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The Close Corporation Under Kentucky Law

By WILLBURT D. HAM

During the present century the tendency in corporation law, for the most part, has been to concentrate attention on the problems of the public issue corporation rather than on those of the closely held corporation. Much has been written as to the need for further legislation at both the federal and state level that would encourage greater participation by shareholders in the affairs of the public issue corporation, thereby promoting greater "corporate democracy." This interest in the public issue corporation is understandable when one considers the tremendous impact that such corporations have on our economy and our way of life. The sheer size of these corporations and the magnitude of their operations give to them a prominence which tends to obscure the fact that many small closely held business enterprises operate within the corporate framework and the fact that these close corporations also play a significant role in the functioning of our economic system. As one commentator has pointed out, "the close corporation is probably the most prevalent form of

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1 See, e.g., Emerson & Latcham, Shareholder Democracy (1954); Gilbert, Dividends and Democracy (1956); Caplin, Shareholder Nominations of Directors: A Program for Fair Corporate Suffrage, 39 Va. L. Rev. 141 (1953).


4 While it is perhaps customary to think of the close corporation as involving a relatively small business enterprise and while that is the emphasis intended in the present article, close corporations are by no means always small enterprises. The Ford Motor Company, which until recent years was a family-owned corporation, provides a good example of the close corporation operating in the field of "big business." See Scott, The Close Corporation in Contemporary Business, 18 Bus. Law. 741, 742 (1958).
business entity in use in the United States," and "it is probably the only form of corporation with which a large proportion of lawyers are familiar." 

Recently, the legal profession has shown a growing interest in the closely held corporation and a considerable number of articles, as well as a two-volume treatise, have been written dealing with the problems of such corporations. This recent literature has made it evident that in the past courts and legislatures have not always given sufficient consideration to the peculiarities of the close corporation to enable the participating shareholders in these corporations to adapt the corporate form to the needs of their business venture.

The close corporation is characterized by its limited membership, restricted trading in stock, and identity of ownership and management. These attributes indicate that the aims of the participants in such a corporation are likely to be quite different from those of the typical investor in the public issue corporation, whose primary objective usually is to find a suitable source of investment for his funds without the need for active participation on his part in the management of the enterprise.

The one-man company represents the close corporation in its most extreme form. Moreover, the one-man company, by its very nature, gives rise to problems that are not always identical with those of the company which has several participants, all of whom may take an active part in the enterprise. Therefore, the legal status of the one-man company under Kentucky law will be examined first, after which consideration will be given to the close corporation with two or more active members.

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5 Id. at 741-42.
8 For a more complete discussion of the attributes of the close corporation, see 1 O'Neal, *Close Corporations* § 1.07 (1958). One writer has observed that "no satisfactory all-purpose definition of a close corporation appears ever to have been worked out." Israels, supra note 6, at 491.
THE ONE-MAN COMPANY

The one-man company has generally received judicial approval in this country, although the real owner of the business has frequently found it necessary to make use of "dummy" incorporators, "dummy" directors, and even "dummy" associates, to enable him to comply with the technical requirements of the applicable corporation statute.10

Most states still retain the requirement of a minimum of three incorporators who must sign and acknowledge the articles of incorporation.11 Most states likewise still retain the requirement that the corporation be managed by a board of directors of at least three persons elected by the shareholders.12 While these requirements are now viewed by many as useless formalities in the creation and operation of the one-man company,13 the requirements must nevertheless be met if the organization of even these corporations is to be perfected according to law.

Furthermore, unexpected risks may lurk in a disregard of organizational formalities. For example, the Kentucky general corporation statute14 provides that no corporation shall incur any debts or begin the transaction of any business (except such as is incidental to its organization) until, among other things, the first board of directors has been elected by the shareholders,15 and

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9 1 O'Neal, Close Corporations § 1.05, at 6 (1958).
10 See Fuller, *The Incorporated Individual: A Study of the One-Man Company*, 51 Harv. L. Rev. 1373, 1375 (1938). For a case in which the court recognized the use of "dummy" incorporators, see State v. Miner, 233 Mo. 312, 135 S.W. 483 (1911). But see Montgomery v. Forbes, 148 Mass. 249, 19 N.E. 342 (1889), where a statute required five "associates" and the court held that use of four nominal associates, along with other organizational defects, resulted in no corporation being formed.
12 Id. § 133.
13 See, e.g., Latty, *The Close Corporation and the New North Carolina Business Corporation Act*, 94 N.C.L. Rev. 432, 443 (1956). In 1 Hornstein, *Corporation Law and Practice* § 135, at 163 (1959), the author observes that "no purpose is now served by the requirement of multiple incorporators—a relic from the concept that a corporation is the product of a number of persons associating for some common object."
14 Ky. Rev. Stat. §§ 271.005-.990 (1959) [hereinafter referred to as KRS]. The present general corporation statute was adopted in 1946. Ky. Acts 1946, ch. 141. It is stated broadly in this statute that "this chapter shall apply to any corporation formed under the laws of this state unless either the statutes relating to a corporation of that kind are inconsistent with this chapter or state that the provisions of this chapter do not apply to it." KRS 271.015.
15 KRS 271.095(1)(c). This provision relates to KRS 271.345, which provides that "the business of every corporation shall be managed by a board of at least three directors" and which makes further provision for the election of the first
provides further that, if a corporation has transacted any business in violation of this provision, the officers who participated in such business and the directors who failed to indicate their dissent are to be treated as severally liable for any resulting debts or liabilities of the corporation.\textsuperscript{16} While the reference to directors in this context seems inappropriate since no directors will have yet been elected and while the reference to officers is ambiguous since technically there are no officers until they are elected by the board of directors or otherwise selected as permitted by the corporation statute,\textsuperscript{17} nevertheless the intent of the statute clearly seems to be to reach at least the active parties who are responsible for the forbidden business transactions.\textsuperscript{18} In the one-man company the owner ordinarily expects to be the dominant party. Accordingly, the desired immunity from personal liability sought by him through incorporation could possibly be lost if this organizational formality of electing the first board of directors is disregarded.\textsuperscript{19}

\textsuperscript{16} KRS 271.095(2).
\textsuperscript{17} KRS 271.355.
\textsuperscript{18} This unfortunate hiatus in the Kentucky statute may have resulted from this provision having been taken from an identical provision which appears in § 8 of the Uniform (Model) Business Corporation Act, promulgated in 1928 by the National Conference of Commissioners on Uniform State Laws, but which does not present the same difficulty due to a requirement contained in § 3 of the Uniform Act that the articles of incorporation name the first board of directors. See 9 U.L.A. 115, 124 (1957). Under the Kentucky statute the first board of directors must be elected by the shareholders at their first meeting. See note 15 supra. In Ohio, which likewise does not require the first board of directors to be named in the articles, liability for nonpayment of the initial stated capital before a corporation commences business is extended to the incorporators participating in such business before the election of directors as well as to the directors participating therein. Ohio Rev. Code Ann. § 1701.12 (Page's Supp. 1960). Similar liability is imposed in Arkansas on "directors and shareholders," and in Georgia on "persons who organize a corporation and transact business." 6 Ark. Stat. Ann. § 64-607 (repl. vol. 1957); Ga. Code Ann. § 22-1872 (Supp. 1958). See generally 2 Model Bus. Corp. Act Ann. § 51 (1960).

Although Kentucky is listed as one of the states which has adopted a corporation statute based on the Uniform Act, nevertheless the statute so adopted contains numerous variations from the provisions of the Uniform Act. See 9 U.L.A. 117 (1957). In Lebus v. Stansifur, 154 Ky. 444, 449, 157 S.W. 727, 729 (1913), the Kentucky Court of Appeals observed with reference to a section contained in a former corporation statute which provided for directors to be elected at a meeting held before the corporation commenced business that "evidently the Legislature had in view when it enacted that section the idea of preventing the incorporators from getting the initial control of corporations at the inception of their organization contrary to the wishes of a majority of the stockholders."\textsuperscript{19}

\textsuperscript{19} Even though the one-man company has been properly organized, the
The recent Kentucky case of *Tri-State Developers, Inc. v. Moore* serves as a warning that the possibility of personal liability on the part of those who act on behalf of a Kentucky corporation before the conditions precedent to beginning business have been complied with is a real and not a fanciful one. In that case a Kentucky corporation had transacted business despite the fact that the minimum amount of capital with which it was to begin business had not been fully paid in as required by the Kentucky corporation statute. The court held that the president of the corporation, who was one of its organizers and one of its directors, could be charged with personal liability for damages resulting from breach of a corporate contract. The court considered but rejected the possibility that since no stock had been issued at the time meetings were held to elect the officers and directors of the corporation, the president never actually became an officer (or director) so as to be liable under the Kentucky statute. The court said that "those who purport to act for a corporation before its governing body is legally constituted must be held its de facto officers for the simple reason that otherwise they could act indefinitely with complete impunity, without ever meeting the" conditions precedent required by the statute for beginning business.

Kentucky is one of a small group of states which today...
specifically grants permission for one person to incorporate,\textsuperscript{23} but such permission has existed in Kentucky only since 1954, when the present general corporation statute was amended so as to provide for a single incorporator.\textsuperscript{24} While the present Kentucky corporation statute thus clarifies the inherent validity of the one-man company by permitting one person to "form" a corporation, the statute does not eliminate the necessity for such an incorporator-owner to comply with the other organizational formalities prescribed by the statute.

The 1954 amendment had particular significance in view of statements made by the Court of Appeals of Kentucky in the case of \textit{Louisville Banking Co. v. Eisenman},\textsuperscript{25} indicating that one person could not organize a corporation under the then existing general incorporation statute which provided that "any number of persons may associate themselves together and become incorporated for the transaction of any lawful business."\textsuperscript{26} In the course of its opinion, the court said that "there is no such being in this State as a sole corporation, and certainly none such allowed to be created by the statute."\textsuperscript{27} The 1954 amendment obviously makes this statement obsolete. Moreover, the amendment probably affects the \textit{Eisenman} case in still another respect. In the \textit{Eisenman} case the court was not concerned with an attempt by one person to organize a corporation but rather with the purchase of all the corporation's stock by one of the original incorporators in a corporation which had been properly created. The court took the position that such a purchase had the effect of suspending the corporate franchise until the stock was transferred to other persons.\textsuperscript{28} By giving statutory recognition to the one-man com-

\textsuperscript{23} KRS 271.025. In addition to Kentucky, the only other states at present are Iowa, Michigan, and Wisconsin. See 1 Iowa Code § 491.2 (1958) (old Iowa general corporation statute); Iowa Business Corporation Act § 48 (effective July 4, 1959), 2 P-H Corp. Serv., Iowa § 235 (1959); 5A Mich. Comp. Laws § 450.3 (Mason's Supp. 1956); 1 Wis. Stat. § 180.44 (1959). New York likewise will require only one incorporator when its new Business Corporation Law becomes effective on April 1, 1963. See 2 Hornstein, Corporation Law and Practice (Appendix, 1961 Pocket Parts, at 87).

\textsuperscript{24} Ky. Acts 1954, ch. 33.

\textsuperscript{25} 94 Ky. 33, 21 S.W. 531 (1893).

\textsuperscript{26} Ky. Acts 1869, ch. 729, § 1.

\textsuperscript{27} 94 Ky. at 39, 21 S.W. at 532.

\textsuperscript{28} The Kentucky Court of Appeals, however, has not construed the "suspension" doctrine as involving a complete merger of the identity of the corporation with the sole owner. In the \textit{Eisenman} case itself the court held that it did not follow from suspension of the corporate franchise that the individual property (Footnote continued on next page)
pany, Kentucky has eliminated the need for continued reference to the "suspension" doctrine by the courts of this state. An unfortunate oversight occurred, however, in connection with the 1954 amendment which needs to be corrected. It pertains to the section of the corporation statute dealing with the filing and recording of the articles of incorporation. This

(Footnote continued from preceding page)
of the sole owner thereby becomes liable for a debt contracted by him on behalf of the corporation when no fraud was practiced by him on the creditor and the creditor extended the entire credit to the corporation, since the creditor gets all he bargained for when he subjects the corporate property to the payment of his debt. Later, in Hawley Coal Co. v. Bruce, 252 Ky. 455, 67 S.W.2d 703 (1934), the court, while recognizing the "suspension" doctrine, held that it was error in an attachment proceeding to sell a corporation's real estate as the property of its sole owner since corporate debts take precedence over the individual debts of the owner and the only interest which such owner has in the assets of the corporation is an equity after paying the debts of the corporation. For other Kentucky decisions referring to the "suspension" doctrine, see Russell Lumber & Supply Co. v. First Nat'l Bank, 262 Ky. 388, 90 S.W.2d 572 (1936); Kentucky Harlan Coal Co. v. Harlan Gas Coal Co., 245 Ky. 234, 58 S.W. 538 (1932); Geo. T. Stagg Co. v. E. H. Taylor, Jr. & Sons, 113 Ky. 709, 68 S.W. 862 (1902); Louisville Gas Co. v. Kaufman, 105 Ky. 131, 48 S.W. 494 (1898).

Until recently the "suspension" doctrine found one of its most frequent expressions in the Kentucky cases, but in 1956 it broke forth with surprising vigor in a North Carolina decision which provoked considerable alarm in that state. See Park Terrace, Inc. v. Phoenix Indem. Co., 241 N.C. 473, 85 S.E.2d 677 (1955), on rehearing, 243 N.C. 595, 91 S.E.2d 584 (1956). In that case the Supreme Court of North Carolina, on rehearing, held that the purchaser of all the stock in a corporation became a necessary party plaintiff in a suit brought by the corporation for breach of contract since as such purchaser he became at least the equitable owner of the corporate property and any recovery would be for his use and benefit. The court said (91 S.E.2d at 586):

When one person acquires all the stock of a corporation, what then is the status of the corporation and the property held in its name? We are of the opinion and so hold that the corporation becomes dormant or inactive and exists only for the purpose of holding legal title of the property for the use and benefit of the single stockholder who becomes seized of the beneficial title to the property. Not possessing the managerial agencies—stockholders, directors, or officers—contemplated by statute, it can no longer act as a corporation. Its decisions are the decisions of the single stockholder, and its action is his action.

For comments on this case and its implications, see Latty, A Conceptualistic Tangle and the One- or Two-Man Corporation, 84 N.C.L. Rev. 471 (1956); Latty, The Close Corporation and the New North Carolina Business Corporation Act, 84 N.C.L. Rev. 492, 441-44 (1956).

In 1957 the North Carolina legislature responded to the Park Terrace decision with curative legislation designed to remove the concept of "dormancy" resulting from acquisition of all the stock in a corporation by less than three persons, even if such acquisition had already occurred. See 2B N.C. Gen. Stat. § 55-3.1(d)(repl. vol. 1960). But in Lester Bros., Inc. v. Pope Realty & Ins. Co., 250 N.C. 505, 109 S.E.2d 263 (1959), the court imposed partnership liability for corporate debts upon two shareholders who had acquired all of the stock in the corporation, holding that at the time the indebtedness was incurred in 1955 the creditor had a vested right in that liability under the law of North Carolina as declared in the Park Terrace decision which the legislature could not take away by retroactive legislation without violating the obligation of contract. The possibility of the retroactive aspects of this curative legislation meeting difficulty was foreshadowed in Comments on North Carolina 1957 Session Laws, 36 N.C.L. Rev. 41, 48 (1957).
section provides that the articles of incorporation shall be acknowledged "by at least three of the incorporators" before delivery to the Secretary of State.\(^{30}\) If the intent of the 1954 amendment permitting one person to "form" a corporation was to permit that person to become the sole incorporator, as seems clearly to have been the case, then it is wholly inconsistent to continue the requirement of acknowledgment by three incorporators in such a case.\(^{31}\) While this appears to have been merely a technical oversight, its correction would eliminate any residual doubt as to the propriety of one person acting as the sole incorporator of a Kentucky corporation.

At the time of the *Eisenman* case it was customary for corporation statutes to require that directors hold stock in the corporation,\(^{32}\) a requirement that further complicated the concept of the one-man corporation. Although the present Kentucky corporation statute does not require directors to be shareholders unless the articles of incorporation so require,\(^{33}\) there is nothing in the present statute which suggests that the use of a board of directors can be completely by-passed.\(^{34}\) The use of "dummy" directors may be a satisfactory, or at least an acceptable, answer in many, perhaps most, instances. Yet it is possible that a sole shareholder

\(^{30}\) KRS 271.045. (Emphasis added.)

\(^{31}\) The Attorney General of Kentucky issued an opinion on February 27, 1959, to the effect that, since KRS 271.025 permits one person to incorporate, in such a case the articles of incorporation need be acknowledged by only the one incorporator. Ops. Att’y Gen. No. 42,873.

\(^{32}\) See Stevens, Private Corporations § 158, at 735-36 (2d ed. 1949). The courts, however, did not take this requirement of stock ownership too seriously. For example, prior to 1946, at a time when the Kentucky corporation statute required that a director own in his own right at least three shares of its capital stock, the Court of Appeals of Kentucky, in Kaye v. Kentucky Pub. Elevator Co., 295 Ky. 661, 175 S.W.2d 142 (1943), held that three directors of a corporation to whom it was alleged stock had been transferred for the sole purpose of qualifying them as directors were not thereby disqualified from acting as directors. The court said that "the general rule is that a director may hold his stock as a trustee, or have only the legal title thereto, even for the express and sole purpose of making him eligible unless the situation was brought about in furtherance of a dishonest or fraudulent scheme concerning the management or control of the company." Id. at 665, 175 S.W.2d at 144.

\(^{33}\) KRS 271.345(1).

\(^{34}\) On March 8, 1961, the Attorney General of Kentucky issued an opinion in which he took the position that KRS 271.025, which permits incorporation by one person, does not have the effect of repealing by implication other sections of the general corporation statute requiring acts to be performed by more than one person. Ops. Att’y Gen. No. 61,206. This opinion specifically overruled an earlier opinion, issued on May 24, 1955, which had indicated that KRS 271.345, pertaining to a board of directors, was nullified "when a corporation has been chartered under KRS 271.025 or where all the shares of stock of a corporation have been subsequently acquired by one person." Ops. Att’y Gen. No. 36,090.
could find himself faced with a real problem as to "control" if the two "dummy" directors should suddenly turn against his wishes before their terms of office expired. The suggestion has been made that in most jurisdictions this problem could be solved by a charter or bylaw provision giving to the sole shareholder the power to remove directors at any time with or without cause. It may be asked, however, why the sole shareholder should not be allowed to accomplish directly what this procedure would allow him to accomplish indirectly, namely, the complete and unrestrained control over corporate affairs.

It has been convincingly argued that there is nothing inherent in the nature of corporate existence which requires the use of a multi-membership board of directors. The practical necessity for delegating managerial responsibility to a small group in the case of corporations with many shareholders probably best explains the use of a board of directors and the recognition of such a board as an attribute of corporateness when general corporation statutes were first formulated. Since no such practical necessity exists in the case of the one-man company, it seems only fair and reasonable that in jurisdictions such as Kentucky which authorize incorporation by one person, authorization should likewise be given for dispensing with the customary three-man board. This

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37 See Stevens, Private Corporations § 143 (2d ed. 1949). Nevertheless, expressions can sometimes be found which suggest that a board of directors is indispensable to corporate existence. See, e.g., Kaplan v. Block, 183 Va. 327, 31 S.E.2d 893, 896 (1944), in which the court said, "A private business corporation without a board of directors is an impossible concept." Statements such as this seem extreme and unwarranted.

38 Iowa has done this recently as to corporations formed under the new Iowa Business Corporation Act. Section 34 of that act as adopted in 1939 provided that "the business and affairs of a corporation shall be managed by a board of directors." By an amendment to § 34 effective July 4, 1961, it is specifically made clear that the board of directors may consist of "one or more" persons. See 1 P-H Corp. Serv., Rep. Bull. Vol. XXX—No. 26, June 21, 1961, f 26:3, 2 P-H Corp. Serv., Iowa f 226 (1961). Under the "old" Iowa general corporation statute, which is still available for incorporation of Iowa corporations, there is no specific statutory requirement that a corporation have a board of directors. It appears therefore that the shareholders could dispense entirely with the use of a board of directors under that statute. See Kessler, supra note 36, at 726. See also Hayes, Stockholders' Rights in the Iowa Corporation, 40 Iowa L. Rev. 459, 468 (1955).
would at least permit a one-man corporation to be organized with a one-man board consisting of the sole shareholder. No doubt such jurisdictions could justifiably take the additional step of permitting the sole incorporator to dispense entirely with the use of a board of directors as unnecessary to the structure and functioning of the one-man company. As Justice Rutledge once said with regard to legislation on the subject of one-man companies:

This should involve not only direct and simple authority for a single individual to incorporate, but also provision for direct control of the incorporated enterprise by the individual whose business is incorporated. Every laborer knows that John Doe is "boss" of John Doe, Incorporated. The law should not be blind to such an elementary "fact of life" in the corporate world. Nor should it create the opportunity, which occasionally is seized, for a mere "dummy" to decide the future of another man's business in a manner contrary to that man's interests and desires.39

THE MULTIPLE-OWNERSHIP COMPANY

1. Distribution of control—In general.

When one turns from the one-man company to the close corporation composed of two, three, four, or more participants, he finds that the legal problems thereby generated tend to change complexion, particularly in the area of control and management. Whereas in the one-man company ownership and control coincide in the sole owner, in the company composed of several participants control normally vests in the participants who own a majority of the stock. It is they who have the power to elect all or at least a majority of the board of directors. For this reason participants holding a minority interest may seek some means of securing an opportunity for participation in corporate affairs.

When considering the distribution of control in these multiple-ownership companies, it must be kept in mind that control operates at both the shareholder level and the director level. Although the general management of corporate business affairs is vested in a board of directors,40 there are certain matters of a

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40 It has been held that decisions of the board of directors are not subject to interference by a mere majority of the shareholders. Automatic Self-Cleansing (Footnote continued on next page)
fundamental nature relating to the structure and operation of the enterprise which modern corporation statutes generally recognize as within the ambit of shareholder action. These include such matters as amendment of the articles of incorporation, dissolution, sale of all the assets of the business, and merger or consolidation. Some of these matters, such as merger and consolidation, relate primarily to the affairs of the public issue corporation, but others, particularly those concerning amendment of the articles of incorporation and dissolution, can touch the affairs of the close corporation with as much frequency as those of the public issue corporation. Accordingly, the participants in the close corporation must evaluate their needs with regard to control both in their capacities as shareholders and also in their capacities as directors.

In addition to recognizing the two-level nature of control, it is also necessary to realize that some of the legal devices available to the participants in the close corporation through which they can distribute control operate within the framework of the corporate structure itself while other such devices operate outside the corporate framework and that a careful evaluation of the relative merits of these alternative devices must be made to determine which of them will best serve the needs of the participants from both a business and a legal standpoint. In the discussion which follows attempt will be made to present some of the specific control problems which face the participants in the multiple-ownership company and to evaluate control devices

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Filter Syndicate Co. v. Cuninghame, [1906] 2 Ch. 34 (C.A.). In Manufacturers' Land & Improvement Co. v. Cleary, 121 Ky. 403, 406, 89 S.W. 248, 249 (1905), the court observed: "The judgment or discretion of the governing body, usually a board of directors, as to matters intra vires, is entirely beyond the control of the stockholders through the intervention of the courts, except for frauds committed or threatened against the corporation or the minority stockholders." However, if all the shareholders in a corporation agree that certain action should be taken, it is arguable that their voice should control over that of the board of directors. As Professor Ballantine has pointed out, "the right to have the affairs of the corporation managed by the board of directors is a right of each shareholder derived from the statute under which the company is formed." Therefore, as he says, "if the real parties in interest unanimously agree on lawful corporate acts, their voice should control." Ballantine, Corporations § 43, at 123 (rev. ed. 1946). A similar viewpoint has been expressed by Dean Stevens. See Stevens, Private Corporations § 143, at 651-53 (2d ed. 1949).

41 KRS 271.445.
42 KRS 271.500.
43 KRS 271.415.
44 KRS 271.470.
which have been used to meet those problems in particular relation to the law in Kentucky.

2. Cumulative voting.

If the main concern of each participant in the multiple-ownership company is that he be assured of representation on the board of directors, he may find that this assurance, in Kentucky at least, can be established through resort to the cumulative voting privilege, which is guaranteed to shareholders in Kentucky corporations by constitutional provision. Under this privilege a shareholder possessing one vote for each share of stock owned by him (the usual situation) may concentrate his total number of votes on one or more candidates of his choice instead of being required to cast his votes on a single candidate for each director position to be filled. The usefulness of this privilege to the individual shareholder will depend, of course, on the total number of voting shares he owns in relation to the number of directors on the board.

In a three-man corporation with a board of directors of three persons, in which the shares of stock are divided equally among the three shareholder-owners, any one of the shareholders through use of cumulative voting could be assured of electing at least one director. On the other hand, if there are five shareholders who own equal interests in the stock of the corporation, one shareholder alone could not by means of cumulative voting elect one of the directors on a three-man board.

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45 Ky. Const. § 207. The provision reads:

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

A similar provision appears in the Kentucky corporation statute. See KRS 271.315(2). Kentucky is one of thirteen states that makes cumulative voting mandatory by constitutional provision. The other states are Arizona, Idaho, Illinois, Mississippi, Missouri, Montana, Nebraska, North Dakota, Pennsylvania, South Carolina, South Dakota, and West Virginia. Ten additional states, Alaska, Arkansas, California, Hawaii, Kansas, Michigan, North Carolina, Ohio, Washington, and Wyoming, provide for mandatory cumulative voting in their corporation statutes. See 1 Model Bus. Corp. Act Ann. 522, 524 (1960).

46 For discussion of the mathematics of cumulative voting, see Cole, The Legal and Mathematical Aspects of Cumulative Voting, 2 S.C.L.Q. 225 (1950). For a good review of the history and functioning of cumulative voting in American corporations, both large and small, see Williams, Cumulative Voting for Directors (1951).
Furthermore, even in those instances in which the cumulative voting privilege would mathematically assure the individual shareholder of representation on the board, he must be alert to certain maneuvers which can sometimes be used to weaken or destroy the effectiveness of his right. One of these consists in reducing the total number of directors, thereby increasing the total number of shares it takes to elect one director; another consists in classifying the board of directors so that only a portion of the board is elected in any one year. Both of these maneuvers it appears could be effectively thwarted by the shareholders in a Kentucky corporation through provisions in the articles of incorporation (or bylaws) setting up a requirement of unanimous consent of the shareholders for any changes in the total number of directors or in their terms of office.

As to the classification procedure, it would probably be unwise to assume that the provision in the Kentucky corporation statute

47 See, e.g., KRS 271.345(4), which provides that the number of directors may be prescribed by the articles of incorporation or bylaws. A majority of the shareholders could, therefore, by amendment of the articles or bylaws change the number of directors as originally fixed. Some of the states with mandatory cumulative voting provisions have built into their corporation statutes a means of preventing a majority from reducing the number of directors to the detriment of the minority. The Michigan General Corporation Act, for example, provides that the number of directors cannot be reduced if a sufficient number of votes are recorded against such reduction which, if cumulatively voted, would elect one or more directors and if, after the reduction, these same votes, could not cumulatively elect the same number of directors as before the reduction. 5A Mich. Comp. Laws § 450.13 (Mason’s Supp. 1956).

48 See, e.g., KRS 271.345(4) which provides that “directors shall be elected for terms of one year, except that it may be provided by the articles or bylaws, or by a vote of the shareholders, that the directors be elected for terms of two years or three years, in which case the terms shall be so arranged that the terms of an equal or nearly equal number of directors will expire each year.”

49 Unanimous consent for amendment of the articles of incorporation would seem to be clearly authorized by KRS 271.445(2), which permits an increase in the voting requirement for amending the articles above the usual majority vote. Unanimous consent for changes in the bylaws would seem to be authorized by KRS 271.315(7), which provides broadly that the articles or the bylaws may specify the votes that shall be necessary for the transaction of any business, except where restricted by the corporation statute itself. KRS 271.285, the section of the statute devoted to the bylaw-making power, contains no restrictions as to the number of votes needed to amend the bylaws. As said by the New York Court of Appeals in Benintendi v. Kenton Hotel, 294 N.Y. 112, 60 N.E.2d 829, 832 (1945), which involved, among other things, an attempt by shareholders in a close corporation to require unanimous consent for amendment of the bylaws:

Every corporation is empowered to make by-laws . . . and by-laws of some sort or other are usually considered to be essential to the organization of a corporation . . . . The State has an interest in seeing to it that such “private laws” or by-laws as the corporation adopts are not inconsistent with the public law and not such as will turn the corporation into some other kind of entity. But, once proper by-laws have been adopted, the matter of amending them is, we think, no concern of the State.
authorizing the staggering of the terms of office of the board of directors would meet the same fate that befell a similar provision in the Illinois Business Corporation Act when the Supreme Court of Illinois, in the well-known case of Wolfson v. Avery, declared such provision unconstitutional as incompatible with the section of the Illinois Constitution guaranteeing shareholders in Illinois corporations the right to vote cumulatively in the election of directors. The Illinois court relied heavily on the debates of the Illinois constitutional convention at which the provision was adopted and the contemporaneous comments in the public press as indicating a purpose to afford the minority protection in proportion to its voting strength. However, the debates of the constitutional convention at which the Kentucky provision was adopted do not carry the same persuasive implications as to purpose. These debates reveal that the effect of failure to elect the entire board at one time was actually considered in the adoption of the Kentucky constitutional provision and a suggestion made but rejected that language be used requiring that all directors (or at least one-half) be voted upon at one time. The inference which one writer has derived from the failure of this suggestion to be adopted is that the delegates were apparently willing to accept classification as compatible with cumulative voting.

It appears, therefore, that the minority shareholder in Kentucky can best insulate himself against the possible adverse effects of the classification procedure by insisting on a built-in protection in the form of a provision in the articles of incorporation (or by-laws) requiring unanimous approval for adoption of any proposals

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50 6 Ill.2d 78, 126 N.E.2d 701 (1955).
51 126 N.E.2d at 707-10.
52 3 Proceedings and Debates in the Convention, Kentucky 3732-37 (1890). Actually, there seems to be some question whether even the debates at the Illinois constitutional convention carried the strong implications as to purpose stressed by the court in Wolfson v. Avery. In a vigorous dissenting opinion, Justice Hershey questioned the interpretation as to purpose which the majority of the court had derived from resort to extrinsic aids and urged that a proper analysis of the constitutional provision demonstrated that the statutory classification procedure was not unconstitutional. Commentators have likewise found similar objections to the majority opinion. See, e.g., Sell & Fuge, Impact of Classified Corporate Directorates on the Constitutional Right of Cumulative Voting, 17 U. Pitt. L. Rev. 151 (1956).
53 3 Proceedings and Debates in the Convention, Kentucky 3732-35 (1890).
to change the terms of directors.\textsuperscript{55} The disastrous consequences which can result to an individual shareholder who fails to require such a provision are vividly illustrated by a recent Ohio case\textsuperscript{56} in which the articles of incorporation of a closely held corporation had been amended so as to provide three-year terms for the three-man board, with their terms so staggered that only one director would be elected at each annual meeting. The effect of this action, upheld by the Supreme Court of Ohio, was to deprive one of the shareholders, who owned forty per cent of the company's stock, from securing representation on the board of directors through use of the cumulative voting privilege given to him by the Ohio corporation statute.\textsuperscript{57} The 1955 revision of the Ohio General Corporation Law has eliminated the possibility of such an extreme maneuver in the future by providing that each class

\textsuperscript{55} See note 49 supra.

\textsuperscript{56} Humphrys v. Winous Co., 165 Ohio St. 45, 133 N.E.2d 780 (1956).

\textsuperscript{57} When this case came before the intermediate appellate court of Ohio for decision, the court held that the resolution amending the articles of incorporation so as to classify the three member board into three classes was invalid since it could not be assumed that the authority granted by the corporation statute to classify the board of directors was intended to permit complete nullification of the right of a shareholder to cumulate his vote, a right which had been recognized in the corporation statute long before the privilege of classification was granted. Humphrys v. Winous Co., 125 N.E.2d 204 (Ohio Ct. App. 1955). In reversing, the Supreme Court of Ohio interpreted the statutory provision for cumulative voting as guaranteeing to minority shareholders only the right of cumulative voting and not as necessarily guaranteeing the effectiveness of the exercise of that right. Humphrys v. Winous Co., 165 Ohio St. 45, 133 N.E.2d 780, 789 (1956).

The Supreme Court of Pennsylvania adopted a similar position as to a constitutional provision guaranteeing the right to vote cumulatively in Janney v. Philadelphia Transp. Co., 387 Pa. 282, 128 A.2d 76 (1956). In this case the Pennsylvania court said (128 A.2d at 80):

All that the Constitution provides is that each stockholder should have the right to concentrate his votes on one or more candidates to be chosen in any given election; that right is undisputed, but as to how many candidates there shall be at the election, whether they must consist of all the directors of the corporation, whether they cannot be classified and their elections staggered, as to these and many other factors which necessarily enter into each situation the Constitution is wholly silent; to write into it any such limiting or qualifying provisions as contended for by plaintiff would be an extreme exercise of judicial legislation.

The Pennsylvania court sought to distinguish the Illinois case of Wolfson v. Avery on the technical ground that the Pennsylvania constitutional provision is framed in terms of each shareholder having as many votes as the number of candidates whereas the Illinois constitutional provision is framed in terms of the number of directors. However, this distinction based on the choice of language is not altogether persuasive. See Sell & Fuge, supra note 52, at 172-74.

Other recent cases in states having mandatory cumulative voting provisions include Bohannan v. Corporation Comm'n, 82 Ariz. 299, 313 P.2d 379 (1957) (provision for classified board in articles of incorporation held to be permissible), and State ex rel. Syphers v. McCune, 143 W. Va. 315, 101 S.E.2d 834 (1958) (provision for classified board in bylaws held to be incompatible with constitutional provision).
in the case of a classified board must consist of not less than three directors.\(^{58}\)

In addition to charter or bylaw provisions which bar reduction in the number of directors and which preclude use of the classification procedure, a minority interest may also need to guard against the possible ability of the majority to remove directors elected by the minority, thereby creating vacancies which could be filled by the majority despite the presence of the cumulative voting privilege. Shareholders are considered as having an inherent power to remove a director for cause,\(^{59}\) and statutes now exist in a number of states granting to shareholders the power of removal without cause.\(^{60}\) Furthermore, even in the absence of such statutes, it appears that a corporation may adopt charter or bylaw provisions for the removal of directors without cause.\(^{61}\) Exercise of this power of removal could, of course, effectively nullify the cumulative voting privilege, particularly if the removal can be accomplished without cause.\(^{62}\) To overcome this threat some states have adopted statutory provisions which prohibit the removal of any individual director if the votes of a sufficient number of shares are voted against his removal which, if cumulatively voted, would be sufficient to elect at least one director.\(^{63}\) Since Kentucky has no such statutory provision, a minority group interested in protecting its cumulative voting


\(^{59}\) Campbell v. Loew's, Inc., 134 A.2d 852 (Del. Ch. 1957).

\(^{60}\) See 1 Hornstein, Corporation Law and Practice § 389 (1959).

\(^{61}\) See Ballantine, Corporations § 185, at 434 (rev. ed. 1946); Stevens, Private Corporations § 163, at 764 (2d ed. 1949).

\(^{62}\) Once removal has been accomplished, the corporation statute in Kentucky tends to favor the majority. KRS 271.345(4)(a) provides that vacancies in the board of directors are to be filled by the remaining members of the board, except as otherwise provided in the articles or bylaws. Such persons hold office until their successors are elected by the shareholders, which may be at the next annual meeting or at a special meeting called for such purpose.

\(^{63}\) See, e.g., Cal. Corp. Code Ann. § 810 (Deering 1953); 2B N.C. Gen. Stat. § 55-27(f)(repl. vol. 1960); Ohio Rev. Code Ann. § 1701.58(C)(Page's Supp. 1980). In jurisdictions which do not have such a statutory provision it has been suggested that courts could forestall arbitrary use of the removal power by the majority to defeat the cumulative voting right by limiting the power of removal without cause to representatives of the majority. Comment, Cumulative Voting—Removal, Reduction and Classification of Corporate Boards, 22 U. Chi. L. Rev. 751, 753 (1955). In New York, a permissive cumulative voting jurisdiction, it has been held that an amendment of a corporate charter to provide for cumulative voting had the effect of invalidating an existing bylaw provision which provided for removal of a director without cause. In re Rogers Imports, Inc., 202 Misc. 761, 118 N.Y.S.2d 106 (Sup. Ct. 1952).
privilege from this removal power may need to arrange for such protection through appropriate clauses in the articles of incorporation or bylaws restricting the scope of the power of removal which can be exercised by the majority.64

This in turn raises another interesting question which presses in the opposite direction. Can shareholders in a corporation organized in a mandatory cumulative voting jurisdiction, such as Kentucky, agree not to exercise their cumulative voting privilege? If a majority in interest were to persuade the minority to agree to such an arrangement, would it be binding on the minority? Two recent cases outside of Kentucky have indicated that shareholders can make such an arrangement, at least if it is done through private agreement among themselves and not as part of the corporate structure itself.

In the most recent of these cases, Sensabaugh v. Polson Plywood Co.,65 the issue arose as the result of a bylaw which a majority of the shareholders of a Montana corporation had adopted providing for straight voting by the shareholders. Later, a shareholder who had approved this bylaw asserted his right to vote cumulatively at a corporate election over the objection of the presiding officer. The latter refused to permit any of the shareholders to vote cumulatively and counted all ballots as straight ballots. The shareholder then brought a suit to have the election of directors declared null and void and to have the court order the holding of a new election. The Supreme Court of Montana affirmed a judgment for the plaintiff shareholder on the basis that a corporation could not through a bylaw deny the right of cumulative voting. Two of the judges, however, indicated that, in their opinion, there was nothing in the constitutional provision guaranteeing cumulative voting which would inhibit shareholders from agreeing among themselves outside the corporate structure to forego their right to vote cumulatively. A third judge concurred in the result, thereby making a three-judge majority. A fourth judge concurred on the point that a corporation could not deprive a shareholder of his right to vote cumulatively, but dissented as to the result reached on the ground that the bylaw provision should

64 See 1 O'Neal, Close Corporations § 3.59 (1958).
have been considered as a binding agreement among those who assented to it. A fifth judge dissented from that part of the opinion of the first two judges which had upheld the right of shareholders to agree to give up their cumulative voting rights, his position being that the constitutional provision voiced a public policy of the state as to the election of directors which could not be altered by private contract.

It is evident that at least three, and perhaps four, out of the five judges in this Montana case were willing to concede that shareholders could by agreement among themselves voluntarily give up their cumulative voting right, the only difference among the judges being the form which such agreement could take. The two judges who wrote the dominant opinion relied heavily on the earlier Nebraska case of *E. K. Buck Retail Stores v. Harkert*, in which the Supreme Court of Nebraska had upheld a private agreement that conflicted with the cumulative method of voting guaranteed by the Nebraska Constitution. The Nebraska court had taken the position that the constitutional provision was intended to secure to minority shareholders a greater representation in corporate business affairs and to prevent involuntary loss of the cumulative voting privilege but was not intended to deprive a shareholder of the right to contract with respect to the voting of his stock if he so desired.

While there appear to be no Kentucky cases directly raising this question, in the early case of *Schmidt v. Mitchell*, the Kentucky Court of Appeals asserted that no shareholder was required to vote his stock cumulatively at a corporate election unless he so desired. From this it could perhaps be inferred that the court would not have objected to an agreement among the shareholders in which they had voluntarily surrendered their cumulative voting privilege. However, there is a considerable difference between a shareholder deciding at any given corporate election not to avail himself of his cumulative voting privilege and a shareholder surrendering such voting privilege as to future elections by virtue of a shareholders' agreement. One thing the court did stress in the *Mitchell* case was that no shareholder had been denied the right to vote his stock cumulatively.

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67 101 Ky. 570, 41 S.W. 929 (1897).
3. Classification of stock.

Another device which may prove useful in achieving the desired end of representation on the board of directors is the classification of shares into two or more classes with provision for election of a designated portion of the board by each class. There is ample statutory basis in Kentucky for using this approach since the Kentucky corporation statute, like other modern corporation statutes, authorizes the use of more than one class of stock. However, a disadvantage which the use of this approach might have today is its possible adverse tax effect in depriving the corporation of eligibility to be taxed on a partnership basis under Subchapter S of the Internal Revenue Code. Moreover, in a state like Illinois which has stressed proportional representation as the purpose served by cumulative voting, there might well be objection to any arrangement which interferes with the right of each shareholder to participate in the election of all directors at each annual meeting.

This latter objection could possibly be raised under Kentucky law since the Kentucky constitutional provision on cumulative voting reads in terms of each shareholder having the right to cast the number of votes to which his share ownership entitles him multiplied by the number of directors to be elected at such election. Even if it should be concluded that the statutory provision authorizing classification of the board of directors is not incompatible with this provision, it would not necessarily follow that an arrangement classifying stock so as to enable each class to elect only a portion of the board would likewise not be incom-
compatible. Under the former arrangement the shareholder would still be free to cumulate his votes in relation to all the directors to be elected at any one time whereas under the latter arrangement the shareholder would be confined in his voting to a particular portion of the board to be elected. This conflicts with the express language of the section. However, if it can be assumed that the purpose of the cumulative voting provision in Kentucky is merely to afford an opportunity for minority representation rather than to assure proportional representation by minorities at all times, then it is arguable that use of classified stock as a means of giving each separate interest in the corporation representation on the board should not be deemed to clash with the constitutional provision on cumulative voting. Indeed, use of classified shares could prove to be an even more effective means than cumulative voting for providing the desired representation on the board by each interest if the stock is so divided among the participants that no one of them could elect a director by cumulating his votes.\(^7\)


Although it appears that in Kentucky the two devices just discussed, cumulative voting and classified stock, are reasonably reliable for achieving the desired end of assuring representation on the board of directors, the participants in a close corporation may sometimes prefer to make use of devices outside the corporate framework for this purpose. Here again, two devices appear to be most suitable—use of a simple shareholders’ pooling agreement or use of the more formal voting trust.

The shareholders’ pooling agreement is one in which the parties agree to vote their stock in the election of directors (and perhaps in other matters) as mutually agreed upon by them. Early courts tended to invalidate such agreements, but the prevailing attitude today is to uphold them so long as they are formed for a proper purpose, that is, to serve corporate ends and not to commit fraud or perpetrate wrong on other shareholders.\(^7\)

\(^7\) For a discussion of certain precautions a draftsman may need to take into account in setting up class voting, see 1 O’Neal, Close Corporations § 3.24 (1958).

\(^7\) 1 O’Neal, Close Corporations § 5.08 (1958).
The recent Kentucky case of *Tri-State Developers, Inc. v. Moore* serves as a warning that the possibility of personal liability on the part of those who act on behalf of a Kentucky corporation before the conditions precedent to beginning business have been complied with is a real and not a fanciful one. In that case a Kentucky corporation had transacted business despite the fact that the minimum amount of capital with which it was to begin business had not been fully paid in as required by the Kentucky corporation statute. The court held that the president of the corporation, who was one of its organizers and one of its directors, could be charged with personal liability for damages resulting from breach of a corporate contract. The court considered but rejected the possibility that since no stock had been issued at the time meetings were held to elect the officers and directors of the corporation, the president never actually became an officer (or director) so as to be liable under the Kentucky statute. The court said that "those who purport to act for a corporation before its governing body is legally constituted must be held its de facto officers for the simple reason that otherwise they could act indefinitely with complete impunity, without ever meeting the" conditions precedent required by the statute for beginning business.

Kentucky is one of a small group of states which today

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privilege of limited liability may also be lost if the sole shareholder fails to provide the company with adequate capital and conducts the business as though it were his individual business. See, e.g., *Dixie Coal Mining & Mfg. Co. v. Williams*, 221 Ala. 331, 128 So. 799 (1930). These are familiar grounds for disregarding the corporate entity or "piercing the corporate veil" and are not peculiar to the one-man company. However, the complete dominion which the sole shareholder has over his company presents such unusual opportunities for abuse that, as one writer has remarked, "the principle that corporate personality will be sustained only so long as it is invoked for legitimate purposes has particular application to the one-man company." Cataldo, *Limited Liability With One-Man Companies and Subsidiary Corporations*, 18 Law & Contemp. Prob. 473, 482-83 (1953). For recent Kentucky cases illustrating the application of this principle to closely held corporations, see *Martin v. Ratliff Furniture Co.*, 264 S.W.2d 273 (Ky. 1954); *Veterans Serv. Club v. Sweeney*, 252 S.W.2d 25 (Ky. 1952). In *Charles Zubik & Sons, Inc. v. Marine Sales & Serv.* 300 S.W.2d 35, 38 (Ky. 1957), involving the question of corporate liability, the court referred to the situation as one in which an individual business owner "in the management of his business affairs, had a persistent habit of switching interchangeably, back and forth, from an individual to a corporate capacity."

20 343 S.W.2d 812 (Ky. 1961).
21 KRS 271.095(1)(b).
22 343 S.W.2d at 816.
specifically grants permission for one person to incorporate, but such permission has existed in Kentucky only since 1954, when the present general corporation statute was amended so as to provide for a single incorporator. While the present Kentucky corporation statute thus clarifies the inherent validity of the one-man company by permitting one person to "form" a corporation, the statute does not eliminate the necessity for such an incorporator-owner to comply with the other organizational formalities prescribed by the statute.

The 1954 amendment had particular significance in view of statements made by the Court of Appeals of Kentucky in the case of *Louisville Banking Co. v. Eisenman*, indicating that one person could not organize a corporation under the then existing general incorporation statute which provided that "any number of persons may associate themselves together and become incorporated for the transaction of any lawful business." In the course of its opinion, the court said that "there is no such being in this State as a sole corporation, and certainly none such allowed to be created by the statute." The 1954 amendment obviously makes this statement obsolete. Moreover, the amendment probably affects the *Eisenman* case in still another respect. In the *Eisenman* case the court was not concerned with an attempt by one person to organize a corporation but rather with the purchase of all the corporation's stock by one of the original incorporators in a corporation which had been properly created. The court took the position that such a purchase had the effect of suspending the corporate franchise until the stock was transferred to other persons. By giving statutory recognition to the one-man com-

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23 KRS 271.025. In addition to Kentucky, the only other states at present are Iowa, Michigan, and Wisconsin. See 1 Iowa Code § 491.2 (1958) (old Iowa general corporation statute); Iowa Business Corporation Act § 48 (effective July 4, 1959), 2 P-H Corp. Serv., Iowa § 235 (1959); 5A Mich. Comp. Laws § 450.3 (Mason's Supp. 1956); 1 Wis. Stat. § 180.44 (1959). New York likewise will require only one incorporator when its new Business Corporation Law becomes effective on April 1, 1963. See 2 Hornstein, Corporation Law and Practice (Appendix, 1961 Pocket Parts, at 87).


25 94 Ky. 83, 21 S.W. 531 (1893).


27 94 Ky. at 89, 21 S.W. at 532.

28 The Kentucky Court of Appeals, however, has not construed the "suspension" doctrine as involving a complete merger of the identity of the corporation with the sole owner. In the *Eisenman* case itself the court held that it did not follow from suspension of the corporate franchise that the individual property (Footnote continued on next page)
pany, Kentucky has eliminated the need for continued reference to the "suspension" doctrine by the courts of this state.

An unfortunate oversight occurred, however, in connection with the 1954 amendment which needs to be corrected. It pertains to the section of the corporation statute dealing with the filing and recording of the articles of incorporation. This

(Footnote continued from preceding page)
of the sole owner thereby becomes liable for a debt contracted by him on behalf of the corporation when no fraud was practiced by him on the creditor and the creditor extended the entire credit to the corporation, since the creditor gets all he bargained for when he subjects the corporate property to the payment of his debt. Later, in Hawley Coal Co. v. Bruce, 252 Ky. 455, 67 S.W.2d 703 (1934), the court, while recognizing the "suspension" doctrine, held that it was error in an attachment proceeding to sell a corporation's real estate as the property of its sole owner since corporate debts take precedence over the individual debts of the owner and the only interest which such owner has in the assets of the corporation is an equity after paying the debts of the corporation. For other Kentucky decisions referring to the "suspension" doctrine, see Russell Lumber & Supply Co. v. First Nat'l Bank, 262 Ky. 588, 90 S.W.2d 372 (1936); Kentucky Harlan Coal Co. v. Harlan Gas Coal Co., 245 Ky. 294, 53 S.W.2d 538 (1932); Geo. T. Stagg Co. v. E. H. Taylor, Jr. & Sons, 113 Ky. 709, 68 S.W. 862 (1902); Louisville Gas Co. v. Kaufman, 105 Ky. 131, 48 S.W. 454 (1898).

Until recently the "suspension" doctrine found one of its most frequent expressions in the Kentucky cases, but in 1956 it broke forth with surprising vigor in a North Carolina decision which provoked considerable alarm in that state. See Park Terrace, Inc. v. Phoenix Indem. Co., 241 N.C. 473, 85 S.E.2d 677 (1955), on rehearing, 243 N.C. 595, 91 S.E.2d 584 (1956). In that case the Supreme Court of North Carolina, on rehearing, held that the purchaser of all the stock in a corporation became a necessary party plaintiff in a suit brought by the corporation for breach of contract since as such purchaser he became at least the equitable owner of the corporate property and any recovery would be for his use and benefit. The court said (91 S.E.2d at 586):

-When one person acquires all the stock of a corporation, what then is the status of the corporation and the property held in its name? We are of the opinion and so hold that the corporation becomes dormant or inactive and exists only for the purpose of holding legal title of the property for the use and benefit of the single stockholder who becomes seized of the beneficial title to the property. Not possessing the managerial agencies—stockholders, directors, or officers,—contemplated by statute, it can no longer act as a corporation. Its decisions are the decisions of the single stockholder, and its action is his action.

For comments on this case and its implications, see Latty, A Conceptualistic Tangle and the One- or Two-Man Corporation, 94 N.C.L. Rev. 471 (1956); Latty, The Close Corporation and the New North Carolina Business Corporation Act, 94 N.C.L. Rev. 432, 441-44 (1956).

In 1957 the North Carolina legislature responded to the Park Terrace decision with curative legislation designed to remove the concept of "dormancy" resulting from acquisition of all the stock in a corporation by less than three persons, even if such acquisition had already occurred. See 2B N.C. Gen. Stat. § 55-3.1(d)(repl. vol. 1960). But in Lester Bros., Inc. v. Pope Realty & Ins. Co., 250 N.C. 565, 109 S.E.2d 263 (1959), the court imposed partnership liability for corporate debts upon two shareholders who had acquired all of the stock in the corporation, holding that at the time the indebtedness was incurred in 1955 the creditor had a vested right in that liability under the law of North Carolina as declared in the Park Terrace decision which the legislature could not take away by retroactive legislation without violating the obligation of contract. The possibility of the retroactive aspects of this curative legislation meeting difficulty was foreshadowed in Comments on North Carolina 1957 Session Laws, 38 N.C.L. Rev. 41, 48 (1957).
section provides that the articles of incorporation shall be acknowledged "by at least three of the incorporators" before delivery to the Secretary of State.\(^{30}\) If the intent of the 1954 amendment permitting one person to "form" a corporation was to permit that person to become the sole incorporator, as seems clearly to have been the case, then it is wholly inconsistent to continue the requirement of acknowledgment by three incorporators in such a case.\(^{31}\) While this appears to have been merely a technical oversight, its correction would eliminate any residual doubt as to the propriety of one person acting as the sole incorporator of a Kentucky corporation.

At the time of the *Eisenman* case it was customary for corporation statutes to require that directors hold stock in the corporation,\(^{32}\) a requirement that further complicated the concept of the one-man corporation. Although the present Kentucky corporation statute does not require directors to be shareholders unless the articles of incorporation so require,\(^{33}\) there is nothing in the present statute which suggests that the use of a board of directors can be completely by-passed.\(^{34}\) The use of "dummy" directors may be a satisfactory, or at least an acceptable, answer in many, perhaps most, instances. Yet it is possible that a sole shareholder

\(^{30}\) KRS 271.045. (Emphasis added.)

\(^{31}\) The Attorney General of Kentucky issued an opinion on February 27, 1959, to the effect that, since KRS 271.025 permits one person to incorporate, in such a case the articles of incorporation need be acknowledged by only the one incorporator. Ops. Att'y Gen. No. 42,873.

\(^{32}\) See Stevens, Private Corporations § 158, at 735-36 (2d ed. 1949). The courts, however, did not take this requirement of stock ownership too seriously. For example, prior to 1946, at a time when the Kentucky corporation statute required that a director own in his own right at least three shares of its capital stock, the Court of Appeals of Kentucky, in *Kaye v. Kentucky Pub. Elevator Co.*, 295 Ky. 661, 175 S.W.2d 142 (1943), held that three directors of a corporation to whom it was alleged stock had been transferred for the sole purpose of qualifying them as directors were not thereby disqualified from acting as directors. The court said that "the general rule is that a director may hold his stock as a trustee, or have only the legal title thereto, even for the express and sole purpose of making him eligible unless the situation was brought about in furtherance of a dishonest or fraudulent scheme concerning the management or control of the company." *Id.* at 665, 175 S.W.2d at 144.

\(^{33}\) KRS 271.345(1).

\(^{34}\) On March 8, 1961, the Attorney General of Kentucky issued an opinion in which he took the position that KRS 271.025, which permits incorporation by one person, does not have the effect of repealing by implication other sections of the general corporation statute requiring acts to be performed by more than one person. Ops. Att'y Gen. No. 61,206. This opinion specifically overruled an earlier opinion, issued on May 24, 1955, which had indicated that KRS 271.345, pertaining to a board of directors, was nullified "when a corporation has been chartered under KRS 271.025 or where all the shares of stock of a corporation have been subsequently acquired by one person." Ops. Att'y Gen. No. 36,090.
could find himself faced with a real problem as to "control" if the two "dummy" directors should suddenly turn against his wishes before their terms of office expired. The suggestion has been made that in most jurisdictions this problem could be solved by a charter or bylaw provision giving to the sole shareholder the power to remove directors at any time with or without cause.\[35\]

It may be asked, however, why the sole shareholder should not be allowed to accomplish directly what this procedure would allow him to accomplish indirectly, namely, the complete and unrestrained control over corporate affairs.

It has been convincingly argued that there is nothing inherent in the nature of corporate existence which requires the use of a multi-membership board of directors.\[36\] The practical necessity for delegating managerial responsibility to a small group in the case of corporations with many shareholders probably best explains the use of a board of directors and the recognition of such a board as an attribute of corporateness when general corporation statutes were first formulated.\[37\] Since no such practical necessity exists in the case of the one-man company, it seems only fair and reasonable that in jurisdictions such as Kentucky which authorize incorporation by one person, authorization should likewise be given for dispensing with the customary three-man board.\[38\] This

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\[37\] See Stevens, Private Corporations § 143 (2d ed. 1949). Nevertheless, expressions can sometimes be found which suggest that a board of directors is indispensable to corporate existence. See, e.g., Kaplan v. Block, 183 Va. 327, 31 S.E.2d 893, 896 (1944), in which the court said, "A private business corporation without a board of directors is an impossible concept." Statements such as this seem extreme and unwarranted.

\[38\] Iowa has done this recently as to corporations formed under the new Iowa Business Corporation Act. Section 34 of that act as adopted in 1959 provided that "the business and affairs of a corporation shall be managed by a board of directors." By an amendment to § 34 effective July 4, 1961, it is specifically made clear that the board of directors may consist of "one or more" persons. See 1 P-H Corp. Serv., Rep. Bull. Vol. XXX—No. 26, June 21, 1961, ¶ 26.3; 2 P-H Corp. Serv., Iowa ¶ 226 (1961). Under the "old" Iowa general corporation statute, which is still available for incorporation of Iowa corporations, there is no specific statutory requirement that a corporation have a board of directors. It appears therefore that the shareholders could dispense entirely with the use of a board of directors under that statute. See Kessler, supra note 36, at 726. See also Hayes, Stockholders' Rights in the Iowa Corporation, 40 Iowa L. Rev. 459, 468 (1955).
would at least permit a one-man corporation to be organized with a one-man board consisting of the sole shareholder. No doubt such jurisdictions could justifiably take the additional step of permitting the sole incorporator to dispense entirely with the use of a board of directors as unnecessary to the structure and functioning of the one-man company. As Justice Rutledge once said with regard to legislation on the subject of one-man companies:

This should involve not only direct and simple authority for a single individual to incorporate, but also provision for direct control of the incorporated enterprise by the individual whose business is incorporated. Every laborer knows that John Doe is "boss" of John Doe, Incorporated. The law should not be blind to such an elementary "fact of life" in the corporate world. Nor should it create the opportunity, which occasionally is seized, for a mere "dummy" to decide the future of another man's business in a manner contrary to that man's interests and desires.3

THE MULTIPLE-OWNERSHIP COMPANY

1. Distribution of control—In general.

When one turns from the one-man company to the close corporation composed of two, three, four, or more participants, he finds that the legal problems thereby generated tend to change complexion, particularly in the area of control and management. Whereas in the one-man company ownership and control coincide in the sole owner, in the company composed of several participants control normally vests in the participants who own a majority of the stock. It is they who have the power to elect all or at least a majority of the board of directors. For this reason participants holding a minority interest may seek some means of securing an opportunity for participation in corporate affairs.

When considering the distribution of control in these multiple-ownership companies, it must be kept in mind that control operates at both the shareholder level and the director level. Although the general management of corporate business affairs is vested in a board of directors,40 there are certain matters of a

40 It has been held that decisions of the board of directors are not subject to interference by a mere majority of the shareholders. Automatic Self-Cleansing (Footnote continued on next page)
fundamental nature relating to the structure and operation of the enterprise which modern corporation statutes generally recognize as within the ambit of shareholder action. These include such matters as amendment of the articles of incorporation,\textsuperscript{41} dissolution,\textsuperscript{42} sale of all the assets of the business,\textsuperscript{43} and merger or consolidation.\textsuperscript{44} Some of these matters, such as merger and consolidation, relate primarily to the affairs of the public issue corporation, but others, particularly those concerning amendment of the articles of incorporation and dissolution, can touch the affairs of the close corporation with as much frequency as those of the public issue corporation. Accordingly, the participants in the close corporation must evaluate their needs with regard to control both in their capacities as shareholders and also in their capacities as directors.

In addition to recognizing the two-level nature of control, it is also necessary to realize that some of the legal devices available to the participants in the close corporation through which they can distribute control operate within the framework of the corporate structure itself while other such devices operate outside the corporate framework and that a careful evaluation of the relative merits of these alternative devices must be made to determine which of them will best serve the needs of the participants from both a business and a legal standpoint. In the discussion which follows attempt will be made to present some of the specific control problems which face the participants in the multiple-ownership company and to evaluate control devices

\begin{footnotes}
\item Filter Syndicate Co. v. Cuninghame, [1906] 2 Ch. 34 (C.A.). In Manufacturers' Land & Improvement Co. v. Cleary, 121 Ky. 403, 406, 89 S.W. 248, 249 (1905), the court observed: "The judgment or discretion of the governing body, usually a board of directors, as to matters intra vires, is entirely beyond the control of the stockholders through the intervention of the courts, except for frauds committed or threatened against the corporation or the minority stockholders." However, if all the shareholders in a corporation agree that certain action should be taken, it is arguable that their voice should control over that of the board of directors. As Professor Ballantine has pointed out, "the right to have the affairs of the corporation managed by the board of directors is a right of each shareholder derived from the statute under which the company is formed." Therefore, as he says, "if the real parties in interest unanimously agree on lawful corporate acts, their voice should control." Ballantine, Corporations § 43, at 123 (rev. ed. 1946). A similar viewpoint has been expressed by Dean Stevens. See Stevens, Private Corporations § 145, at 651-53 (2d ed. 1949).
\item KRS 271.445.
\item KRS 271.500.
\item KRS 271.415.
\item KRS 271.470.
\end{footnotes}
which have been used to meet those problems in particular relation to the law in Kentucky.

2. *Cumulative voting.*

If the main concern of each participant in the multiple-ownership company is that he be assured of representation on the board of directors, he may find that this assurance, in Kentucky at least, can be established through resort to the cumulative voting privilege, which is guaranteed to shareholders in Kentucky corporations by constitutional provision.\(^4\) Under this privilege a shareholder possessing one vote for each share of stock owned by him (the usual situation) may concentrate his total number of votes on one or more candidates of his choice instead of being required to cast his votes on a single candidate for each director position to be filled. The usefulness of this privilege to the individual shareholder will depend, of course, on the total number of voting shares he owns in relation to the number of directors on the board. In a three-man corporation with a board of directors of three persons, in which the shares of stock are divided equally among the three shareholder-owners, any one of the shareholders through use of cumulative voting could be assured of electing at least one director. On the other hand, if there are five shareholders who own equal interests in the stock of the corporation, one shareholder alone could not by means of cumulative voting elect one of the directors on a three-man board.\(^4\)

\(^4\) Ky. Const. § 207. The provision reads:

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

A similar provision appears in the Kentucky corporation statute. See KRS 271.315(2). Kentucky is one of thirteen states that makes cumulative voting mandatory by constitutional provision. The other states are Arizona, Idaho, Illinois, Mississippi, Missouri, Montana, Nebraska, North Dakota, Pennsylvania, South Carolina, South Dakota, and West Virginia. Ten additional states, Alaska, Arkansas, California, Hawaii, Kansas, Michigan, North Carolina, Ohio, Washington, and Wyoming, provide for mandatory cumulative voting in their corporation statutes. See 1 Model Bus. Corp. Act Ann. 522, 524 (1960).

Furthermore, even in those instances in which the cumulative voting privilege would mathematically assure the individual shareholder of representation on the board, he must be alert to certain maneuvers which can sometimes be used to weaken or destroy the effectiveness of his right. One of these consists in reducing the total number of directors, thereby increasing the total number of shares it takes to elect one director; 47 another consists in classifying the board of directors so that only a portion of the board is elected in any one year. 48 Both of these maneuvers it appears could be effectively thwarted by the shareholders in a Kentucky corporation through provisions in the articles of incorporation (or bylaws) setting up a requirement of unanimous consent of the shareholders for any changes in the total number of directors or in their terms of office. 49

As to the classification procedure, it would probably be unwise to assume that the provision in the Kentucky corporation statute

47 See, e.g., KRS 271.345(4), which provides that the number of directors may be prescribed by the articles of incorporation or bylaws. A majority of the shareholders could, therefore, by amendment of the articles or bylaws change the number of directors as originally fixed. Some of the states with mandatory cumulative voting provisions have built into their corporation statutes a means of preventing a majority from reducing the number of directors to the detriment of the minority. The Michigan General Corporation Act, for example, provides that the number of directors cannot be reduced if a sufficient number of votes are recorded against such reduction which, if cumulatively voted, would elect one or more directors and if, after the reduction, these same votes, could not cumulatively elect the same number of directors as before the reduction. 5A Mich. Comp. Laws § 450.13 (Mason's Supp. 1956).

48 See, e.g., KRS 271.345(4) which provides that "directors shall be elected for terms of one year, except that it may be provided by the articles or bylaws, or by a vote of the shareholders, that the directors be elected for terms of two years or three years, in which case the terms shall be so arranged that the terms of an equal or nearly equal number of directors will expire each year."

49 Unanimous consent for amendment of the articles of incorporation would seem to be clearly authorized by KRS 271.445(2), which permits an increase in the voting requirement for amending the articles above the usual majority vote. Unanimous consent for changes in the bylaws would seem to be authorized by KRS 271.315(7), which provides broadly that the articles or the bylaws may specify the votes that shall be necessary for the transaction of any business, except where restricted by the corporation statute itself. KRS 271.285, the section of the statute devoted to the bylaw-making power, contains no restrictions as to the number of votes needed to amend the bylaws. As said by the New York Court of Appeals in Benintendi v. Kenton Hotel, 294 N.Y. 112, 60 N.E.2d 829, 832 (1945), which involved, among other things, an attempt by shareholders in a close corporation to require unanimous consent for amendment of the bylaws: Every corporation is empowered to make by-laws . . . and by-laws of some sort or other are usually considered to be essential to the organization of a corporation. . . . The State has an interest in seeing to it that such "private laws" or by-laws as the corporation adopts are not inconsistent with the public law and not such as will turn the corporation into some other kind of entity. But, once proper by-laws have been adopted, the matter of amending them is, we think, no concern of the State.
authorizing the staggering of the terms of office of the board of directors would meet the same fate that befell a similar provision in the Illinois Business Corporation Act when the Supreme Court of Illinois, in the well-known case of Wolfson v. Avery, declared such provision unconstitutional as incompatible with the section of the Illinois Constitution guaranteeing shareholders in Illinois corporations the right to vote cumulatively in the election of directors. The Illinois court relied heavily on the debates of the Illinois constitutional convention at which the provision was adopted and the contemporaneous comments in the public press as indicating a purpose to afford the minority protection in proportion to its voting strength. However, the debates of the constitutional convention at which the Kentucky provision was adopted do not carry the same persuasive implications as to purpose. These debates reveal that the effect of failure to elect the entire board at one time was actually considered in the adoption of the Kentucky constitutional provision and a suggestion made but rejected that language be used requiring that all directors (or at least one-half) be voted upon at one time. The inference which one writer has derived from the failure of this suggestion to be adopted is that the delegates were apparently willing to accept classification as compatible with cumulative voting.

It appears, therefore, that the minority shareholder in Kentucky can best insulate himself against the possible adverse effects of the classification procedure by insisting on a built-in protection in the form of a provision in the articles of incorporation (or by-laws) requiring unanimous approval for adoption of any proposals

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50 6 Ill.2d 78, 128 N.E.2d 701 (1955).
51 126 N.E.2d at 707-10.
52 3 Proceedings and Debates in the Convention, Kentucky 3732-37 (1890). Actually, there seems to be some question whether even the debates at the Illinois constitutional convention carried the strong implications as to purpose stressed by the court in Wolfson v. Avery. In a vigorous dissenting opinion, Justice Hershey questioned the interpretation as to purpose which the majority of the court had derived from resort to extrinsic aids and urged that a proper analysis of the constitutional provision demonstrated that the statutory classification procedure was not unconstitutional. Commentators have likewise found similar objections to the majority opinion. See, e.g., Sell & Fuge, Impact of Classified Corporate Directorates on the Constitutional Right of Cumulative Voting, 17 U. Pitt. L. Rev. 151 (1956).
53 3 Proceedings and Debates in the Convention, Kentucky 3732-35 (1890).
to change the terms of directors. The disastrous consequences which can result to an individual shareholder who fails to require such a provision are vividly illustrated by a recent Ohio case in which the articles of incorporation of a closely held corporation had been amended so as to provide three-year terms for the three-man board, with their terms so staggered that only one director would be elected at each annual meeting. The effect of this action, upheld by the Supreme Court of Ohio, was to deprive one of the shareholders, who owned forty per cent of the company's stock, from securing representation on the board of directors through use of the cumulative voting privilege given to him by the Ohio corporation statute. The 1955 revision of the Ohio General Corporation Law has eliminated the possibility of such an extreme maneuver in the future by providing that each class

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55 See note 49 supra.

56 Humphrys v. Winous Co., 165 Ohio St. 45, 133 N.E.2d 780 (1956).

57 When this case came before the intermediate appellate court of Ohio for decision, the court held that the resolution amending the articles of incorporation so as to classify the three member board into three classes was invalid since it could not be assumed that the authority granted by the corporation statute to classify the board of directors was intended to permit complete nullification of the right of a shareholder to cumulate his vote, a right which had been recognized in the corporation statute long before the privilege of classification was granted. Humphrys v. Winous Co., 125 N.E.2d 204 (Ohio Ct. App. 1955). In reversing, the Supreme Court of Ohio interpreted the statutory provision for cumulative voting as guaranteeing to minority shareholders only the right of cumulative voting and not as necessarily guaranteeing the effectiveness of the exercise of that right. Humphrys v. Winous Co., 165 Ohio St. 45, 133 N.E.2d 780, 789 (1956).

The Supreme Court of Pennsylvania adopted a similar position as to a constitutional provision guaranteeing the right to vote cumulatively in Janney v. Philadelphia Transp. Co., 387 Pa. 282, 128 A.2d 76 (1956). In this case the Pennsylvania court said (128 A.2d at 80) :

All that the Constitution provides is that each stockholder should have the right to concentrate his votes on one or more candidates to be chosen in any given election; that right is undisputed, but as to how many candidates there shall be at the election, whether they must consist of all the directors of the corporation, whether they cannot be classified and their elections staggered, -as to these and many other factors which necessarily enter into each situation the Constitution is wholly silent; to write into it any such limiting or qualifying provisions as contended for by plaintiff would be an extreme exercise of judicial legislation.

The Pennsylvania court sought to distinguish the Illinois case of Wolfson v. Avery on the technical ground that the Pennsylvania constitutional provision is framed in terms of each shareholder having as many votes as the number of candidates whereas the Illinois constitutional provision is framed in terms of the number of directors. However, this distinction based on the choice of language is not altogether persuasive. See Sell & Fuge, supra note 52, at 172-74.

Other recent cases in states having mandatory cumulative voting provisions include Bohannan v. Corporation Comm'n, 82 Ariz. 299, 313 P.2d 879 (1957) (provision for classified board in articles of incorporation held to be permissible), and State ex rel. Syphers v. McCune, 143 W. Va. 315, 101 S.E.2d 834 (1958) (provision for classified board in bylaws held to be incompatible with constitutional provision).
in the case of a classified board must consist of not less than three
directors.\textsuperscript{58}

In addition to charter or bylaw provisions which bar reduction in the number of directors and which preclude use of the classification procedure, a minority interest may also need to guard against the possible ability of the majority to remove directors elected by the minority, thereby creating vacancies which could be filled by the majority despite the presence of the cumulative voting privilege. Shareholders are considered as having an inherent power to remove a director for cause,\textsuperscript{59} and statutes now exist in a number of states granting to shareholders the power of removal without cause.\textsuperscript{60} Furthermore, even in the absence of such statutes, it appears that a corporation may adopt charter or bylaw provisions for the removal of directors without cause.\textsuperscript{61} Exercise of this power of removal could, of course, effectively nullify the cumulative voting privilege, particularly if the removal can be accomplished without cause.\textsuperscript{62} To overcome this threat some states have adopted statutory provisions which prohibit the removal of any individual director if the votes of a sufficient number of shares are voted against his removal which, if cumulatively voted, would be sufficient to elect at least one director.\textsuperscript{63} Since Kentucky has no such statutory provision, a minority group interested in protecting its cumulative voting

\textsuperscript{59} Campbell v. Loew's, Inc., 134 A.2d 852 (Del. Ch. 1957).
\textsuperscript{60} See 1 Hornstein, Corporation Law and Practice § 889 (1959).
\textsuperscript{61} See Ballantine, Corporations § 185, at 434 (rev. ed. 1946); Stevens, Private Corporations § 163, at 764 (2d ed. 1949).
\textsuperscript{62} Once removal has been accomplished, the corporation statute in Kentucky tends to favor the majority. KRS 271.345(4)(a) provides that vacancies in the board of directors are to be filled by the remaining members of the board, except as otherwise provided in the articles or bylaws. Such persons hold office until their successors are elected by the shareholders, which may be at the next annual meeting or at a special meeting called for such purpose.
\textsuperscript{63} See, e.g., Cal. Corp. Code Ann. § 810 (Deering 1958); 2B N.C. Gen. Stat. § 55-27(f) (repl. vol. 1960); Ohio Rev. Code Ann. § 1701.58(C) (Page's Supp. 1960). In jurisdictions which do not have such a statutory provision it has been suggested that courts could forestall arbitrary use of the removal power by the majority to defeat the cumulative voting right by limiting the power of removal without cause to representatives of the majority. Comment, Cumulative Voting—Removal, Reduction and Classification of Corporate Boards, 22 U. Chi. L. Rev. 751, 753 (1955). In New York, a permissive cumulative voting jurisdiction, it has been held that an amendment of a corporate charter to provide for cumulative voting had the effect of invalidating an existing bylaw provision which provided for removal of a director without cause. In re Rogers Imports, Inc., 202 Misc. 761, 116 N.Y.S.2d 106 (Sup. Ct. 1952).
privilege from this removal power may need to arrange for such protection through appropriate clauses in the articles of incorporation or bylaws restricting the scope of the power of removal which can be exercised by the majority.64

This in turn raises another interesting question which presses in the opposite direction. Can shareholders in a corporation organized in a mandatory cumulative voting jurisdiction, such as Kentucky, agree not to exercise their cumulative voting privilege? If a majority in interest were to persuade the minority to agree to such an arrangement, would it be binding on the minority? Two recent cases outside of Kentucky have indicated that shareholders can make such an arrangement, at least if it is done through private agreement among themselves and not as part of the corporate structure itself.

In the most recent of these cases, Sensabaugh v. Polson Plywood Co.,65 the issue arose as the result of a bylaw which a majority of the shareholders of a Montana corporation had adopted providing for straight voting by the shareholders. Later, a shareholder who had approved this bylaw asserted his right to vote cumulatively at a corporate election over the objection of the presiding officer. The latter refused to permit any of the shareholders to vote cumulatively and counted all ballots as straight ballots. The shareholder then brought a suit to have the election of directors declared null and void and to have the court order the holding of a new election. The Supreme Court of Montana affirmed a judgment for the plaintiff shareholder on the basis that a corporation could not through a bylaw deny the right of cumulative voting. Two of the judges, however, indicated that, in their opinion, there was nothing in the constitutional provision guaranteeing cumulative voting which would inhibit shareholders from agreeing among themselves outside the corporate structure to forego their right to vote cumulatively. A third judge concurred in the result, thereby making a three-judge majority. A fourth judge concurred on the point that a corporation could not deprive a shareholder of his right to vote cumulatively, but dissented as to the result reached on the ground that the bylaw provision should

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64 See 1 O'Neal, Close Corporations § 3.59 (1958).
have been considered as a binding agreement among those who assented to it. A fifth judge dissented from that part of the opinion of the first two judges which had upheld the right of shareholders to agree to give up their cumulative voting rights, his position being that the constitutional provision voiced a public policy of the state as to the election of directors which could not be altered by private contract.

It is evident that at least three, and perhaps four, out of the five judges in this Montana case were willing to concede that shareholders could by agreement among themselves voluntarily give up their cumulative voting right, the only difference among the judges being the form which such agreement could take. The two judges who wrote the dominant opinion relied heavily on the earlier Nebraska case of *E. K. Buck Retail Stores v. Harkert*, in which the Supreme Court of Nebraska had upheld a private agreement that conflicted with the cumulative method of voting guaranteed by the Nebraska Constitution. The Nebraska court had taken the position that the constitutional provision was intended to secure to minority shareholders a greater representation in corporate business affairs and to prevent involuntary loss of the cumulative voting privilege but was not intended to deprive a shareholder of the right to contract with respect to the voting of his stock if he so desired.

While there appear to be no Kentucky cases directly raising this question, in the early case of *Schmidt v. Mitchell*, the Kentucky Court of Appeals asserted that no shareholder was required to vote his stock cumulatively at a corporate election unless he so desired. From this it could perhaps be inferred that the court would not have objected to an agreement among the shareholders in which they had voluntarily surrendered their cumulative voting privilege. However, there is a considerable difference between a shareholder deciding at any given corporate election not to avail himself of his cumulative voting privilege and a shareholder surrendering such voting privilege as to future elections by virtue of a shareholders' agreement. One thing the court did stress in the *Mitchell* case was that no shareholder had been denied the right to vote his stock cumulatively.

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67 101 Ky. 570, 41 S.W. 929 (1897).
3. Classification of stock.

Another device which may prove useful in achieving the desired end of representation on the board of directors is the classification of shares into two or more classes with provision for election of a designated portion of the board by each class. There is ample statutory basis in Kentucky for using this approach since the Kentucky corporation statute, like other modern corporation statutes, authorizes the use of more than one class of stock. However, a disadvantage which the use of this approach might have today is its possible adverse tax effect in depriving the corporation of eligibility to be taxed on a partnership basis under Subchapter S of the Internal Revenue Code. Moreover, in a state like Illinois which has stressed proportional representation as the purpose served by cumulative voting, there might well be objection to any arrangement which interferes with the right of each shareholder to participate in the election of all directors at each annual meeting.

This latter objection could possibly be raised under Kentucky law since the Kentucky constitutional provision on cumulative voting reads in terms of each shareholder having the right to cast the number of votes to which his share ownership entitles him multiplied by the number of directors to be elected at such election. Even if it should be concluded that the statutory provision authorizing classification of the board of directors is not incompatible with this provision, it would not necessarily follow that an arrangement classifying stock so as to enable each class to elect only a portion of the board would likewise not be incom-

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68 See 1 O'Neal, Close Corporations § 3.23 (1958).
69 KRS 271.155(1) provides: "The shares of a corporation may be divided into one or more classes or one or more series within any class. . . ."
70 Int. Rev. Code of 1954, §§ 1371-77. One of the requirements for receiving this special tax treatment is that the corporation have only one class of stock. However, under Regulations issued by the Treasury Department, this requirement is deemed to be met if two or more classes of stock are identical in every respect except the right of each class to elect the number of directors proportionate to the number of shares in that class. Treas. Reg. § 1.1371-1 (g) (1959). See Caplin, Subchapter S and Its Effect on the Capitalization of Corporations, 13 Vand. L. Rev. 185, 189-90 (1959).
71 See People ex rel. Watseka Tel. Co. v. Emmerson, 302 Ill. 300, 134 N.E. 707 (1922), which held that the constitutional provision on cumulative voting prevented the use of nonvoting preferred shares. See also § 28 of the present Illinois Business Corporation Act, which provides that "each outstanding share, regardless of class, shall be entitled to one vote on each matter submitted to a vote at a meeting of shareholders." 1 Ill. Rev. Stat. ch. 32, § 157.28 (1939).
72 See note 45 supra.
compatible. Under the former arrangement the shareholder would still be free to cumulate his votes in relation to all the directors to be elected at any one time whereas under the latter arrangement the shareholder would be confined in his voting to a particular portion of the board to be elected. This conflicts with the express language of the section. However, if it can be assumed that the purpose of the cumulative voting provision in Kentucky is merely to afford an opportunity for minority representation rather than to assure proportional representation by minorities at all times, then it is arguable that use of classified stock as a means of giving each separate interest in the corporation representation on the board should not be deemed to clash with the constitutional provision on cumulative voting. Indeed, use of classified shares could prove to be an even more effective means than cumulative voting for providing the desired representation on the board by each interest if the stock is so divided among the participants that no one of them could elect a director by cumulating his votes.\footnote{73}


Although it appears that in Kentucky the two devices just discussed, cumulative voting and classified stock, are reasonably reliable for achieving the desired end of assuring representation on the board of directors, the participants in a close corporation may sometimes prefer to make use of devices outside the corporate framework for this purpose. Here again, two devices appear to be most suitable—use of a simple shareholders’ pooling agreement or use of the more formal voting trust.

The shareholders’ pooling agreement is one in which the parties agree to vote their stock in the election of directors (and perhaps in other matters) as mutually agreed upon by them. Early courts tended to invalidate such agreements, but the prevailing attitude today is to uphold them so long as they are formed for a proper purpose, that is, to serve corporate ends and not to commit fraud or perpetrate wrong on other shareholders.\footnote{74}

\footnote{73 For a discussion of certain precautions a draftsman may need to take into account in setting up class voting, see 1 O’Neal, Close Corporations § 3.24 (1958).}

\footnote{74 1 O’Neal, Close Corporations § 5.08 (1958).}
constitutional provision on cumulative voting. With regard to the Illinois constitutional provision and its effect on unanimity requirements in Illinois, Professor Cary has suggested that a court might feel concern as to whether a rule of unanimity is fundamentally consistent with the theory of cumulative voting, since such a requirement evidences a policy to favor the representation of minorities on the board, whereas a unanimous vote requirement nullifies corporate action in the event of any dissent.\footnote{Cary, How Illinois Corporations May Enjoy Partnership Advantages: Planning for the Closely Held Firm, 48 Nw. U.L. Rev. 427, 431 (1953).} He adds, however, that "perhaps the function of the cumulative vote should be limited to companies which are publicly held, or at least to those where there is no prior agreement on voting written into the charter or by-laws."\footnote{Ibid.}

As to establishing a high vote requirement at the director level, the answer for Kentucky seems quite favorable. In the first place, there is the broad language of the statutory provision on "voting rights," which, as indicated, does not necessarily need to be construed as restricted to voting at the shareholder level.\footnote{KRS 271.815(7).} In addition, there is specific language in the section of the statute devoted to the board of directors which points to a legislative intent to recognize such a requirement. This section contains a series of miscellaneous provisions introduced by the clause, "except as otherwise provided in the articles or bylaws."\footnote{KRS 271.345(4).} One of these provisions states that "the acts of a majority of the directors present at a meeting at which a quorum is present shall be the acts of the board of directors."\footnote{KRS 271.845(4)(c).} This provision, taken together with the introductory clause, seems clearly to sanction the possible use of greater than majority vote for director action.

Another method of achieving veto over corporate action, whether at the director or the shareholder level, is through the...
use of high quorum requirements for shareholder and director meetings. If unanimous attendance is required to constitute a quorum, a shareholder or director by staying away from a meeting could prevent corporate action from being taken. This presupposes, of course, that the shareholder or director knows in advance that certain matters are to come before the meeting which he does not wish to approve. If he attends the meeting and a matter to which he objects arises for the first time at the meeting, a high quorum requirement alone will not protect him. He then needs the protection of a high vote requirement. To achieve complete veto protection, therefore, a high vote requirement becomes a desirable supplement to whatever quorum requirements may have been established.

If shareholders in a Kentucky corporation should wish the double protection of both high quorum and high vote requirements, there appears to be ample statutory authority in the Kentucky corporation statute for use of high quorum requirements both at the shareholder and at the director level. The provision regarding quorums at shareholders' meetings is clear and unambiguous. It reads, "except as otherwise provided in the articles of incorporation: (a) the presence, in person or by proxy, of the holders of a majority of the voting power of all shareholders shall constitute a quorum..."

The provision regarding quorum at directors' meetings, while clear enough in recognizing possible changes in the usual majority, is unfortunately not as clear as it should be as to the corporate document in which such changes may appear. The provision appears among the miscellaneous provisions pertaining to director action in the section dealing with the board of directors. The provision itself reads that "a majority of the board of directors shall constitute a quorum for the transaction of business, unless the bylaws provide that a different number shall constitute a quorum, which in no case

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134 See 1 O'Neal, Close Corporations § 4.22 (1958).
135 One method of protecting the high quorum requirement is to require that notices of meetings state the business to be transacted at the meeting. This would serve to sidetrack the possibility of a particular shareholder unwittingly attending a meeting at which corporate action might be taken which he opposed. 1 O'Neal, Close Corporations § 4.22 (1958). However, any scheme which induces shareholders to stay away from corporate meetings to that extent reduces the opportunities for resolving differences through combined deliberation and discussion. Ibid.
136 KRS 271.335(2)(a).
137 KRS 271.345(4), (4)(c).
shall be less than one-third of the total number of directors nor less than two directors." This provision, however, appears in relation to an introductory clause to the entire series of miscellaneous provisions which reads "except as otherwise provided in the articles or bylaws." Does this mean that the change can appear in either the articles or bylaws or, as suggested by the language of the provision itself, must the change be made in the bylaws? If confined to the bylaws, the rather anomalous result is produced that quorum changes with regard to shareholders' meetings must appear in the articles whereas quorum changes as to directors' meetings must appear in the bylaws. Quirks such as this are not uncommon in corporation statutes and again suggest the need for placing provisions requiring a high vote or setting a high quorum in both the charter and the bylaws.

In summary, then, the Kentucky corporation statute would appear to contain the needed flexibility to permit the use of charter or bylaw clauses containing veto provisions and to forestall the likelihood of a Benintendi decision being handed down by the courts of this state. However, it must be remembered that, while veto provisions can prove useful at times to the shareholders of a close corporation, such provisions enable any one shareholder to block proposed corporate action. The shareholders must ask themselves, therefore, whether the need for protection of minority interests through use of the veto power

138 KRS 271.345(4)(c). (Emphasis added.)
139 KRS 271.345(4). (Emphasis added.)
140 See 1 O'Neal, Close Corporations § 4.23 (1958).
141 One of the possible occasions for beneficial use of veto provisions in the close corporation is that pertaining to the issue of additional stock. Even if a shareholder possesses a pre-emptive right to subscribe to his proportionate share of the new issue, he may not be in a position to make the purchase for financial or other reasons. If the price of the new issue is considerably below the true value of the stock, his interest in the corporation may suffer serious dilution. In Scheirich v. Otis-Hidden Co., 204 Ky. 289, 264 S.W. 755 (1924), the Kentucky Court of Appeals refused to intercede on behalf of a shareholder who sought to have the court nullify an increase in the capital stock of the corporation because the new stock was offered to shareholders at par instead of at its book value. Since it appears, therefore, that in Kentucky a shareholder cannot depend on court intervention to protect his interests from dilution, the veto arrangement assumes all the more significance as a means whereby the minority shareholder may protect himself from oppressive action by the majority. Compare McClanahan v. Heidelberg Brewing Co., 303 Ky. 739, 199 S.W.2d 127 (1947) (shareholder's pre-emptive right does not entitle him to purchase additional issue of stock at par rather than at its market value as set by corporation). See generally Comment, Pre-emptive Rights In Close Corporations, 23 U. Chi. L. Rev. 697 (1956).
is so great as to override the benefits to be derived from the greater flexibility in corporate action possible through majority vote.\textsuperscript{142}

**Restrictions on Stock Transfer**

1. *The first-option restriction.*

Although proper allocation of control is a paramount consideration to the participants in a close corporation, they will also likely wish protection against a possible transfer of stock to strangers with whom they do not care to be associated. This protection may be needed not only against possible voluntary transfers by one or more of the participants themselves but also against involuntary transfers by operation of law, such as may occur upon the death of one or more of the participants. Restrictions on the transfer of stock can take many forms and can be framed to operate in various ways, but one of the most popular and useful restrictions is the first-option restriction. This restriction typically imposes a requirement that before stock of a shareholder is transferred to an outsider an offer must first be made to sell the stock to the corporation or to the other shareholders (or perhaps both). Such a restriction may appear as part of a private agreement among the shareholders or as one of the provisions governing the corporate affairs appearing in the articles of incorporation or the bylaws.

Although at first there was some tendency to condemn these first-option restrictions as constituting illegal restraints on the alienation of property, they are generally sustained today as reasonable restraints not involving an absolute prohibition against the transfer of property.\textsuperscript{143} Where the restriction appears in the

\textsuperscript{142}O'Neal, Close Corporations § 4.30 (1958).

\textsuperscript{143}Id. § 7.09. To be guarded against are restrictions that tend to place an absolute restriction on transfer, such as restrictions which prohibit transfer without the consent of the directors or other shareholders. These have frequently been held invalid as imposing unreasonable restraints upon the alienation of property. Ballantine, Corporations § 337, at 778 (rev. ed. 1946). Even "consent" restrictions, however, have sometimes been upheld, and Professor Lattin comments that the tendency of recent decisions is to uphold such restrictions, a tendency which he attributes to a recognition that the needs of the participants in an enterprise (particularly the closely held group) may override the policy against restraint. Lattin, Corporations 340-41 (1959). Of course, if a statute specifically authorizes the type of restriction involved, the problem of legality is minimized since the statute can be treated as establishing a public policy of the state favoring the restriction. See, \textit{e.g.}, Carpenter v. Dummit, 221 Ky. 67, 297 S.W. 695 (1927), in
articles of incorporation, it has been held binding as a contract between the corporation and the shareholders, under the recognized doctrine that the charter of a corporation involves a contract not only between the corporation and the state but also between the corporation and its shareholders.\textsuperscript{144} On the other hand, where the restriction appears as a mere bylaw provision, some doubt has existed as to its enforceability.\textsuperscript{145} However, most courts today seem willing to treat such a bylaw provision as constituting a separate agreement binding upon all those assenting to it, even if the bylaw itself remains of doubtful validity.\textsuperscript{146}

In \textit{Taylor's Adm'r v. Taylor},\textsuperscript{147} the Kentucky Court of Appeals indicated its approval of bylaw restrictions of the first-option variety, even in the absence of statutory authority for such bylaws. There would seem to be little doubt, therefore, that, in view of this favorable attitude on the part of the court coupled with a provision in the present corporation statute which specifically refers to the regulation of stock transfers in the bylaws,\textsuperscript{148} such restrictions will be recognized today in Kentucky even if included

\textsuperscript{144}Lawson v. Household Fin. Corp., 17 Del. Ch. 343, 152 Atl. 723 (Sup. Ct. 1930). In Thompson v. Fairleigh, 300 Ky. 144, 147, 187 S.W.2d 812, 813 (1945), speaking in relation to a provision in the articles of incorporation for retiring preferred stock, the court said: "It is primary law that the charter of a private corporation constitutes a contract between it and its stockholders and also between the stockholders inter se." However, it has been held that once an unrestricted stock certificate has been issued to a shareholder, the corporation through amendment of the bylaws cannot later impose a restriction without his consent, since to do so would impair the contract existing between him and the corporation. Sandor Petroleum Corp. v. Williams, 321 S.W.2d 614 (Tex. Civ. App. 1959).

\textsuperscript{145}Palmer v. Chamberlin, 191 F.2d 532 (5th Cir. 1951); Searles v. Bar Harbor Banking & Trust Co., 138 Me. 34, 145 Atl. 391 (1929); Elson v. Schmidt, 140 Neb. 646, 1 N.W.2d 314 (1941).

\textsuperscript{146}301 S.W.2d 579 (Ky. 1957).

\textsuperscript{147}See KRS 271.225, which reads: "The transfer of shares of stock may be regulated by the bylaws provided such bylaws are not inconsistent with the provisions of Chapter 274 of the Kentucky Revised Statutes." This latter reference is to the Uniform Stock Transfer Act, which was adopted in Kentucky in 1944. See Ky. Acts 1944, ch. 12. This act, however, was repealed in Kentucky as of July 1, 1960, when the Uniform Commercial Code became effective in this state. See Ky. Acts 1958, ch. 77, § 10-102.
in the bylaws rather than in the articles of incorporation. The *Taylor* case, however, illustrates the strict construction that courts sometimes give to such provisions and the need which thereby arises for the language used in specifying a restriction to be clear and explicit.

In the *Taylor* case a corporate bylaw read that “no transfer or sale of the stock of the Company can be made without first offering said stock for sale to the remaining stockholders.” The stock in the company had been held by three brothers. When one of them died, he left his stock to his widow under his will. Later his administrator and the widow sued the corporation and its president to compel a transfer of the stock to her. The defendants pleaded noncompliance with the bylaw restriction on the transfer of the stock. The court, however, reversing the chancellor, held that the corporation must transfer the stock to the widow. The court treated the words “transfer” and “sale” as used in the bylaw as synonymous, adopting the rather surprising position that “the use of the word ‘transfer’ looks to a sale and has no natural application to any other disposition.” Here, argued the court, there was no sale of the stock but a devolution of title by operation of law.

Whatever criticism of this reasoning by the court in the *Taylor* case might be thought appropriate, the decision makes it evident that when a restriction is intended to bind the estate of a deceased shareholder, the restriction should specifically so provide. Even such additional language might not have sufficed at the time of the *Taylor* decision, in view of the comments made by the Kentucky court in that case when attempting to distinguish a Massachusetts case presenting a similar issue. In this latter case the articles of incorporation of a closely held corporation contained a provision which read that “no sale, pledge or transfer of the stock of this corporation shall be valid unless the same shall have been first offered in writing to the corporation. . . .” The court held that the executors of a deceased shareholder were obligated to offer the stock to the company in accordance with this restriction despite the fact that the shareholder had be-

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149 301 S.W.2d at 583.
queathed the stock to certain named persons. The court reasoned that the language of the restriction was sufficiently broad to apply to all transfers of stock and that the executors, who acquired title to the stock in the place of the testatrix, acquired no greater rights than the testatrix and held the shares subject to the same restrictions on transfer which were in effect at the time of her death.

The Kentucky court sought to distinguish this Massachusetts case on two grounds: (1) in the Massachusetts case the condition read that no transfer should be "valid" whereas in the Kentucky case the condition read that the company would not recognize a sale unless the condition was complied with, and (2) in the Kentucky case a statute existed which authorized the probate court to order the transfer by the personal representative of shares of stock to the persons entitled under the will to receive such stock. Actually, however, it is doubtful whether either of these grounds was sufficient to distinguish satisfactorily the Massachusetts decision. The first ground seems somewhat strained and the second seems to have involved an unwarranted interpretation of the probate statute. The court evidently thought that this statute required it to treat the persons named in the will as the ones entitled to receive the stock whereas a proper reading of the statute seems to have left this issue open for independent determination by appropriate rules of law. It may be doubted, therefore, whether the statute was intended to carry the absolute mandate indicated by the court. Nevertheless, this interpretation of the statute by the court, if adhered to, might have interfered rather seriously with the efforts of shareholders in the close corporation to protect themselves against the possible unwanted intrusion of outside interests. However, the possible adverse effects of this interpretation may have been averted by the recent repeal of the statutory provision upon which the court rested its argument.

152 This statutory provision, which appeared as KRS 395.280, read:

In order to effect the distribution of a deceased person's estate either under a will or in case of intestacy the county court may ... authorize the personal representative to transfer shares of corporate stock which the decedent owned at his death or which was acquired after that by the estate. Such transfers shall be made to the persons entitled under the will or as distributees in case of intestacy. . . .


2. The transfer price.

In the drafting of first-option restrictions it is important to provide a method or formula for fixing the transfer price.\textsuperscript{155} While judges have indicated that they will consider unfairness of the selling price in determining whether a particular restriction is reasonable or not, they are reluctant to interfere merely because of a disparity between the option price and the current or true value of the stock.\textsuperscript{156}

The freedom which a court will give to the parties in the fixing of the transfer price is evident from the case of \textit{Krebs v. McDonald's Ex'x},\textsuperscript{157} which the Court of Appeals of Kentucky decided in 1953. The shareholders in a close corporation executed a written agreement whereby in the event of the sale or other disposition of the stock held by any one of them the other shareholders were to have the right to purchase such stock at a price to be fixed annually by the shareholders. Subsequently, one of the shareholders who had participated in the formulation of this method of evaluating the stock died and the surviving shareholders sought to purchase the stock at $100 per share, which was the valuation set at the most recent annual meeting. The widow of the deceased shareholder sought $175 a share, which was the price the State Department of Revenue had placed upon it for inheritance tax purposes. In a suit by the surviving shareholders to compel the sale to them of the stock at the price fixed by the method provided for in the agreement, the court upheld the right of the surviving shareholders to enforcement of the agreement at the valuation so established. The court said:

While a precise method of evaluating the stock might be desirable from our standpoint, such restrictive agreements often allow a lot of leeway. . . . In the case at bar, the criteria for evaluating the stock are so broad in their implications that we conclude they amounted to a carte blanche grant of power to the shareholders to set the valuation at whatever they considered reasonable so long

\textsuperscript{155} A wide variety of formulae are available for this purpose. See the discussion of these in 2 O'Neal, Close Corporations § 7.24 (1958).

\textsuperscript{156} See, \textit{e.g.}, Palmer v. Chamberlin, 191 F.2d 532 (5th Cir. 1951); Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 141 N.E.2d 812, 161 N.Y.S.2d 418 (1957). It is important, however, that the terms be as precise as possible so as to avoid the possibility of a court considering the restrictive agreement too indefinite for enforcement. See, \textit{e.g.}, Hardin v. Rosenthal, 213 Ga. 313, 98 S.E.2d 501 (1957) (price set at "market value or true value").

\textsuperscript{157} 266 S.W.2d 87 (Ky. 1953).
as they acted in good faith. . . . As heretofore stated, the valuations under the agreement never sensitively reflected changes in actual value throughout the prior twenty years of its operation, and Mr. McDonald [the deceased shareholder] was one of the architects of this method. His widow, as executrix and sole successor in interest, cannot now be heard to complain about this method of valuation.  

3. Notations on stock certificates.

If restrictions on the transfer of stock are to have their intended effect of assuring the participants in a close corporation that outsiders cannot acquire an interest in the corporation without their consent, it is important that the restrictions take the form of provisions appearing in the articles of incorporation (or bylaws), rather than as provisions contained in a private agreement outside the corporate framework, and that appropriate reference be made to the restrictions on each stock certificate. Otherwise, an innocent purchaser of stock without notice of a restriction may gain a foothold in the corporation despite the existence of the restriction.

This latter possibility is intensified by provisions which appear in the Uniform Stock Transfer Act and the Uniform Commercial Code. Section 15 of the Uniform Stock Transfer Act provides that "there shall be no restriction upon the transfer of shares . . . unless the . . . restriction is stated upon the certificate."  

A similar provision in the Uniform Commercial Code reads that "unless noted conspicuously on the security a restriction on transfer imposed by the issuer even though otherwise lawful is ineffective except against a person with actual knowledge of it." Both of these provisions emphasize the importance of making adequate reference to restrictions on the stock certificates. However, the language of the Uniform Commercial Code clarifies two problems of interpretation which had remained unsettled under the language of the Uniform Stock Transfer Act.

158 Id. at 89-90.
159 Uniform Stock Transfer Act § 15. This act was at one time the law in all fifty states, but has recently been supplanted by the Uniform Commercial Code in those states, including Kentucky, that have enacted the code. See note 148 supra. Two states, however, Kansas and North Dakota, when adopting the Uniform Stock Transfer Act, omitted § 15. See Annot., 29 A.L.R.2d 901 (1953).
160 Uniform Commercial Code § 8-204. The code became effective in Kentucky on July 1, 1960. See Ky. Acts 1958, ch. 77. The particular provision referred to in the text appears in KRS 355.8-204.
The first of these problems relates to whether it is necessary to set forth the restriction verbatim on the stock certificate or whether a shortened reference is sufficient. In *Allen v. Biltmore Tissue Corp.*, the New York Court of Appeals took the position that the word "stated" as used in the Uniform Stock Transfer Act "sanctions a notation indicating where the restriction appears and permits incorporation by adequate reference." The intent in drafting the provision which now appears in the Uniform Commercial Code was to adopt this approach and to clarify the ambiguity arising from the use of the word "stated" by using the word "noted."

The other troublesome interpretative problem under the Uniform Stock Transfer Act has been whether a restriction to be valid even against purchasers with notice must be stated on the stock certificate. The courts have been sharply divided in their answer to this question. In *Costello v. Farrell*, the Supreme Court of Minnesota held that, where the restriction did not appear on the certificate, a purchaser who was unaware of it at the time of the agreement to purchase or at the time she gave her checks in payment but who was informed of it before delivery of the certificate was not affected by the restriction. The court said that in view of the language of section 15, "whether or not Mrs. Farrell [the purchaser] was a purchaser for value in good faith, without notice of the restriction, is, in our opinion, not material." The court pointed to the statement made by the Commissioners on Uniform State Laws that section 15 was designed "to make certificates of stock so far as possible the sole representatives of the shares which they represent." By way of contrast, in an earlier New Jersey case, the court, in refusing

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162 141 N.E.2d at 814, 161 N.Y.S.2d at 421.
163 See the official comments to § 8-204 in Uniform Commercial Code, 1958 Official Text with Comments, published by the American Law Institute and National Conference of Commissioners on Uniform State Laws.
166 48 N.W.2d at 561; 6 U.L.A. 20 (1922).
167 Baumohl v. Goldstein, 95 N.J.Eq. 597, 124 Atl. 118 (Ch. 1924) (purchase by officer and director who was one of incorporators with notice of bylaw restriction). Accord, Doss v. Yingling, 95 Ind. App. 494, 172 N.E. 801 (1930) (purchase by officer who was one of original parties to agreement containing restriction on transfer).
to apply section 15 to a purchaser with notice, commented that “this act, of course, was designed for the protection of innocent purchasers of stock, in the open market or otherwise, and not at all as a shield by one with knowledge of a condition to unconscionably protect himself from the consequences thereof.”

A recent New York case echoes the same attitude when, in referring to the New York counterpart of section 15, the court said that “it does not affect the rule that one may not purchase and obtain good title to stock in a corporation when one knows of equities in another stockholder affecting such purchased stock.” The Uniform Commercial Code has settled this conflict by treating the unnoted restriction as ineffective except against a person with actual knowledge of it.

**Deadlock and Dissolution**

1. *In general.*

One of the most critical problems which face the participants in a close corporation is that arising when disputes and disagreements among them hinder the amicable pursuit of their business affairs. Such dissension becomes particularly acute when veto arrangements prevent vital corporate decisions from being made, thereby causing a deadlock and stalemate in the corporate business. When dissension and deadlock reach such serious proportions, dissolution may seem to one or more of the participants to be the only practical solution. Yet dissolution is not always as readily available in a close corporation as in a commercial partnership.

The Uniform Partnership Act recognizes the power of any one partner to dissolve the partnership at any time even though this may subject such partner to damages for violating the partnership agreement. As one court put it, “there can be no

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168 Baumohl v. Goldstein, 95 N.J.Eq. 597, 124 Atl. 118, 121 (Ch. 1924).
170 121 N.E.2d at 624. Despite the reasonableness of this interpretation of § 15, it is stated in 12 Fletcher, Cyclopedia Corporations § 5458 (perm. ed. rev. vol. 1957) that a majority of the cases seem to have held the statutory language to apply to all purchasers regardless of notice. To the same effect, see 53 Mich. L. Rev. 620 (1955). It is there pointed out that special fiduciary considerations may sometimes intervene as in Baumohl v. Goldstein and Doss v. Yingling, where the person seeking to avoid the restriction was an officer of the corporation.
171 Uniform Commercial Code §§ 31(2), 33(2). These same provisions appear in KRS 362.300(2), 335(2). The Uniform Partnership Act was adopted by the (Footnote continued on next page)
such thing as an indissoluble partnership." 73 Individual participants in the close corporation do not ordinarily possess such general power, at least in the absence of agreement among them recognizing such power, and they may find that appeal to the courts is fruitless despite dissension if their enterprise remains a profitable going concern. 74

The legal problems relating to dissolution in the close corporation typically move in two directions: (1) the extent to which the participants may secure voluntary or involuntary dissolution by virtue of procedures contained in the corporation statutes of the state, and (2) the extent to which the participants may provide their own procedures for dissolution, either within or without the corporate structure, independently of corporation statutes.

2. Dissolution under corporation statutes.

The Kentucky corporation statute contains a group of sections that deal extensively with the voluntary dissolution of a corporation. 75 These sections provide that a Kentucky corporation may elect to dissolve voluntarily and wind up its affairs either by the act of the corporation or by the written consent of the holders of all the voting power of the shareholders. If dissolution is by act of the corporation, such dissolution must be authorized by a vote of the holders of at least a majority of the voting power of all shareholders entitled to vote, unless the articles of incorporation

(Footnote continued from preceding page)

Kentucky General Assembly during its 1954 legislative session and became effective in Kentucky on June 17, 1954. See Ham, Kentucky Adopts the Uniform Partnership Act, 43 Ky. L.J. 5 (1954). This Act is now law in thirty-eight states. See Table of States Wherein Act Has Been Adopted in 7 U.L.A., 1960 Cumulative Annual Pocket Part.


74 See, e.g., Reid Drug Co. v. Salyer, 268 Ky. 522, 105 S.W.2d 625 (1937). In a recent New York case, Application of Pivot Punch & Die Corp., 15 Misc.2d 459 (Sup. Ct.), modified, 9 App. Div.2d 861, 193 N.Y.S.2d 34 (1959), which involved a petition for dissolution of a corporation because of dissension and deadlock between the two fifty per cent owners, the trial judge indicated his acute awareness of the similarity of the relationship between partners and that between shareholders in a close corporation when he said (182 N.Y.S.2d at 463):

In addition to the technical rules surrounding a partnership and perhaps from a purely moral point of view, more important, there exists between partners the highest degree of fidelity, loyalty, trust, faith and confidence. When these characteristics in a partnership cease, then the true partnership ceases, and when these characteristics cease between owners of equal, or verily, substantially equal, shares in a close corporation, the close corporation ceases to be beneficial to the deadlocked stockholders.

75 KRS 271.485—545.
require a greater percentage. The board of directors may call a shareholders' meeting for such purpose, or shareholders holding one-fifth of the voting power may have a meeting called for such purpose. After dissolution has been authorized by the shareholders, the formalities which follow consist in the filing of an intent to dissolve with the Secretary of State, followed later when all debts and liabilities have been paid or provided for and all remaining assets have been distributed to the shareholders, by articles of dissolution, and ultimately by issuance of a certificate of dissolution by the Secretary of State, upon assurance from the Commissioner of Revenue that all tax liabilities of the corporation have been satisfied in full.

Until 1952 the Kentucky corporation statute contained no provision directly concerned with the problem of dissension and deadlock in the close corporation. In that year, the General Assembly, following a trend in other states, enacted a statutory provision which provides for a decree of involuntary dissolution in cases of deadlock. The provision declares that a corporation "may be dissolved" by decree of court when the corporation has an even number of directors who are deadlocked in the management of the business and the shareholders are likewise divided into two equal factions representing the respective views of the directors or when the shareholders are unable to elect a board of directors consisting of an uneven number. Under such conditions the shareholders possessing one-half or more of the voting power can bring a suit for the appointment of a receiver.

It is to be observed that this statute merely says a corporation may be dissolved if the other provisions of the statute are satisfied. Does this language mean that a court is free to decide in each case whether to grant such relief, or does it mean that the court must decree dissolution if the requirements of the statute are met? If the language is considered discretionary and if the court should take a restrictive approach to the granting of equitable relief by way of dissolution, as courts in some jurisdictions have done under similar statutes, the usefulness of the Kentucky statute will no

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177 KRS 271.570(2).
178 See, e.g., Paulman v. Kritzer Radiant Coils, Inc., 143 A.2d 272 (Del. Ch. 1958) (chancellor refused to appoint receiver although for the last four annual
(Footnote continued on next page)
doubt to that extent be curtailed. Furthermore, this statute, predicated as it is on an equal division of voting power, does not reach the problems of deadlock brought about through high vote requirements whereby each shareholder regardless of his relative share ownership has an absolute veto over corporate decisions. Since it appears that unanimity and high vote requirements are permitted by the Kentucky corporation statute, it would seem desirable for the deadlock statute to be amended so as to account for deadlock arising from such veto arrangements, as has been done in New York.179

Such an amendment to the Kentucky deadlock statute would appear appropriate even if the general receivership sections of the Kentucky corporation statute are considered as available to reach this kind of deadlock.180 These sections recognize the possibility of a court appointing a liquidating receiver (as well as a receiver pendente lite) in suits brought by creditors or shareholders of a Kentucky corporation. In receivership suits in which a liquidating receiver has been appointed the court may enter a decree of involuntary dissolution after the corporate assets have been liquidated. The sections, however, do not specify under what circumstances a court would be justified in appointing a receiver, such apparently being left to the general rules of equity jurisdiction.

In the case of Oscar C. Wright Co. v. Steenman,181 the Kentucky Court of Appeals, in upholding the appointment of a receiver for a group of financially embarrassed corporations all but one of which had suspended business, made the general observation that “a court of equity has inherent jurisdiction at the instance of stockholders (or creditors) where the facts call for the exercise of its jurisdiction to appoint a receiver of either a solvent or insolvent corporation ‘on the ground of fraud, gross

(Footnote continued from preceding page)
meetings there had been a failure to elect directors because of an evenly divided vote of the shareholders). But see Krall v. Krall, 141 Conn. 325, 106 A.2d 165 (1954) (appointment of receiver for deadlocked corporation upheld under provision of statute giving shareholders holding not less than one-tenth of capital stock the right to apply for dissolution of the corporation and appointment of a receiver “whenever any good and sufficient reason exists for the dissolution of such corporation,” even though there was no finding of fraud or gross mismanagement in the conduct of the business).

180 KRS 271.550–575.
181 254 Ky. 381, 71 S.W.2d 991 (1934).
mismanagement or dissension among the stockholders, directors or officers, if there is no other adequate remedy.”

Although dissension among the participants was recognized in this broad statement as a possible ground for the exercise of equitable jurisdiction, the court three years later, in the case of *Reid Drug Co. v. Salyer*, made it clear that mere dissension and deadlock standing alone would not furnish grounds for the appointment of a receiver for a solvent corporation. The court said that such drastic measures as to a solvent corporation would not be approved “except in extremely rare cases of fraud and mismanagement.”

This lends no encouragement therefore to the use of receivership proceedings as a “way out” for the dissatisfied shareholder who encounters good faith differences between himself and his colleagues in an otherwise successful business.

Not only is the *Reid Drug Co.* case of significance for what it actually holds with reference to the inherent power of a court of equity to appoint a receiver for a solvent corporation wherein

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182 Id. at 889, 71 S.W.2d at 995.
183 268 Ky. 522, 105 S.W.2d 625 (1937).
184 Id. at 531, 105 S.W.2d at 629. The receivership proceedings in this case grew out of differences between two equally divided factions in the Reid Drug Co. The two plaintiffs had purchased a one-half interest in the business from Reid, who theretofore had operated the business as a sole proprietorship. After incorporation, Reid and his wife owned the remaining one-half interest, and they along with the two plaintiffs became the four directors of the corporation. The main source of the difficulty between the two factions seems to have come from a complaint by the plaintiffs that the business was not showing the profit which they claimed Reid had promised would be forthcoming when plaintiffs had purchased their interest in the business. Nevertheless, the business was admitted to be solvent and Reid, who had been made manager of the business, expressed his confidence that profits could be made if he were left unmolested and allowed to continue the operation of the business, there having been only about a five months operating period since the time of the incorporation of the business. Despite the deadlock which thereby resulted, the court reversed the order of the trial judge appointing a receiver, on the ground that the allegations of the petition and the testimony given in the case failed to establish fraud or mismanagement in the conduct of the corporate affairs by Reid justifying resort to such a drastic remedy in the case of a solvent corporation.
185 On the other hand, when acts of mismanagement accompany dissension and deadlock, courts may recognize receivership (and liquidation) as an appropriate remedy, even in the case of a solvent corporation. See, for example, *Graham v. McAdoo*, 135 Ky. 677, 123 S.W. 260 (1909), in which the court upheld the appointment of a receiver and an order for the sale of the corporate property where the evidence sustained the charge that the president, as the representative of one of two equally divided factions in a successfully operated closely held corporation, had engaged in such acts of mismanagement as to jeopardize the corporate property and the interests of the opposing faction. See also *Adams v. Farmers Nat'l Bank*, 167 Ky. 506, 180 S.W. 807 (1915), in which the court upheld the appointment of a temporary receiver for a solvent corporation where there were charges of mismanagement on the part of the directors of the corporation accompanied by internal dissensions among the shareholders and officers of the corporation.
deadlock exists but it is also significant for the possible influence which it may have in the decision of similar cases arising under the 1952 deadlock statute. As previously indicated, the language of this statute is permissive—the corporation may be dissolved by decree of court. In an early Kentucky case involving construction of a receivership statute, the court said that the language of the statute that a receiver “may” be appointed was not equivalent to “must” be appointed. If a similar interpretation is given to the language of the deadlock statute, then a court would be free to adopt the reasoning of the Reid Drug Co. case when a solvent corporation is involved and deny dissolution despite the existence of deadlock.

A Delaware court has already adopted this parity of reasoning with reference to the Delaware deadlock statute. The statute of that state provides that, upon application of any shareholder, the Court of Chancery may appoint a receiver (or receivers) for a corporation whenever, by reason of an equally divided vote of the shareholders, there is a failure to elect directors and such failure exists at two successive annual elections. In a suit brought by two sisters, who together owned fifty per cent of the corporation’s stock, against their brother, who owned the other fifty per cent, the plaintiffs contended that the mere showing of a failure to elect directors for two successive annual elections because of equal division among the shareholders was itself sufficient to require the court to appoint a receiver. Defendant challenged this contention, pointing to the use of the word “may” in the language of the statute. The chancellor said:

If the appointment were intended to be automatic and not within the court’s discretion there was no reason to use the permissive word “may” rather than the mandatory “shall.” It will be noticed that under 8 Del. C. § 291, dealing with the power of the court to appoint receivers for insolvent corporations, the permissive “may” is employed. This has been held on many occasions to give the court a discretionary power even though insolvency exists. . . . By parity

188 8 Del. Code Ann. tit. 8, § 226 (1953). This section grants the same power to the Court of Chancery if there is a failure to elect directors by reason of an equally divided vote of the shareholders at an election ordered by the Court of Chancery under the provisions of § 224 of the Delaware General Corporation Law.
of reasoning, particularly where the drastic receivership remedy is involved, a bare showing of failure to elect directors for two successive annual meetings because of stockholder deadlock is not sufficient to require the court to appoint a receiver, under the language of the statute. 8

Despite the position thus taken by the Delaware chancellor, it is arguable that his construction of such statutory language is not the most desirable as far as the Kentucky deadlock statute is concerned, since it could result in the deadlock statute adding little, if anything, to the already existing general receivership provisions of the corporation statute.

In this connection it is of interest to note that the present New York deadlock statute contains a specific mandate that a final order of dissolution shall be made only "if upon the application for the final order, it shall appear that . . . a dissolution will be beneficial to the stockholders or members and not injurious to the public." 9 This restrictive language has resulted in the New York Court of Appeals refusing to allow a petition for dissolution to be entertained in the case of a prosperous corporation despite the existence of allegations of serious and irreconcilable conflict resulting in deadlock. 10

Commenting on this and other deadlock statutes, Professor Lattin has said:

Generally, these statutes provide for dissolution without reference to the matter of whether it will be for the best interests of the corporation, the assumption apparently being that, in the very nature of things, the continuation of the corporate business under deadlock conditions is in itself intolerable and necessarily damaging. 11

The assumption underlying these statutes which Professor Lattin speaks of seems particularly appropriate to the Kentucky statute and points to an interpretation of the statute which makes dissolution automatic upon a proper showing of the kind of deadlock described by the statute. 12

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191 In re Radom & Neidorff, Inc., 307 N.Y. 1, 119 N.E.2d 563 (1954). The restrictive language which influenced this decision has been deleted from New York's new Business Corporation Law. See 1 Hornstein, Corporation Law and Practice (Appendix, 1961 Pocket Parts, at 112).
192 Lattin, Corporations 560 (1959).
193 See Strong v. Fromm Laboratories, Inc., 273 Wis. 159, 77 N.W.2d 389 (1956), for such an interpretation by the Supreme Court of Wisconsin of a clause (Footnote continued on next page)
3. Dissolution independently of corporation statutes.

Turning next to the second aspect of dissolution in the close corporation, that is, the extent to which the participants may provide their own criteria for dissolution, it becomes necessary to consider whether this can better be accomplished, if it can be accomplished at all, through the use of charter or bylaw provisions or through the use of an independent shareholders' agreement.

Suppose first that the participants desire to relax the requirements for dissolution as contained in the corporation statutes. Could they provide in the articles of incorporation or bylaws for dissolution of the corporation upon application of any one shareholder or stated percentage of the voting shares less than a majority? There are two possibilities for support of such provisions under the Kentucky corporation statute, neither of which, however, lends much encouragement to their successful adoption. The first possibility flows from the section of the statute dealing with the makeup of the articles of incorporation. After listing the items of information which must appear in the articles, the section contains the statement that the "articles of incorporation may contain any other provisions, consistent with the laws of this state, for regulating the corporation's business or the conduct of its affairs." While this is a broadly worded provision, its reliability to support a charter clause giving the minority the power to force dissolution is weakened for at least two reasons. In the first place, experience in other states with these broadly worded statutes sanctioning optional charter provisions has left some uncertainty as to their scope, and secondly, the illusive requirement...
ment of "lawfulness" makes it possible to attack a dissolution provision which relaxes the minimum statutory voting requirement on the ground that it violates a statutory "norm." The other possibility for supporting an optional dissolution provision relaxing dissolution requirements flows from the section of the corporation statute, already considered, which provides that the articles of incorporation or bylaws may specify the votes that shall be necessary for the transaction of any business. It will be remembered, however, that this provision is prefaced by the clause, "subject to the provisions of this chapter with respect to the vote that shall be required for a specific action." Since the section on voluntary dissolution provides that the articles cannot make provision for less than a vote of a majority of the voting power, these two sections taken together seem to preclude giving to the minority power in the corporate charter (or bylaws) to force a dissolution of the corporation.

If a minority is not permitted to call for dissolution by provision in the articles or bylaws, can this be accomplished by a shareholders' agreement? For example, could an agreement provide that if any one shareholder requests dissolution all other

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of present-day corporate life and the acceptance of the idea that corporate charters and codes of bylaws are primarily contracts among the participants in the enterprises, courts are likely in the future to give a consistently broad and inclusive scope to these statutory authorizations." O'Neal, Recent Legislation Affecting Close Corporations, 23 Law & Contemp. Prob. 341, 345 (1958).

1 O'Neal, Close Corporations § 3.49 (1958).

197 KRS 271.315(7).

198 KRS 271.500.

199 Professor Lattin has offered the suggestion that unless the statutes indicate that dissolution is possible "only" through the statutory processes "there would seem to be no good reason for a court's failing to support this kind of provision." Lattin, Corporations 598 (1959). However, another writer, commenting on a series of provisions in the Kansas corporation statute similar to those in Kentucky, has said that "the purpose of the Kansas requirement of at least a two-thirds vote for dissolution would seem to be to protect large minorities from untimely dissolution," and that "perhaps it would be felt that a provision which required a majority to accept dissolution at the instance of a minority would be inconsistent with this intention." Logan, Methods to Control the Closely Held Kansas Corporation, 7 Kan. L. Rev. 405, 442 (1959). Professor Cary, expressing similar doubts as to the validity under Illinois law of charter provisions permitting any one shareholder to call for dissolution, has observed that "perhaps it is fitting that a going concern should not be dissolvable at the whim of one shareholder, although the question might be raised why the rule should be different from that for businesses operating as a partnership." Cary, How Illinois Corporations May Enjoy Partnership Advantages: Planning for the Closely Held Firm, 48 Nw. U.L. Rev. 427, 438 (1953). It is significant that New York has made provision for relaxing dissolution requirements in its new Business Corporation Law. See 2 Hornstein, Corporation Law and Practice (Appendix, 1961 Pocket Parts, at 89).
shareholders will vote their shares for dissolution? Such an agreement, if entered into by all the shareholders in the corporation, might well be upheld in some jurisdictions, despite the fact that it would involve possible infringement on the statutory "norms" for dissolution. The result is more doubtful as far as Kentucky is concerned due to the emphasis placed on the inviolability of statutory "norms" in the reasoning of the court in the Haldeman case, discussed in connection with voting agreements. Certainly where less than all the shareholders seek to arrange for one of their number to compel dissolution, the agreement would appear doomed to failure under the reasoning of the court in that case. Still another question remains. Even assuming such an agreement involves all the shareholders and is otherwise valid, will it be enforced? It is not self-executing and this once again plunges the entire matter into the welter of uncertainty which surrounds the enforcement of shareholders' agreements generally. The draftsman must here again consider the possible use of an irrevocable proxy arrangement as a means of assuring enforceability of the agreement.

Instead of seeking ways to relax dissolution requirements the shareholders in a close corporation may wish instead to tighten such requirements so as to prevent dissolution even by a majority. This wish may be particularly evident where the shareholders have arranged for veto powers in each participant, since otherwise a group of shareholders through use of the dissolution procedure might be able to circumvent the veto power and thereby freeze out a minority shareholder against his will. Could the shareholders, therefore, set up a unanimity or high vote requirement for dissolution in the articles of incorporation to accompany whatever other veto arrangements they may have made? The sec-


201 See note 76 supra.

202 See Logan, Methods to Control the Closely Held Kansas Corporation, 7 Kan. L. Rev. 405, 442 (1959).
tion of the Kentucky statute which sets forth the vote required for voluntary dissolution is framed in terms of an affirmative vote of not less than a majority of the voting power.\textsuperscript{203} While such a provision, as already indicated, seems clearly to prevent "going down" with the vote requirements, it seems equally clearly to sanction "going up" with such requirements even to the point of unanimity. This would probably not prevent a petition for involuntary dissolution on the part of majority shareholders under the receivership sections of the Kentucky statute, but if the corporation is solvent and its business profitable, it has been suggested that under such circumstances a court would likely be willing to recognize and protect the interests of the minority.\textsuperscript{204} In other words, unanimity agreements such as this probably cannot exclude whatever power a court of equity may feel it has to investigate the need or desirability for liquidation in the interests of the corporation and \textit{all} the shareholders.\textsuperscript{205}

Whether the requirements for dissolution in any given case should be relaxed, if possible, or made more difficult is not an easy question to answer. As observed by Professor O'Neal, "whether a provision for easy dissolution or a requirement making dissolution difficult will in the long run be more advantageous to the enterprise and fairer to the participants is almost impossible to foresee."\textsuperscript{206} He indicates that in deciding what advice to give, about all the lawyer can do is weigh carefully all factors involved, including the personalities of the shareholders and how they are likely to conduct themselves in the event of conflict.\textsuperscript{207}

4. Other relief from deadlock—Arbitration.

The drastic nature of dissolution as a solution for dissension and deadlock among the participants of a close corporation,

\textsuperscript{203} KRS 271.500.
\textsuperscript{204} Logan, \textit{Methods to Control the Closely Held Kansas Corporation}, 7 Kan. L. Rev. 405, 444 (1959).
\textsuperscript{205} See 1 Hornstein, \textit{Corporation Law and Practice} \S 183 (1959). The North Carolina Business Corporation Act, as adopted in 1955, contained a provision recognizing the power of a court to liquidate the assets and business of a corporation and to enter a decree dissolving the corporation in an action brought by a shareholder when it was established that the shareholders were deadlocked in voting power and for that reason could not at two consecutive annual meetings elect successors to directors whose terms had expired. In 1959 this provision was amended so as to exclude shareholder deadlock of this kind arising "by virtue of special provisions or arrangements designed to create veto power among the shareholders." 2B N.C. Gen. Stat. \S 55-125(a)(2)(repl. vol. 1960).
\textsuperscript{206} O'Neal, \textit{Close Corporations} \S 9.06, at 175 (1959).
\textsuperscript{207} \textit{Id.} at 176-77.
particularly when the corporation is prosperous, has led to a search for other and less severe methods of resolving such strife when it arises. This search has uncovered arbitration as a possible deadlock-breaking device. However, the usefulness of arbitration in this area has been tempered somewhat by the failure of most present state arbitration statutes to provide for enforcement of agreements to arbitrate future disputes. While the Kentucky arbitration statute, for example, expressly sanctions the submission to arbitration, by written agreement of the parties, of "any controversy that might be the subject of an action,"208 language such as this has generally been interpreted as applying only to the submission of disputes which have already arisen.209 Confined in this way arbitration will not prove too helpful in resolving disputes over management and policy questions arising among the participants in a close corporation since arbitration of such matters to be effective should be agreed upon in advance.210

In states, like Kentucky, which have arbitration statutes, common law arbitration is usually also accepted, under which the parties may establish their own rules for resolving disputes.211 However, an agreement to arbitrate future disputes, while valid under the common law, does not prevent the parties from resorting to the courts if they prefer, such agreements being treated as revocable until an award has been rendered.212

New York was the first state to enact a statute broad enough to encompass future disputes.213 This action was taken in 1920. Since that time some eighteen states have adopted statutory provisions with language sufficiently broad in scope to permit enforcement of agreements to arbitrate future disputes.214 How-

208 KRS 417.010.
209 Sturgis, Commercial Arbitrations and Awards 88 (1930). See the discussion of Kentucky law in Gatliff Coal Co. v. Cox, 142 F.2d 876 (6th Cir. 1944).
212 Sturgis, Commercial Arbitrations and Awards 45 (1930). For Kentucky cases, see Kramer v. Gough, 310 Ky. 299, 220 S.W.2d 577 (1949); Jones v. Jones, 229 Ky. 71, 16 S.W.2d 503 (1929).
214 1 Hornstein, Corporation Law and Practice § 184, at 230 (1959).
ever, a 1956 decision of the New York Court of Appeals,\textsuperscript{215} construing the New York arbitration statute, has cast a dark shadow on the availability of arbitration, even under such statutes, as a solution to managerial disputes in the close corporation where unanimity agreements exist.

In that case, one of the principal shareholders in two closely held real estate corporations sought to have the court require submission to arbitration of his claim that the other principal shareholder should be removed from his position as an officer and director in each of these corporations. Arbitration was sought under the terms of an agreement between the shareholders, made at the time the corporations were formed, which stated that should any "arbitrable controversy" arise between them such controversy was to be settled by arbitration. The court held that arbitration was unavailable under the New York arbitration statute until a resolution had actually been adopted by the shareholders ousting one of them from office, since until then there would be no controversy which could be the "subject of an action" as required by the statute.\textsuperscript{216} Such a resolution was not possible in the case under consideration, however, because the agreement between the shareholders also contained a provision, embodied in the charter of each of the corporations, requiring unanimous vote for shareholder and director action.

This New York decision, if followed in other jurisdictions having similar statutory language, could interfere considerably with arbitration as a practical solution for management controversies in the close corporation. However, even if the legal pathway to use of arbitration as a deadlock-breaking measure were unencumbered, it would probably still be true that some management disputes are of such a nature as to be unsuited for


\textsuperscript{216} The pertinent part of the New York statute provided that two or more persons could submit to arbitration "any controversy existing between them at the time of the submission which may be the subject of an action, or they may contract to settle by arbitration a controversy thereafter arising between them." N.Y. Civ. Prac. Act § 1448. The question has been asked whether, as a matter of statutory construction, the court needed to interpret the phrase "which may be the subject of an action" as applicable to contracts to submit future as well as existing disputes to arbitration. 2 O'Neal, Close Corporations § 9.14 n.86 (1958). New York has sought to offset the effects of the Burkin case in its new Business Corporation Law by authorizing judicial removal of a director for cause at the suit of holders of ten per cent of the outstanding shares. See 2 Hornstein, Corporation Law and Practice (Appendix, 1961 Pocket Parts, at 99).
successful arbitration. Is arbitration, for example, a suitable solution to a dispute in a closely held corporation which involves an attempt to remove one of the parties from a corporate office, thereby depriving him of active participation in corporate affairs? Or does such a situation more nearly approximate that pictured by one writer who suggested that when the relationship between the parties has deteriorated to the extent that removal has been attempted, a dissolution seems both inevitable and desirable, and arbitration would only postpone the result?217

A possible solution which Kentucky might consider for the less serious forms of deadlock in the close corporation is to provide in its corporation statute for use of a provisional director such as now provided for in the corporation statutes of California218 and Missouri.219 The California statute provides that when a corporation has an even number of directors who are equally divided, so that business cannot be conducted to advantage or so that there is danger that the property and business of the corporation will be impaired and lost, the court may appoint a provisional director at the request of one-half of the directors or holders of not less than 33\(\frac{1}{3}\) per cent of the stock. It has been said of this approach that it "is a salutary solution for what might be only a temporary...

217 69 Harv. L. Rev. 1323, 1325 (1956). Of interest in connection with this suggestion is the fact that in the Burkin case, Burkin, the majority shareholder, whose removal through arbitration had been sought by Katz, the minority shareholder, actually instituted a proceeding to dissolve the two corporations. Katz sought by motion to stay Burkin’s application for dissolution pending a determination of arbitration of certain other matters of disagreement between the parties. The trial judge, however, refused such a stay in light of the hopeless disagreement and stalemate which existed between them. The judge pointed to the fact that the parties had been embroiled in almost continuous litigation since their corporations were formed, and that, ironically, most of such litigation had been concerned with which disputes were arbitrable and which were not. Application of Fulton-Washington Corp., 3 Misc. 2d 822, 151 N.Y.S.2d 417 (Sup. Ct.), aff’d, 2 App. Div. 2d 987, 157 N.Y.S.2d 894 (1956). The petition for dissolution was entertained even though the corporations involved continued to be profitable. The trial judge emphasized that, since the plan of operation of these two men was to form corporations for the purpose of improving vacant parcels of real estate, selling these parcels as thus improved at a profit, and then dissolving the corporations, the situation was quite different from that involved in those close corporations where the parties contemplated indefinite continuance of business operations. One writer, commenting on this aspect of the judge’s opinion in relation to the strict attitude of the New York Court of Appeals concerning dissolution of solvent corporations under the New York deadlock statute as reflected in the Radom case, offered the suggestion that “whether this is a valid distinction or not, any relaxation of the prevailing view on this point is to be welcomed,” de Capriles, Corporations, 1958 Survey N.Y. Law, 31 N.Y.U.L. Rev. 1427, 1432 (1956).


stalemate in an otherwise thriving corporation because it makes it unnecessary to put the corporation in the hands of a receiver, even when that is possible,” and “thus avoids the danger to a corporation’s business or credit, which a receivership might entail, while remedying the internal dissension.”

Purchase by one faction of the stock held by the opposing faction is one way for two groups in disagreement to avoid the losses that dissolution and liquidation might bring. Indeed, it has been recommended that majority shareholders be given an option to purchase the minority interest either as an alternative to or as an addition to agreements among shareholders providing that all will vote for dissolution in case of corporate paralysis brought about by unanimity requirements for corporate action. Furthermore, statutory provisions exist in at least two states which recognize this need for protection of majority interests. In California, for example, which permits one-third of the shareholders to petition for dissolution on certain stated grounds, including deadlock, holders of fifty per cent or more of the outstanding shares may avoid dissolution by purchasing the shares of the petitioning shareholders at their fair value. The

220 1 P-H Corp. Serv., Rep. Bull., Vol. XXIX—No. 1, July 8, 1959, § 1.7. To the effect that the use of a provisional director is of only limited utility, see Comment, Unusual Statutory Remedies for the Deadlocked Corporation in California: Voluntary Dissolution and the Provisional Director, 48 Calif. L. Rev. 272, 281 (1960), wherein the writer says: “As a remedy for deadlock with a minimum of disruption to the corporation involved, the advantages of the provisional director are obvious. . . . [A] provisional director may provide valuable assistance over rough spots when they are relatively few and far between and the points of disagreement are sharply defined. But a permanent solution to deadlocks caused by general disagreement on management policies should not be expected.” In Note, Deadlock and Dissolution in Close Corporations, 45 Iowa L. Rev. 767, 780 (1960), the writer points out two weaknesses in the provisional director statutes: (1) they apply only when there is deadlock in an even-numbered board, and (2) once the deadlock is broken there is no assurance that the directors will not again become deadlocked.


223 Cal. Corp. Code Ann. § 4658 (Deering 1953). Professor O'Neal comments that “this buy-out feature is desirable because it permits majority shareholders to preserve the enterprise as a going business and at the same time guarantees a dissatisfied shareholder a fair price for his holdings.” O’Neal, Oppugnancy and Oppression in Close Corporations: Remedies in America and in Britain, 1 B.C. Ind. & Com. L. Rev. 1, 23 (1959). Commenting on the California statutory provisions for involuntary dissolution and the accompanying buy-out feature, another recent writer has said: “When a minority stockholder ‘is locked in’ and the majority are being unfair to him, as is so often the case in close corporations, what is needed is some means by which the contending factions can get a ‘divorce.’ What the minority needs is some way to get their investment out of the corporation. This (Footnote continued on next page)
West Virginia corporation statute contains a similar provision,\(^\text{224}\) which served as precedent for the California provision.\(^\text{225}\)

A recent lower court decision in New York illustrates the practical usefulness of an arrangement whereby one faction can buy out the other faction.\(^\text{226}\) The court in that case confirmed an award by an arbitrator under a shareholders' agreement providing in broad terms for the arbitration of any differences which might arise between the parties in the operation of the business. The arbitrator had devised a plan whereby one faction could (and might be required to) purchase the stock of the other faction at a price fixed in the plan by the arbitrators. The court took the position that, when an arbitration clause is sufficiently broad, "equitable relief is proper and may be granted by the arbitrators even though such relief would not be proper if the controversies between the parties were being determined by a court rather than by arbitrators."\(^\text{227}\)

The Kentucky Court of Appeals has also recognized the usefulness of buy-out arrangements. In the early case of *Graham v. McAdoo*,\(^\text{228}\) the court, in approving the appointment of a receiver and an order for the sale of the property of a corporation owned by two equally divided factions, made the observation "that it is to the interest of all the stockholders that the corporation should be dissolved and the property sold, in order that it may be (Footnote continued from preceding page)
can be accomplished either by an involuntary dissolution or by a majority buying out the minority at a fair price. It was to provide just such a mechanism that the above-mentioned sections of the Corporations Code of California were adopted in 1931." Sturdy, *Mandatory Cumulative Voting: An Anachronism*, 16 Bus. Law. 550, 558 (1961). This same writer also observed that "in discussions with lawyers dealing with close corporations, they advise that in their opinion those in control of such corporations are more attentive to the rights of minority stockholders by reason of the existence of these remedial sections of the California Corporations Code, and that if an action is commenced under these sections a settlement satisfactory to both parties is usually reached without the necessity of going to trial." Id. at 560-61.


\(^{\text{227}}\) 185 Ky. 677, 123 S.W. 260 (1909).
purchased by one faction or the other, and thus restore a harmony in the management which it is evident never can be obtained while the situation remains as it is now." The court added: "When the case returns to the circuit court, the chancellor will doubtless order the sale on such terms as to time as will enable either party to purchase it if they desire, and this will insure such an active competition between the factions, and perhaps others, for the property, as will insure that there will be so sacrifice of it at the sale." The court added:

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**Operational Activities**

1. **Formalities.**

Not only must the participants in the close corporation cope with difficult and sometimes frustrating problems in the organization and dissolution of their enterprise but they must likewise be on constant guard for pitfalls that may confront them in the active day-to-day pursuit of their business affairs.

Perhaps no phase of their operational activities harbors more potential trouble for the participants than that pertaining to formalities required by law in the conduct of their business. The statutory mandate that the business of a corporation shall be managed by a board of directors has been construed to permit

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229 *Id.* at 688-84, 123 S.W. at 262.

230 *Id.* at 684, 123 S.W. at 262-63. Along the same lines, the Supreme Court of Wisconsin in the recent case of *Strong v. Fromm Laboratories, Inc.*, 273 Wis. 159, 77 N.W.2d 389, 396 (1958), recognized the utility of the buy-out device when, in directing the appointment of a receiver for, and the liquidation of, a prosperous business, it approved the suggestion made in the Missouri case of *Handlan v. Handlan*, 360 Mo. 1150, 232 S.W.2d 944, 951 (1950) that in such case if the opposing shareholder groups could agree upon the sale of the interest of one group to the other by a plan approved by the court, such should be permitted. The Wisconsin court added: "Therefore, we recommend that the trial court devise some plan whereby both the plaintiff trustee and the Fromm group (considering the latter to constitute a single entity) will be given an opportunity to submit offers to the receiver for the purchase of the 50 per cent stock interest of the other, or the interest of the other in the net assets of the business, before the receiver proceeds with an attempt to liquidate the business." 77 N.W.2d at 396-97. See also *Jackson v. Nicolai-Neppach Co.*, 219 Ore. 560, 348 P.2d 9 (1959), in which the Supreme Court of Oregon seemed to consider the possible availability of a buy-sell agreement as a factor justifying denial of a petition for dissolution and liquidation of a deadlocked but prosperous corporation. The court said: "We think an equitable adjustment will be reached by denying rather than granting dissolution in this case. . . . To deny liquidation imposes upon each party a certain amount of burden and uncertainty so long as their differences continue. . . . If they can not settle their disagreement, then we think that denial of relief at the present time may well lead to a fairer buy-sell agreement than the remedy of enforced liquidation, a remedy which might destroy the going concern value of the plant and give both parties an unduly small return for the value of their investment." 348 P.2d at 22.
directors to bind the corporation only when they act as a body.\textsuperscript{231} The basis for this requirement is the assumption that the shareholders are entitled to the advantages which come from combined discussion and deliberation over a problem.\textsuperscript{232} In \textit{Star Mills v. Bailey},\textsuperscript{233} the Kentucky Court of Appeals recognized this “board action” rule when, in refusing to enforce a promissory note executed by a corporate president for lack of sufficient proof of authority from the board of directors for the president so to act, it said:

A corporate board of directors must act as a board, in order to bind the corporation. When a board can delegate a power and intends to, it should act in an official meeting, and by its records. If this were not so, unofficial, casual meetings of the men who constituted the board, and parol statements thereat, would be the warrant on which would be bound the stockholders whom they represented. That is what might have been done by a co-partnership. The law creating it distinguishes between the two in several particulars, one being the manner of acting. The corporation being artificial, it can act only in the manner allowed by law.\textsuperscript{234}

Expressions such as this are obviously not entirely realistic when applied to the close corporation,\textsuperscript{235} and it is significant,

\textsuperscript{231} 2 Fletcher, Cyclopedia Corporations § 392 (perm. ed. rev. vol. 1954).
\textsuperscript{232} Ballantine, Corporations § 44 (rev. ed. 1946).
\textsuperscript{233} 140 Ky. 194, 130 S.W. 1077 (1910).
\textsuperscript{234} Id. at 197, 130 S.W. at 1079. In Bastin v. Givens, Adm’x, 170 Ky. 201, 205, 185 S.W. 885, 887 (1916), the court reiterated its position in the Bailey case when it said that “it is a well settled doctrine that a corporation can act only through its directors at an official meeting regularly held, and that its acts can be proven only by the records of such meeting.” The vigor with which early courts applied the board action rule is well illustrated in the Minnesota case of Baldwin v. Ganfield, 26 Minn. 48 (1879), in which the court declared null and void a deed signed by all the directors of a corporation despite the fact that the directors had complied with the wishes of the sole shareholder.
\textsuperscript{235} A more realistic attitude is reflected in the following expressions by a New York court in Gerard v. Empire Square Realty Co., 195 App. Div. 244, 187 N.Y. Supp. 306, 310 (1921):

We must recognize the fact that to a greater and greater degree all business, great and small, is being brought under the management of corporations, instead of partnerships; that they are, in perhaps the majority of instances, conducted by officers and directors little informed in the law of corporations, who often act informally, sometimes without meetings or even by-laws. To hold that in all instances technical conformity to the requirements of the law of corporations is a condition to a valid action by the directors would be to lay down a rule of law which could be used as a trap for the unwary who deal with corporations, and to permit corporations sometimes to escape liability to which an individual in the same circumstances would be subjected.
therefore, that the Kentucky court itself has recognized that exceptions sometimes may be necessary to the "board action" rule, such as when informality of action by directors is established through custom and usage or when the directors themselves own all the stock of the corporation and informally authorize an executive officer to act or when there has been acquiescence by the shareholders in action taken by the directors separately.\textsuperscript{236} Despite this indication of judicial tolerance toward informality by the Kentucky court, no doubt the wisest course of action to follow as to matters at least of an extraordinary nature is to insist upon the proper formalities being adhered to so as to forestall the possible development of troublesome future litigation.\textsuperscript{237}

Several of the modern corporation statutes have relaxed the requirement of formal board action\textsuperscript{238} but, with the exception of the North Carolina statute,\textsuperscript{239} these statutory provisions are framed in terms of unanimous written consent. Kentucky has no such statutory provision, and even in those states that do have such provisions, it has been pointed out that the provisions are

\textsuperscript{236} See, e.g., Kozy Theatre Co. v. Love, 191 Ky. 595, 231 S.W. 249 (1921). Even in the Bailey case, the court had conceded that it was possible for a corporation to become bound for the unauthorized acts of its officers through estoppel or acquiescence. In Paducah & Ill. Ferry Co. v. Robertson, 161 Ky. 485, 171 S.W. 171 (1914), the court recognized an exception to the general rule that all directors are entitled to notice of special meetings where an emergency existed requiring immediate action and a director who claimed that he had received no notice of such a special meeting nevertheless appeared at the meeting but left after learning of the action which was about to be taken. More recently, in Slater v. Bright, 248 S.W.2d 915 (Ky. 1952), the court held that whether one corporation had acted as a volunteer in paying the debts of another corporation should not be decided by adherence to strict formality where the affairs of the two corporations had been conducted informally and an interlocking relationship of shareholders and officers existed between the two corporations.

\textsuperscript{237} See 1 Hornstein, Corporation Law and Practice § 412 n.9 (1959).


\textsuperscript{239} 2B N.C. Gen. Stat. § 55-29 (repl. vol. 1960). The most elaborate statutory provisions yet drafted concerning informal action by directors (and shareholders) appear to be those contained in the North Carolina Business Corporation Act, which Professor O'Neal has predicted "may well set a pattern for future legislation." 2 O'Neal, Close Corporations § 8.03, at 90 (1958). The North Carolina provision recognizes informal action by directors if:

1. Written consent to the action in question is signed by all the directors . . . and filed with the minutes of the proceedings of the board . . . whether done before or after the action so taken, or if

2. All the shareholders know of the action in question and make no prompt objection thereto, or if

3. The directors . . . are accustomed to take informal action and this custom is generally known to the shareholders and if all the directors . . . know of the action in question and no director . . . makes prompt objection thereto.
of limited use and are not an invitation to ignore all the formalities of directors' meetings.\textsuperscript{240}

A similar problem of informality arises in connection with action by shareholders. This may arise in connection with action which the shareholders themselves have the power to initiate or with action initiated by the directors which requires the approval of the shareholders. Here again the general rule requires group action\textsuperscript{241} except as this rule may have been relaxed by statute or by recognition of informality by the courts. About one-half the states,\textsuperscript{242} including Kentucky,\textsuperscript{243} now by statute permit action to be taken by shareholders without a meeting provided the shareholders unanimously agree in writing to the action which is to be taken. Some of these states, like Kentucky, provide for this relaxation with respect to shareholder action but not in relation to director action. Since the general management of corporate affairs rests in the board of directors, the relaxation of formal action at the shareholder level alone obviously does not serve completely (or adequately) the needs of the close corporation. Relaxation at both levels seems preferable.\textsuperscript{244}

2. Exercise of corporate authority.

The fact that all of the participants in a typical close corporation may desire to take an active part in the operation of the business tends to blur the lines of corporate authority as usually visualized. The standard operating procedure for corporations has been described as pyramidal in form, with the shareholders at the base electing the directors and passing on other major corporate action, the board of directors at the next level acting as the policy-making body of the corporation, and the officers at the top executing the policies formulated by the board.\textsuperscript{245} The participants in a close corporation are not likely to isolate care-


\textsuperscript{241} 5 Fletcher, Cyclopedia Corporations \textsection 1996 (perm. ed. repl. vol. 1952).

\textsuperscript{242} See 2 Model Bus. Corp. Act Ann. \textsection 138, \textsuperscript{2.01-.02 (1960).}

\textsuperscript{243} KRS 271.405.

\textsuperscript{244} It is of interest that even the ABA-ALI Model Business Corporation Act makes no provision for informal action by directors. Commenting on such omission in this Model Act, Hornstein calls attention to the fact that this was a deliberate omission, especially significant, he says, because of the provision in the Model Act permitting shareholders to take action by unanimous consent in writing without the necessity of a meeting. 1 Hornstein, Corporation Law and Practice \textsection 413, at 509 (1959).

fully the several capacities in which they act, with the result that when any one of them purports to act for the corporation as its representative, questions may arise as to the scope of his authority to bind the corporation by his action. Here, reference to the law of partnership again proves helpful. Under the Uniform Partnership Act, each partner is considered to be an agent of the firm for the purposes of its business and each partner is considered to have apparent authority to bind the firm by acts for carrying on in the usual way the business of the partnership.246

Since the participants in a close corporation tend to follow a pattern which is more analogous to that of a partnership than to that of a publicly held corporation, a strong argument can be made for applying the partnership rule to the officers of a close corporation, thereby eliminating the customary distinctions drawn as to the authority of particular corporate officers.247

The most acute form in which this agency problem arises is in the one-man corporation with its sole owner-operator and

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246 Uniform Partnership Act § 9.
247 See 2 O'Neal, Close Corporations § 8.05 (1958). Professor O'Neal indicates that courts have rather consistently recognized much more extensive powers in the officers of close corporations than would be generally sanctioned in the public issue corporation, a result which he commends as consistent with the nature of the close corporation.

The president, because of the fact he is usually made the chief executive officer of the company, is said by virtue of his office to have authority to act for the corporation in matters concerning the usual course of the corporation's business. Joseph Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co., 34 Del. 567, 156 Atl. 850 (Super. Ct. 1931). However, the law in Kentucky as to the inherent power of the president to act for the corporation appears somewhat uncertain. Compare Caddy Oil Co. v. Sommer, 186 Ky. 843, 218 S.W. 288 (1920), with Ross v. Eagle Coal Co., 297 Ky. 660, 36 S.W.2d 48 (1931). For a general discussion of the implied powers of the corporation president see Note, 40 Ky. L.J. 184 (1952). The Kentucky court has described the secretary as "merely a ministerial officer who keeps the books and minutes of the stockholders' and directors' meetings and has charge of the seal of the company." Citizens Dev. Co. v. Kypawva Oil Co., 191 Ky. 154, 158, 229 S.W. 88, 90 (1921). The court has similarly referred to a bookkeeper as "a mere clerical employe." Main St. Tobacco Warehouse Co. v. Bain Moore Tobacco Warehouse Co., 198 Ky. 777, 781, 250 S.W. 98, 100 (1923). The treasurer is also usually considered a ministerial officer whose power does not extend to the execution of promissory notes unless the corporation confers such power upon him. Chemical Nat'l Bank v. Wagner, 95 Ky. 525, 20 S.W. 535 (1899). But the corporation may be estopped to deny authority on the part of the treasurer to execute such notes if he has been held out by long usage as the officer whose duties included the signing of all corporate obligations. Trapp v. Fidelity Nat'l Bank, 101 Ky. 485, 41 S.W. 577 (1897). The corporation may likewise clothe other corporate officers with authority to represent it without a formal grant of authority from the board of directors. Paducah Newspapers, Inc. v. Goodman, 251 Ky. 754, 65 S.W.2d 930 (1933); Enterprise Foundry & Mach. Works v. Miners' Elkhorn Coal Co., 241 Ky. 779, 45 S.W.2d 470 (1931); Hall-Watson Furniture Co. v. Cumberland Tel. & Tel. Co., 203 Ky. 90, 261 S.W.883 (1924).
immobilized board of directors. One authority has remarked that "probably a one-man company will be bound by any action taken in its name and on its behalf which is within the scope of its express or implied powers, if the act was performed or authorized by the shareholder-manager." His postulate is that the one-man company is no proper place for the application of general agency principles since the shareholder manager acts in his own interest and for himself alone.

A recurring question as to the scope of authority of corporate officers has been that pertaining to the bringing of suits on behalf of the corporation, particularly by the president. Although it appears that no Kentucky cases have yet been decided involving this particular question, two New York decisions illustrate the somewhat refined distinctions that may be encountered. In the first of these cases, Sterling Industries, Inc. v. Ball Bearing Pen Corp., the New York Court of Appeals held the president of plaintiff corporation to be without authority to institute an action against defendant corporation for breach of contract where the matter had been submitted to the board of directors of plaintiff corporation and the board of four members, two of whom were representatives of defendant corporation, had split evenly on a motion that suit be brought. The position of the court seemed to be that, since the bylaws of plaintiff corporation contained no authority for the president to institute litigation and since under these bylaws board action required the act of a majority of the entire board, the president had no authority to bring the suit. In

249 Fuller, The Incorporated Individual: A Study of the One-Man Company, 51 Harv. L. Rev. 1373, 1389 (1938). In the recent Kentucky case of Virginia Collins Coal Co. v. Byrge, 340 S.W.2d 464 (Ky. 1960), where the evidence showed that the owner of a majority of the stock in each of three coal corporations had treated these corporations as if she solely owned them, the court concluded that the jury was justified in finding that the majority owner had authority to employ plaintiff Byrge on behalf of the corporations. And in 20th Century Coal Co. v. Taylor, 275 S.W.2d 72, 75 (Ky. 1954), the court, in treating a corporation bound by an oral agreement entered into with its president, commented that "while it is true that ordinarily a corporation only acts through its board of directors, it appears from the evidence that Mr. Bryant [the president] was in effect the corporation and that he handled all of its important business."


251 In Savings Bank v. Benton, 59 Ky. (2 Metc.) 240, 244 (1859), the court remarked, in a suit brought against the Savings Bank, that "the president of the bank, being its chief executive officer, had a right as such to appear and answer for it, and employ counsel for its defense."

the second of these two cases, *West View Hills, Inc. v. Lizau Realty Corp.* the court held that a corporate president, who owned one-third of the stock in the corporation, could institute a suit in the name of the corporation against the remaining two shareholders, who comprised a majority of the board of directors, to protect and preserve the corporation’s interest since neither the bylaws of the corporation nor any action by the board of directors prohibited the president from bringing such suit. The court distinguished the *Sterling Industries* case on the ground that in that case any presumptive authority the president might have had to bring suit had been extinguished by the refusal of the board of directors to sanction the suit.

To meet the problem of deadlock presented by the factual situation in the *Sterling Industries* case, the new North Carolina Business Corporation Act contains a provision that "the president has authority to institute or defend legal proceedings when directors are deadlocked." Whether this solution is considered desirable or not as a matter of policy no doubt depends to some extent on how one reacts to the statement made by the New York court in the *Sterling Industries* case when it said that to sanction such a suit by the president would in effect change the corporation statute to read that "the corporation shall be managed by its board of directors, except in the case of deadlock when it shall be managed by any director who happens to be president." One conclusion seems evident. Recognition of such a power in the president (or any other managing officer) may not appeal to

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254 In reaching this result the court relied on Rothman & Schneider, Inc. v. Beckerman, 2 N.Y.2d 493, 141 N.E. 2d 610, 161 N.Y.S.2d 118 (1957) (secretary-treasurer as only active officer held authorized to institute suit against outside parties charged with converting a portion of the corporation’s assets), and Paloma Frocks, Inc. v. Shamokin Sportswear Corp., 3 N.Y.2d 572, 147 N.E.2d 779, 170 N.Y.S.2d 509 (1958) (president held authorized to commence arbitration of dispute under contract containing general arbitration clause). Judge Froessel, dissenting in the *West View Hills* case in an opinion concurred in by Judge Conway, pointed to the fact that in both the *Rothman* and *Paloma Frocks* cases (as well as in the *Sterling Industries* case), the directors were evenly split and corporate management was thereby deadlocked whereas in the *West View Hills* case it was clear that the president knew that the two other shareholders opposed the suit. The two dissenting judges thought that this made the case an even stronger one against permitting suit than the *Sterling Industries* case. For a good review of the New York cases, see Note, 46 Cornell L.Q. 159 (1961), written in specific relation to the implications of the *West View Hills* decision.
participants in a close corporation who have arranged for a veto power over corporate decisions. They may need, therefore, to augment their veto provisions so as to make it clear that no officer of the corporation is to have authority to bring suits on behalf of the corporation without prior authorization by the board of directors.\footnote{See 1 P-H Corp. Serv., Rep. Bull., Vol. XXIX—No. 9, Oct. 28, 1959, ¶ 9.2.}

3. Executive compensation.

Space limitations prevent expanding more fully on the numerous operational problems which may confront the close corporation but one additional matter deserves mention, even if only briefly, and that is the matter of executive compensation. In a close corporation the participants may well depend on the business for their livelihood, and to the extent that they do so depend, they are likely, as in the case of partners, to seek assurance of some minimum stated annual salary from the profits of the business. Indeed, the temptation often will be to set the salary of participants in their capacity as officers as high as possible to avoid the double taxation on the corporate income which may result when profits are paid out to the participants in the form of dividends.

The general rule in corporation law is that the compensation of officers rests with the board of directors.\footnote{Ballantine, Corporations § 74, at 190 (rev. ed. 1946).} However, in the close corporation the same persons who serve as officers also frequently compose the board of directors, or at least a majority of such board, and a dual relationship thereby arises which, under the accepted fiduciary principles applicable to the director position, may make vulnerable action taken in setting executive compensation.\footnote{Fletcher, Cyclopedia Corporations § 2129 (perm. ed. rev. vol. 1952).} The majority of the courts in this country still adhere to the rule that a contract made with an interested director is voidable regardless of its fairness unless in the making of the contract the corporation was represented by a disinterested quorum and voting majority of its directors.\footnote{Ballantine, Corporations § 67 (rev. ed. 1946). For Kentucky cases applying this rule to executive compensation, see Carter v. Louisville Ry., 238 Ky. 42, 36 S.W.2d 836 (1931); Beha v. Martin, 161 Ky. 838, 171 S.W. 393 (1914). Applying the rule to contracts generally, see Chilton v. Bell County Coke & Improvement Co., 153 Ky. 775, 156 S.W. 889 (1913). But see People's State Bank v. Kentucky Electric Light Co., 159 Ky. 186, 107 S.W. 845 (1908).}
statutes rarely provide any relief to the participants in the close corporation from the operation of this fiduciary principle and courts have been astute to outlaw maneuvers designed to establish an appearance of compliance with the requirement of a disinterested voting majority.

One such maneuver which has been tried is for the members of an interested board of directors to split the resolution involving their salaries into parts so that each director refrains from voting on his own salary. In an early Kentucky case, Beha v. Martin,261 where the directors did not do this, the court by way of dictum left the inference that had the directors split the resolution into separate resolutions for each officer so that each director refrained from voting on his own salary this might have made the action effective.262 In 1950, however, the Supreme Court of Wisconsin, in the case of Stoiber v. Miller Brewing Co.,263 flatly rejected this split-resolution technique, which Professor Ballantine once described as "mutual back-scratching,"264 and there is no reason to assume that the Kentucky Court of Appeals today would allow such an obvious maneuver to circumvent an established legal principle.265

If relief from such principle is needed, and a strong argument can be made that it is needed, not only in the close corporation but also in the public issue corporation, a better approach would appear to be the inclusion of a provision in the corporation statute of the state, as in California, freeing directors' contracts generally from the rigid requirements of disinterested quorum and voting majority if such contracts are otherwise found to be just and

(Footnote continued from preceding page)

261 Id. at 838, 171 S.W. 393 (1914).

262 Id. at 845, 171 S.W. at 396. See also Poutch v. National Foundry & Mach. Co., 147 Ky. 242, 143 S.W. 1003 (1912), in which the court affirmed the dismissal of a petition by minority shareholders challenging certain increases in the salaries of the three corporate officers, who owned a majority of the stock and who constituted the board of directors of the corporation. The court remarked that "there was a quorum of the Board without either of appellees voting on his own increase of salary and none of them did vote in his own case." Id. at 244-45, 143 S.W. at 1004.

263 257 Wis. 18, 42 N.W.2d 144 (1950).

264 Ballantine, Corporations § 74, at 130 (rev. ed. 1946).

265 For other cases elsewhere rejecting this reciprocal voting technique, see Angelus Sec. Corp. v. Ball, 20 Cal. App. 2d 423, 67 P.2d 152 (1937); Wonderful Group Mining Co. v. Rand, 111 Wash. 557, 191 Pac. 631 (1920).
reasonable as to the corporation. A more limited approach would be the adoption of a statutory provision directed specifically at the problem of executive compensation as was done in Wisconsin after the *Stoiber* decision. To meet the problem posed by that decision, Wisconsin added a new section to its corporation statute in 1951 which specifically permits the board of directors to fix executive compensation despite personal interest. A similar provision was added to the Ohio corporation statute in 1955. The major difference between these latter statutory provisions and the California provision is that they are limited to contracts for compensation whereas the California provision applies to directors' contracts generally.

Another possibility for meeting the dual relationship problem, independently of legislative action, is to include in the articles of incorporation (or bylaws) a provision recognizing the privilege of interested directors to be counted to make up a quorum and to vote on resolutions in which they have a personal interest. Case authority exists outside of Kentucky which indicates that such a provision will be upheld even though it may have the effect of changing the common law rule. Of course, if the shareholders approve action taken by directors in which the directors have a personal interest, this cures the defect, provided such action is considered as voidable only, and renders the action valid and enforceable. However, if such shareholder approval is by less than all the shareholders, then as the Kentucky court said in *Benha v. Martin*, "a court of equity, on application by the minority stockholders, will review the reasonableness of the salaries allowed the corporate officers by the directors, with the approval of the majority of the stockholders, and where it appears that the salaries allowed, considering the nature and extent of the services

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269 See Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 20, 89 A.2d 862 (Ch. 1952), aff'd, 38 Del. Ch. 253, 93 A.2d 107 (Sup. Ct. 1952) (recognized right of interested directors to be counted for purposes of quorum).

270 3 Fletcher, Cyclopedia Corporations §§ 979, 982 (perm. ed. rev. vol. 1947). There is support for the position that interested directors are entitled to vote as shareholders on the ratification of their action as directors. Ballantine, Corporations § 71 (rev. ed. 1946). But see 3 Fletcher, op. cit. supra § 988.
rendered, are exorbitant or unreasonable, will afford adequate relief, by enjoining the payment of such salaries and adjudging a recovery for the excess over what is a reasonable salary.”

CONCLUSION

The aim of the present article has been to discuss the problems of the close corporation in particular relation to Kentucky law. Yet it becomes evident that any attempt to portray the status of the close corporation in Kentucky of necessity drives one to a comparison and review of the treatment given to such corporations elsewhere. This is understandable since the law of no one state, legislative or judicial, is likely to be complete enough to cover or anticipate the variety of legal problems which may face a corporation from the time of its formation until its ultimate liquidation. Kentucky is no exception to this condition.

As one writer has observed, “possibly the most serious fault to be found in the present scheme of things is that extraordinary reliance must be had upon skilled draftsmanship and that certain areas of uncertainty cannot be wholly avoided.” In discussing trends in the law, this same writer says, “we are witnessing a process of judicial recognition of the close corporation as an instrumentality that has ends and justifiable procedures distinguishable from those of the publicly held corporation.” But, he adds, “unfortunately, the noticeable trend of thinking among the courts is not paralleled by similar legislative action.” In England special provision has been made for so-called “private” companies having fifty or less shareholders and in the United States there are those who have from time to time urged that separate legislative treatment be given to the close corporation in this country. For the most part, however, the view here

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271 161 Ky. at 844, 171 S.W. at 395.
273 Id. at 756.
274 Id. at 757.
seems to be that what is needed is not so much a special statute for close corporations but a greater awareness within the framework of existing corporation law of the peculiarities of the close corporation. To a certain extent this awareness has become evident. With increasing frequency corporation statutes now authorize such things as (1) unanimity or high vote requirements, (2) shareholder and director action by written consent without formal meetings, and (3) dissolution for deadlock. These developments are helpful but even more in meeting the needs of the close corporation can be provided for if a real effort in that direction is undertaken. A good example of such an effort can be found in the numerous provisions designed to meet the needs of the close corporation contained in the new North Carolina Business Corporation Act, enacted in 1955.

Although there is no reason to view with alarm the status of the close corporation in Kentucky, nevertheless there are some aspects of its organization, structure, and operation that are shrouded in uncertainty due to a dearth of judicial decisions, particularly modern decisions, and to ambiguous or fragmentary treatment of such corporations in the provisions of the general corporation statute. Perhaps the best approach to removing this uncertainty and the hazards resulting therefrom would be to supplement the present corporation statute with provisions that would clarify existing areas of uncertainty and that would further free the close corporation from some of the customary restrictions

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278 See 1 O'Neal, Close Corporations § 1.14 (1958). Mr. Whitney Campbell, who for many years has been a member of the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the American Bar Association, commented as follows on the provisions of the Model Business Corporation Act prepared by that Committee, in an address he gave to the Utah Bar Association in 1956 under the title “The Model Business Corporation Act,” as published in 11 Bus. Law. 98, 104, 106 (July 1956): “I have said earlier that the model act is not designed for particular application to large or small corporations, but is intended to be equally applicable to the requirements of both the large and the small incorporated enterprise. . . . I think it is clear that a careful selection and use of the devices available under the model act afford adequate opportunity to keep the closed corporation closed and to operate it in a manner quite similar to partnership operation.” Special attention has also been given to the needs of the close corporation in the drafting of the new Business Corporation Law for New York. See 2 Hornstein, Corporation Law and Practice (Appendix, 1961 Pocket Parts, at 88).

imposed on corporations generally. In that manner a firm legislative foundation at least could be established for the needs of the close corporation, and this in turn would no doubt have its effect in encouraging a realistic and tolerant reaction on the part of the Kentucky courts as cases involving close corporations came before them for decision. Indeed, a properly constructed corporation statute adapted to the needs of the close corporation can do much to reduce the need for litigation over the affairs of these corporations, since much of this litigation in the past has been concerned with the propriety under applicable corporation statutes of action taken by the participants in the conduct of their affairs.

The small business enterprise forms an integral part of our free enterprise system on both the state and national level. The conception that limited liability is a privilege to be enjoyed only by business enterprises with large accumulations of capital coming from many investors has long since been dispelled. Accordingly, the corporate mechanism should be made flexible enough to meet the needs of all those privileged to use it.