSA § 217A.090, was the term dollars as found in § 18 of the Model Act. Had the foregoing language been left in the statute, it would have required the board of directors to specifically value each of the assets received in the combination and thereby circumvent the concept of a basis carryforward as contemplated by the "pooling of interests" approach.
218 KRSA § 271A.105(3).