ISSUES IN VERMONT LAW

ARTICLES

VERMONT'S BUSINESS CORPORATION LAW: A CALL FOR MUCH NEEDED REFORM

Linda O. Smiddy*

CONTENTS

 Associate Professor of Law, Vermont Law School; Chair, Vermont Bar Association, Business Association Law Committee, and the Committee that drafted the Business Corporation Reform Act, the subject of this article; LL.M. 1983, Yale University Law School; J.D. 1979, Vermont Law School; M.A.T. 1965, Harvard University; B.A. 1964, Northwestern University. The author wishes to thank Paul S. Gillies, Esq. and her Vermont Law School colleagues for commenting on earlier drafts of this article, and Laura Gillen and Scott Ober for their helpful administrative and research assistance.

INTRODUCTION

The Vermont Business Corporation Reform Act[1] will be introduced in the next session of the Vermont Legislature. The Reform Act is a much needed, long overdue piece of legislation. Although Vermont's corporation law was up-to-date when promulgated in the 1970s,[2] today it appears eccentric and outdated.[3] If the Reform Act is passed, it will modernize Vermont's corporation law,[4] provide the flexibility needed to adapt to changing business practices, and make Vermont's law consistent with the law of other jurisdictions.

Comprehensive reform is needed in both the substance and the form of Vermont's corporate law. Present law is unsuitable to modern business transactions.[5] It also is organized poorly,[6]

---

1. The Business Corporation Reform Act ("Reform Act") will be introduced in the senate, possibly as Senate Bill 1, during the first session of the 62d Legislative Biennial, which opens in 1993. The bill was introduced originally as House Bill 265 during the 61st Legislative Biennial (1991). H. 265 61st Leg. Biennial (1991) [hereinafter H. 265 (S. 1)]. H. 265 was unanimously passed by the House on March 13, 1992, and won the support of the Senate General Affairs Committee on March 27, 1992. (dates and status confirmed with the Office of the Vermont Legislative Council, Sept. 17, 1992).

The Reform Act is based primarily on the 1984 version of the Revised Model Business Corporation Act. The Revised Model Business Corporation Act can be found in the Model Business Corporation Act Annotated. MODEL BUSINESS CORP. ACT ANN. (3d ed. 1985) (updated annually). The bill was drafted by an ad hoc subcommittee of the Vermont Bar Association, Business Association Law Committee. The Reform Act Committee consisted of attorneys representing both large and small businesses, corporate general counsel, the Deputy Secretary of State, the Chief Legislative Counsel, and a legislator. During the drafting process, the committee sought the counsel of attorneys, accountants, and members of several departments of the state administration.

2. Vermont Business Corporation Act, 1969 Vt. Laws 286 (codified as amended at VT. STAT. ANN. tit. 11, ch. 17 (1984 & Supp. 1992)). The Act was passed in 1970, during the 1969 Adjourned Session. The section relating to preemptive rights was effective on passage. VT. STAT. ANN. tit. 11, § 1872 (1984 & Supp. 1992). The rest of the Act was given an effective date of July 1, 1971, subject to subsequent ratification by the 1971 General Assembly. The following year the Act was ratified. 1971 Vt. Laws 286.

3. Vermont is the only state whose law is still based on the 1960 version of the Model Business Corporation Act. 1 MODEL BUSINESS CORP. ACT ANN. at xxxiv.vii (3d ed. 1985) (updated annually) (referring specifically to indemnification provisions). That 1960 Act was, in turn, largely based on a 1950s version of the Illinois Business Corporation Law. *Id.* Only the District of Columbia and Puerto Rico have earlier versions of the code. *Id.*

4. The Reform Act applies only to Vermont's business corporation law. It does not directly modify the law of Professional Corporations or of Nonprofit Corporations. VT. STAT. ANN. tit. 11, §§ 804-813, 2301-2806 (1984 & Supp. 1992).

5. For example, present law does not address share exchange, a common form of merger. *See generally id.* §§ 1951-1957.

lacks clarity and certainty,[7] and does not meet the needs of small corporations.[8] Furthermore, the implementation of Vermont's corporate code is problematic. Although a corporate law is primarily an enabling law, the Vermont code's complex regulatory provisions and its lack of supplementary provisions make it overly rigid and inefficient to apply.[9]

The Reform Act will modernize the law to serve both state and business interests. This article discusses why reform is needed, how it should be implemented, and what changes should be made to Vermont's present corporation code. Part I discusses the interests of Vermont and of Vermont businesses in having a

---

6. Provisions on the same topic often are scattered through several chapters of the code and are not cross-referenced. *See, e.g., id.* §§ 1802(9)-(14), 1889, 1890, 1941, 1942 (all of which are concerned with distributions of assets to shareholders). Section 1802 is included in Subchapter 1, titled "General"; sections 1889 and 1890 are contained in Subchapter 3, titled "General Provisions"; sections 1941 and 1942 are found in Subchapter 7, titled "Amendments." The sections are not cross-referenced.

7. Shareholders may elect to have preemptive rights to acquire new issues of shares of the corporation in which they hold stock. Present law, however, neither defines nor provides guidelines as to the scope of those rights. *Id.* § 1872.

8. Although numerous Vermont-based corporations are large, many others are small by any measure: asset value, employees, and number of investors. Most are privately held and consequently have no ready market for their shares. As of January 7, 1992, there were 15,062 business corporations incorporated in Vermont. Of those, 1414 were new incorporations during fiscal year 1991. Memorandum from Paul S. Gillies, Deputy Secretary of State, to Oreste Valsangiacomo, Sr., Chair House Ways and Means Committee 1 (Jan. 7, 1992) [hereinafter Gillies Memo] (on file with author). Vermont companies have a significant range in size. VT. BUS. MAG. 1992 BOOK OF LISTS [hereinafter BOOK OF LISTS]. For example, Vermont banks ranged in size based on total assets from $2 million to $1.128 billion. Of the 34 banks listed, 21 had assets in excess of $100 million. *Id.* at 8. Sales of the 100 largest Vermont companies of any type ranged from $7.2 million to $1 billion. *Id.* at 29-38.

The 40 largest Vermont non-government employers have work forces from 491 to 6600. *Id.* at 15, 17, 19. Vermont business locations are classified based on number of employees. VT. DEP'T OF EMPLOYMENT & TRAINING, 1991 ANN. PLANNING INFO. Although the report treats each business location as a separate unit, regardless of whether the location is an independently owned business or is one of several affiliated units, the information nonetheless is instructive. Sixty percent of Vermont business locations employ four or fewer workers, and 19% employ five to nine workers. Thus, almost 80% of Vermont's work force is employed at locations with nine or fewer workers. *Id.* at 51, tbl. 10, 1990 Vermont Size Class by Industry. The "typical NFIB/Vermont member employs five workers and rings up gross sales of about $275,000 per year. In the aggregate, the organization's members employ nearly 22,000 workers." Nat'l Fed. Indep. Bus., Vt. Membership Profile 3 (1991) (on file with author). Ninety of the 100 largest Vermont-based businesses ranked according to sales were privately held. BOOK OF LISTS, *supra*, at 29-39.

9. *See infra* part II.

modern corporation code. Part II considers the options available for implementing reform. A corporate code's provisions may be enabling, supplementary, regulatory, or remedial in function. Part III identifies the components of Vermont law that are in greatest need of reform. This section discusses what substantive changes are required and how they should be implemented. Finally, the author concludes that reform is long overdue.

I. THE NEED FOR REFORM

To be effective, a corporation code must advance the interests of the state and of the companies governed. It must serve state interests by making sure that the use of the corporate form does not become an instrument of social abuse. The code also must promote corporate interests so that companies will choose to incorporate in Vermont. Vermont's obsolete code diminishes its effectiveness in both respects.

Vermont needs a modern corporation code for many reasons. One important reason is the state's interest in making sure its corporate policies apply to corporations located in Vermont. A company may incorporate in any state, whether or not it does business there. The law of the state of incorporation controls the compact among corporate constituents.[10] If Vermont law discourages incorporation, the state will lose the opportunity to apply its corporate policies to companies conducting business within its borders.

For example, six of Vermont's eleven principal bank holding companies are incorporated in Delaware,[11] a state with a modern

---

10. According to Harry G. Henn and John Alexander, foreign corporations generally are exempt from or not subject to the regulatory provisions applicable to domestic corporations. HARRY G. HENN & JOHN ALEXANDER, LAWS OF CORPORATIONS § 98, at 216, 221-22 (3d ed. 1983). The notable exception is California, which has made many of its domestic corporation provisions applicable to foreign corporations doing business in the state. These provisions include cumulative voting, removal of directors without cause, indemnification, limitations on distributions to shareholders, and the definition of the standard of care for directors. *Id.* To be subject to these provisions, a foreign corporation must have significant contacts with the state as measured by ownership of property, employees, sales, or shareholders located in the state. *Id.* at 216.

11. The location and state of incorporation of the Vermont Bank Holding Companies:

corporation law. Twenty-seven of the one hundred largest Vermont-based corporations are incorporated in other states, primarily Delaware.[12] This means that the law of other states, not Vermont law, will define the responsibilities of directors and their obligations to shareholders. Because it is more costly for Vermont-based businesses to incorporate outside the state,[13] it is reasonable to assume that these companies would be Vermont corporations if the state's laws were up-to-date.

Bank Holding Company	*Place of Incorporation*	*Location in Vermont*
Banknorth Group, Inc.	Delaware	Burlington
Central Financial Corp.	Vermont	Randolph
Chittenden Corp.	Vermont	Burlington
Community Bancorp	Delaware	Derby
Factory Point Bancorp, Inc.	Delaware	Manchester
Merchants Bancshares	Delaware	Burlington
Independent Bankgroup, Inc.	Vermont	Springfield
Marble Financial Corp.	Vermont	Rutland
Middlebury National Corp.	Delaware	Middlebury
Union Bankshares, Inc.	Vermont	Morrisville
VERBANC Financial Corp.	Vermont	Bellows Falls
Vermont Financial Services Corp.	Delaware	Brattleboro

Arrow Bank Corporation was omitted because its principal location is Glens Falls, New York. BOOK OF LISTS, *supra* note 8, at 9 (identifying Vermont Bank Holding Companies and their Vermont locations); Personal Communication, Office of the Vermont Secretary of State (July 6, 1992) (incorporation information).

12. This figure is based on a comparison of the list of the top 100 Vermont-based corporations ranked according to sales with the records of the Office of the Secretary of State of Vermont as of August 5, 1992. BOOK OF LISTS, *supra* note 8, at 29-39 (containing the list of the top 100 Vermont-based corporations). The number may be slightly higher with respect to Vermont-based companies that have their principal place of business in Vermont because the Secretary of State's records require only disclosure of the principal office in the state of incorporation. Fourteen of the 27 Vermont-based companies that incorporated elsewhere had 50% or more of their directors and officers located in Vermont. Of these, in excess of 60% of directors and officers are located in Vermont. In addition, in response to a survey the Reform Act Committee sent to Vermont corporate and commercial lawyers, one attorney responded that he had incorporated over 50 Vermont-based businesses in Delaware. H. 265 (S. 1) Committee Survey, Sept. 1990 (undated response) (on file with the author).

13. A Vermont-based company that incorporates in another state and conducts business in Vermont must pay the incorporation and annual report fees to that state, register in Vermont as a foreign corporation, and pay fees associated with that registration, including legal and accounting fees. For example, if a Vermont-based company incorporates in Delaware, it pays incorporation fees pursuant to Delaware's law. DEL. CODE ANN. tit. 8, § 391 (1991). When the corporation registers to do business in Vermont, it pays the fees required in Vermont. VT. STAT. ANN. tit. 11, § 2201(14) (1984).

An obsolete law also affects the state's economic development. Among the factors corporations consider when deciding where to locate is the cost and difficulty of operating under a particular corporate code. Since obsolete law makes it more expensive and difficult to do business in Vermont than in other states,[14] new businesses may decide against coming to Vermont; businesses which are already here may leave; and, investors may be reluctant to put their money in Vermont companies. The result in each case is fewer jobs in Vermont.

This is not an abstract proposition. The current political uncertainty in Canada has caused many Canadian companies to consider establishing a business presence in the United States.[15] Vermont should be a likely choice because of its proximity to Canada. The fact that Vermont's corporation law is seriously outdated will make other states more desirable.

The current outdated code also affects state revenue. A decision not to incorporate in Vermont can cost the state money[16] because Vermont corporations pay the state a franchise fee at the time of incorporation,[17] and registration subjects the corporation to the state's taxing power.[18] Although modernizing Vermont's corporation law will not make the state a contender in the

---

14. *See, e.g., infra* notes 103-11 and accompanying text.

15. Conversations with Patricia Gabel, Esq., member of the Board of Directors of the Vermont/Canada Trade Commission and the Vice-Chair of the Vermont/Quebec Commission (Mar. 1992).

16. Some or all of that lost incorporation revenue, however, may be recaptured if the corporation registers to do business in Vermont as a foreign corporation. For foreign corporations, the fee for obtaining a certificate of authority is $100; the same amount is charged for filing an annual report. VT. STAT. ANN. tit. 11, § 2201(14), (19) (1984). Fees from 591 new foreign corporations registering to do business in Vermont during the 1991 fiscal year were $59,600. Fees raised by foreign corporations filing an annual report were $400,000. Gillies Memo, *supra* note 8, attachment.

17. VT. STAT. ANN. tit. 11, § 2201 (1984). Fees for incorporating in Vermont range from a minimum charge of $35 to $1500 for corporations for which the aggregate par value of the authorized shares does not exceed $2 million. The charge for corporations with an aggregate par value in excess of $2 million is $1500 plus "$500 for each additional million dollars or fraction thereof." *Id.* § 2201(1)(G). Fees paid by the 1414 new domestic corporations during fiscal year 1991 totalled $107,657. Gillies Memo, *supra* note 8, at 1, attachment. The fees averaged $76.13 per corporation. Currently, Vermont does not impose a fee on the filing of annual reports by domestic corporations.

18. VT. STAT. ANN. tit. 32, § 5811(15) (1984).

competition for incorporation revenues,[19] the proposed revisions nevertheless may increase state revenues.

These state interests will be given effect only if companies select Vermont as the state of incorporation. Companies will choose Vermont if the state's corporation code serves their interest in having law that is predictable and flexible. Corporate law is unpredictable when it does not cover a particular subject or when a statutory provision is incomplete, ambiguous, or both. As it stands, Vermont law is also unpredictable because few judicial decisions resolve issues of corporate law.[20] To construe Vermont

---

19. Over the years, states like Delaware, New Jersey, and New York have engaged in such competition. *See* HENN & ALEXANDER, *supra* note 10, § 12, at 26-27, 31-32.

20. A review of Vermont Statutes Annotated, title 11, §§ 1801-2216 confirms that present law has been the subject of relatively few judicial decisions. Only about 50 corporate law cases have been decided in Vermont since 1858. Only 18 of these construe Vermont's present corporate law. *See* Hardwick-Morrison Co. v. Albertsson, 605 A.2d 529 (1992); Bunbury Corp. v. Wendham Sports, Inc., 154 Vt. 589, 580 A.2d 966 (1990); Cab-Tek, Inc. v. E.B.M., Inc., 153 Vt. 432, 571 A.2d 671 (1990); *In re* Mayo, 112 B.R. 607 (Bankr. D. Vt. 1990); Chase Comm. Corp. v. Barton, 153 Vt. 457, 571 A.2d 672 (1990); Hospitality Inns, Inc. v. South Burlington R.I., Inc., 153 Vt. 410, 571 A.2d 40 (1989); American Trucking Ass'n v. Conway, 152 Vt. 363, 566 A.2d 1323 (1989); F.W. Webb Co. v. Martell, 149 Vt. 254, 542 A.2d 286 (1988); *In re* Vermont Toy Works, Inc., 82 B.R. 258 (Bankr. D. Vt. 1987); Biron v. Abare, 147 Vt. 567, 522 A.2d 230 (1987); Pennconn Enter. v. Huntington, 148 Vt. 603, 538 A.2d 673 (1987); LaRoche v. Vermont Fed. Bank, 626 F. Supp. 1157 (D. Vt. 1986); Contractor's Crane Serv., Inc. v. Vermont Whey Abatement Auth., 147 Vt. 441, 519 A.2d 1166 (1986); *In re* Burke Mountain Recreation, Inc., 64 B.R. 799 (Bankr. D. Vt. 1986); *In re* Vermont Fiberglass, Inc., 38 B.R. 151 (Bankr. D. Vt. 1984); *In re* Poole, 136 Vt. 242, 388 A.2d 422 (1978); Jerene Enter., Inc. v. Burlington Hous. Auth., 363 F. Supp. 1380 (D. Vt. 1973); Lash v. Lash Furniture Co., 130 Vt. 517, 296 A.2d 207 (1972); Redd Distrib. Co. v. Bruckner, 128 Vt. 635, 270 A.2d 580 (1970); Koerber v. Middlesex College, 128 Vt. 11, 258 A.2d 572 (1969); West-Nesbitt, Inc. v. Randall, 126 Vt. 481, 236 A.2d 676 (1967); Hall v. Pilgrim Plywood Corp., 126 Vt. 224, 227 A.2d 285 (1967); A & W Artesian Well Co. v. Tornabene, 124 Vt. 413, 207 A.2d 140 (1965); New England Road Mach. Co. v. Calkins, 121 Vt. 118, 149 A.2d 734 (1959); Lapham Motors, Inc. v. Rutland R.R., 121 Vt. 24, 146 A.2d 242 (1958); Hopwood v. Topsham Tel. Co., 120 Vt. 97, 132 A.2d 170 (1957); Ruppert v. Commissioner of Taxes, 117 Vt. 83, 85 A.2d 584 (1952); Powers v. Bellows Falls Hydro-Elec. Co., 114 Vt. 536, 49 A.2d 174 (1946); Woodbury Granite Co. v. United States, 59 F. Supp. 150 (Ct. Cl. 1945); Siwooganock Guar. Sav. Bank v. Cushman, 109 Vt. 221, 195 A. 246 (1937); Wheelock v. Haskess, 98 Vt. 47, 124 A. 713 (1924); Aetna Chem. Co. v. Spaulding & Kimball Co., 98 Vt. 51, 126 A. 582 (1924); Underhill v. Rutland R.R., 90 Vt. 462, 98 A. 1017 (1916); Kinnear & Gager Mfg. Co. v. Miner, 89 Vt. 572, 96 A. 333 (1916); St. Albans Granite Co. v. Elwell & Co., 88 Vt. 479, 92 A. 974 (1915); Powers v. Rutland R.R., 88 Vt. 376, 92 A. 463 (1914); Livingstone Mfg. Co. v. Rizzi Bros., 86 Vt. 419, 85 A. 912 (1913); Herald & Globe Ass'n v. Clere Clothing Co., 86 Vt. 141, 84 A. 23 (1912); Roberts v. W.H. Hughes Co., 86 Vt. 76, 83 A. 802 (1912); State v. Rutland R.R., Light & Power Co., 85 Vt. 91, 81 A. 252 (1911); Clark v. Wild, 85 Vt. 212, 81 A. 536 (1911); Bacon v. Boston & Maine R.R., 83 Vt. 421, 81 A. 252 (1910); *In re* Consolidated Rendering Co., 80 Vt. 55, 66 A. 790 (1907); Lawrie v. Silsby, 76 Vt. 241, 56

law, business advisors must resort to other states' interpretations of comparable provisions. Such comparisons, however, are useful only when Vermont's corporate code is consistent with the law of other states.

The uncertainties of Vermont's present code make it difficult for Vermont corporations to determine in advance the legal consequences of their acts. Strategic planning becomes difficult and legal liability is uncertain. Although Vermont businesses can avoid these problems by reincorporating in other states, the process can be costly and time consuming. A modern Vermont corporation law will help eliminate uncertainty, expense, and delay.

Business corporation law also must be flexible. It must be adaptable to the particular needs of the individuals forming and operating corporations and to changes in the business environment. In good times and bad, corporations change their structure, sell and repurchase shares of stock, and combine with other companies. New financial instruments develop and old ways of doing business pass away. Large and small companies alike participate in the dynamics of both national and international markets. The need for flexibility is constant. Rigid rules quickly become outdated, increase the costs of doing business, and cause corporate flight to other states.

In summary, corporate law must further state policies and also permit corporations to operate without undue restraint. A sensible balance between these competing interests is central to the success of a corporate code because companies choose for themselves which state's law will apply to them. An unused law is a law with no effect.

A. 1106 (1904); Buck v. Troy Aqueduct Co., 76 Vt. 75, 56 A. 285 (1903); Barton Nat'l Bank v. Atkins, 72 Vt. 33, 47 A. 1716 (1899); E. Corey & Son v. Morrill, 61 Vt. 598, 17 A. 840 (1889); Cady v. Sanford, 53 Vt. 632 (1881); Perrin v. Granger, 30 Vt. 595 (1858).

One could argue that the lack of judicial decisions is evidence that there are few problems with the code. However, the relative ease with which a state's corporation code may be avoided undercuts this notion. The paucity of litigation also may be caused by the fact that businesses do not come to Vermont because of the code, or they reincorporate in other states, or that investors are advised to take their money elsewhere rather than deal with the uncertainties of Vermont law.

II. METHODS OF IMPLEMENTING REFORM

Vermont's business corporation law[21] establishes the procedures for forming, financing,[22] operating, and dissolving a business corporation. It also defines the relationships of the corporate constituents: the shareholders, and the corporate managers.[23] Although some provisions of the corporation law are intended to protect creditors, these protections are incidental to the primary focus of corporate statutes. According to one commentator, "[m]ost corporate law is concerned with the array of substantive rules and procedural devices that are aimed at controlling managerial slack and diversion while preserving adequate discretion to carry out business operations efficiently."[24]

---

21. In Vermont, as in other states, business corporation law is statutory. VT. STAT. ANN. tit. 11, § 1801 (1984 & Supp. 1992). The Vermont Constitution authorizes the General Assembly to "provide by general laws for the organization of all corporations hereafter to be created. All general laws passed pursuant to this section may be altered from time to time or repealed." VT. CONST. ch. II, § 69. Vermont's laws relating to business corporations were passed under the authority of that constitutional provision. VT. STAT. ANN. tit. 11, ch. 17 (1984 & Supp. 1992).

General corporation laws emerged during the late 19th and early 20th centuries in response both to the growing popularity of the corporate form and to the inefficiencies of having corporations created by special legislative acts. *See* Paul S. Gillies, *A Short History of Vermont's Corporation Law Part I and II*, 18 VT. B.J. & L. DIG., No. 2, at 19-20, No. 3, at 14-16 (1992) [hereinafter Gillies History] (informative discussion of the history of Vermont's business corporation law). Common law doctrines, such as piercing the corporate veil, continue to be an important part of corporate law by providing an equitable check on the strict application of the statutory rules. *See* HENN & ALEXANDER, *supra* note 10, § 146, at 344-52, § 346, at 985-86; ROBERT C. CLARK, CORPORATE LAW § 2.4, at 71-85, § 10.7, at 458-61 (1986).

22. A state corporation code deals with equity financing, that is, raising money through the sale of ownership interests represented by shares of stock. VT. STAT. ANN. tit. 11, §§ 1862-1866 (1984 & Supp. 1992). Although it authorizes the corporation to borrow money, the code does not establish procedures for issuing debt instruments, such as bonds and debentures, or for incurring short-term debt, such as loans from banks. *Id.* § 1852(8).

23. *See infra* notes 56-147 and accompanying text. Although some provisions of the corporation law are intended to protect creditors, these protections are incidental to the primary focus of corporate statutes. For example, one purpose of the provisions regulating the distribution of dividends is to prevent the distribution of corporate assets in the form of dividends and/or redemptions to shareholders to the disadvantage of corporate creditors. *See* VT. STAT. ANN. tit. 11, §§ 1867, 1889, 1890, 1891, 1941, 1942 (1984 & Supp. 1992); *see also* CLARK, *supra* note 21, §§ 2.5, 14.3 (discussing dividend statutes and how dividend statutes are intended to protect creditors, respectively).

24. CLARK, *supra* note 21, at xxiii.

The concept of the corporation as expressed in state corporation law is a limited one: a corporation is an association of owner/investors and managers. State corporation law does not treat the corporate entity as a complex economic unit that also includes employees, creditors, and suppliers. With some exceptions concerning creditors, definition and control of these other relationships are generally outside the scope of the state corporation law.

In this narrow context, corporate law serves several purposes. It establishes the process for forming, operating, combining, and dissolving corporations. It defines the relationships among corporate constituents and, to a limited extent, between the corporation and third parties. Ideally, it also should provide for flexibility of operation within the corporate structure and permit adaptation to changing business environments.

These purposes suggest two different theoretical bases of corporateness: the concession theory and the contract theory. According to the concession or "government paternity" theory, a corporation is a creature of the state and exists only under the authority of a governmental grant.[25] Those conducting business in corporate form must comply with statutory strictures imposing a significant measure of governmental control.[26] Legislatively mandated procedures control corporate conception, viability, combination, and death. According to the contract theory, incorporation creates contracts among corporate constituents, between constituents and the corporation itself, and between the state and the corporation.[27] To the extent that the corporate membership can define these terms for itself, a code based on the contract theory promotes flexibility, evoking the principle of freedom of contract.

A successful corporate code contains provisions that further its objectives in both substance and function. The substance of

---

25. Farmer's Loan & Trust Co. v. Pierson, 222 N.Y.S. 532, 538 (N.Y. Sup. Ct. 1927) (discussing concession theory); *see also* HENN & ALEXANDER, *supra* note 10, § 78, at 144-47 (including concession and contract theories in discussion of the nature of corporateness).

26. HENN & ALEXANDER, *supra* note 10, at 146.

27. *Id.* (discussing contract theory); *see also* Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819) (charter granted by British Crown to trustees of Dartmouth is contract and cannot be impaired by action of the state).

Vermont's code needs significant reform. Modification of the substance alone, however, will not correct all of the problems with Vermont's law. The functional role of the statutory provisions and the interconnections between substance and function also must be considered.

Classified according to function, statutory provisions are enabling, supplementary, regulatory, or remedial.[28] By combining different functional types of statutory provisions in a single body of corporate law and by resolving the tensions resulting from the combination, the legislature gives expression to the state's policy concerns.

A. Enabling Provisions

Enabling legislation[29] is empowering legislation. Business corporation law is primarily enabling legislation. Persons may form corporations only if authorized by the state and only within the parameters established by the state. The law empowers corporations to act[30] and authorizes corporate constituents to make certain elections.[31]

The possibilities of the corporate form originate in enabling legislation. It provides the flexibility for individuals to tailor the corporate structure to their particular needs and for the corporation to adapt to changing business environments. With limited exceptions, present law permits corporations to be organized for the purpose of "carrying on any business or effecting any object

---

28. Classification such as this always presents problems. A particular statutory provision may not fit neatly into a particular functional category, and distinctions between categories may be unclear. In addition, the line between substance and function may be difficult to draw. Nevertheless, the author believes that some consideration of the functional characteristics of individual statutory provisions aids the discussion of the development of law.

29. An enabling statute is one that "enabl[es] persons or corporations . . . to do what before they could not. It is applied to statutes which confer new powers." BLACK'S LAW DICTIONARY 619 (6th ed. 1991).

30. VT. STAT. ANN. tit. 11, § 1852 (1984 & Supp. 1992).

31. Shareholders, for example, have the options of indemnifying corporate directors and electing preemptive rights. *See id.* §§ 1852(15), 1926(7) (discussing indemnification of officers and directors and shareholders' preemptive rights with respect to future sales of stock of the corporation, respectively); *infra* notes 144-47 and accompanying text.

not repugnant to the laws of this state."[32] The generality of the language presents corporate associates with the opportunity to design an innovative corporate structure and to modify it as time passes and conditions change.

The generality of enabling legislation also imposes costs. Its flexibility in application produces uncertainty and a lack of predictability. In addition, the presence of enabling legislation unaccompanied by supplementary guidelines for its use increases information and implementation costs. Users must investigate the range of possibilities available and spend time and money to study and choose among them. For example, present law permits the election of preemptive rights, but leaves the definition of the rights to the shareholders.[33] Although this approach provides maximum flexibility, it is also costly. Each electing corporation must formulate its own definition and incur attorneys' fees that might be unnecessary if the statute included supplementary terms that apply unless displaced by tailor-made provisions.

B. Supplementary Provisions

Supplementary law[34] provides rules and standards that apply when corporate constituents elect an option, but fail to specify how it should be implemented. Supplementary law addresses key considerations on a particular topic and simplifies the corporate drafting process.[35] The Reform Act, for example, not only enables shareholders to elect preemptive rights, it also provides statutory terms that apply to the extent they are not displaced by terms drafted by the parties.[36] Supplementary law preserves the flexibility of enabling provisions and increases their efficiency by eliminating the costs of unnecessary drafting and by

---

32. VT. STAT. ANN. tit. 11, § 1851 (1984).

33. *See id.* § 1926(7) (articles of association must set forth any preemptive rights elected by the shareholders). Preemptive rights give current shareholders the option to buy a predetermined percentage of new issues of stock of the same class(es) they currently own. The purchase percentage is based on the percentage of current ownership. *See* CLARK, *supra* note 21, at 719 (discussing preemptive rights).

34. A supplemental act is "[t]hat which supplies a deficiency, adds to or completes, or extends that which is already in existence without changing or modifying the original." BLACK'S LAW DICTIONARY 1438 (6th ed. 1991).

35. *See* 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 6.40 official cmt.

36. H. 265 (S. 1), *supra* note 1, § 6.30.

providing informative guidelines to those unfamiliar with the law. The use of enabling and supplementary regulations is consistent with the theory of corporateness that promotes freedom of contract among the participants in the corporate enterprise.[37]

C. Regulatory Provisions

Corporate law also is regulatory[38] in nature because many of its provisions impose categorical rules that must be strictly obeyed.[39] Regulatory provisions often reflect the concession theory of corporateness in which the state mandates the terms of corporate existence. Compliance with corporate formation procedures is obligatory,[40] as is the requirement that the corporation maintain a registered office and registered agent within the state of incorporation.[41] Vermont does not permit a corporation's president and secretary to be the same person,[42] and requires fundamental corporate changes to be approved by the affirmative vote of at least two-thirds of the shares entitled to vote.[43]

Regulatory legislation is useful for imposing limits on corporate operation and for implementing important state policies, such as the standards for directors' conduct.[44] However, drafters of legislation must use categorical rules judiciously. Although rules may be sensible at the time they are written, they, in time, may become ineffective or even counterproductive.[45] One example in present law is the collection of rules controlling distributions to shareholders. When the provisions were written, they reflected accounting principles of the time. Today, the rules may

---

37. *See supra* note 27 and accompanying text.

38. To regulate is "[t]o fix, establish, or control; to adjust by rule, method, or established mode; to direct by rule or restriction; to subject to governing principles or laws." BLACK'S LAW DICTIONARY 1286 (6th ed. 1991).

39. *See supra* note 25 and accompanying text.

40. VT. STAT. ANN. tit. 11, §§ 1921-1929 (1984 & Supp. 1992).

41. *Id.* § 1859.

42. *Id.* § 1897.

43. Under current law, for example, amendments to the articles of association, plans of merger or consolidation, and resolutions of dissolution must be approved by "the affirmative vote of the holders of at least two-thirds of the [outstanding] shares [of the corporation] entitled to" vote on the matter. *Id.* § 1932(a)(3); *see also id.* §§ 1953(b), 2002(3), 2053(3).

44. *See infra* notes 200-304 and accompanying text.

45. *See infra* notes 55-135 and accompanying text.

prevent a financially healthy company from issuing dividends to its shareholders.

Drafters also are tempted to use substantively broad regulatory mechanisms to safeguard what they perceive to be desirable state policies. The danger here, too, is that changing times will call for changes in policy, but overly restrictive rules make change difficult. For example, Vermont presently requires all corporations to approve fundamental corporate changes by a super-majority vote. The rule is cumbersome and overly burdensome to the operation of corporations with many shareholders.[46]

D. Remedial Provisions

Compared with regulatory provisions, corporate remedial provisions are few in number and more limited in application.[47] They provide a remedy to those who are wronged and they have a cautionary effect on potential wrongdoers. For example, shareholders objecting to certain fundamental corporate changes may require the corporation to pay them the fair value of their shares.[48] Similarly, shareholders may bring a legal action on behalf of the corporation to remedy wrongs caused by misconduct of directors, officers, or both,[49] or they may sue on their own behalf when information is not provided to them as required.[50] In other situations, failure to adhere to the requirements of the statutory provisions imposes personal liability on those purporting to act as a corporation.[51]

State corporation codes include only a few remedial provisions. Many disputes among corporate constituents are resolved through the application of other remedial bodies of law, such as

---

46. *See infra* notes 148-76 and accompanying text.

47. "Remedial" is defined as "[a]ffording a remedy; giving means of obtaining redress." BLACK'S LAW DICTIONARY 1457 (6th ed. 1991). A remedial statute is one that provides a private remedy to the injured person. *Id.*

48. *See infra* notes 177-99 and accompanying text.

49. VT. STAT. ANN. tit. 11, §§ 2003, 2004 (1984).

50. *Id.* § 1877 (imposing personal liability on corporate officers or agents for failure to provide a shareholder list as required).

51. *Id.* § 2213.

federal and state securities laws.[52] Similarly, since corporations are recognized as legal persons in their own right, third parties dealing with corporations generally are protected by the same statutory and common law rules that apply to their dealings with individuals.[53] Finally, the key purposes of corporate law—to provide a general law permitting persons to form and operate a corporation—can be served best through law that is primarily enabling, rather than remedial in nature.

Vermont's corporation law needs reform both in its substance and in its methods of implementing substantive law. Many of its substantive provisions are based on outdated policy concerns and business practices. In some situations, regulatory provisions are overbroad. In others, regulatory provisions are unnecessarily technical and complex. In still others, a regulatory approach is used when an enabling provision would be better. In addition, the present Vermont code contains broad enabling provisions that are not complemented by supplementary law. The absence of supplementary provisions increases the costs of implementing the law.[54]

III. PROVISIONS IN NEED OF REFORM

The following sections of the article identify several areas of substantive law that should be changed, and discuss why change is needed.[55] Each section also provides examples of problems with the current form of the law. The provisions governing corporate finance demonstrate problems with using overly technical regulatory provisions in one instance and using regulatory provisions instead of enabling provisions in another. The provisions applicable to shareholders are both regulatory and remedial. The problem lies not in the choice of form, but in the substantive implementation of that choice. The regulatory provision is overbroad, and the remedial provision is too narrow.

---

52. *See, e.g.*, Securities Exchange Act of 1934, 15 U.S.C. §§ 78-78jj (1988); Vermont Securities Act, VT. STAT. ANN. tit. 9, §§ 4201-4302 (1984 & Supp. 1992). *See generally* HENN & ALEXANDER, *supra* note 10, §§ 13-14, at 36-46 (other laws that apply to corporations).

53. HENN & ALEXANDER, *supra* note 10, § 80, at 149.

54. *See supra* notes 143-47 and accompanying text.

55. *See* Appendix, *post* (Reform Act Summary providing a complete list of changes needed).

The section on corporate management presents issues related to the regulation of management conduct. It addresses the need for supplementary provisions to complement the enabling legislation permitting indemnification of directors and officers. The remaining section on corporate formation, restructuring, and dissolution also raises issues both of substance and of form.

It is not surprising that much of the following discussion focuses on the code's regulatory provisions. If the code is outdated, regulatory provisions are likely to be the cause. If the code is inflexible, these provisions are also likely to be the culprits. Regulatory provisions undermine the enabling purpose of the legislation as a whole and its ability to accommodate the interests of those it governs. However, if regulatory provisions have substantive flexibility or are combined with enabling provisions, they can provide stability in the law without sacrificing its responsiveness to change.

A. Financing the Corporation and Distributing Corporate Assets

The financing and distribution provisions of a state's corporate code supply one legal mechanism for controlling the flow of assets into and out of the corporation.[56] State corporation codes regulate the purchase of shares by investors. They also control the corporation's distribution of its assets to shareholders through the payment of dividends and repurchase of shares. Corporation codes do not limit a corporation's ability to incur or to repay its debt.[57] They do, however, attempt to protect creditors' interests by restricting the distribution of corporate assets while corporate obligations remain outstanding.

1. Distributions of Assets—Dividends and Repurchase of Shares

A corporation may distribute assets to shareholders either by issuing dividends or by repurchasing shares of the corporation's

---

56. Federal securities laws, for example, also regulate the offer and sale of securities of corporations. *See, e.g.*, Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1988).

57. VT. STAT. ANN. tit. 11, § 1852(8) (1984) (authorizes the corporation to borrow money and issue debt securities).

stock.[58] Generally, similar rules apply to both types of distributions because, in each situation, the corporation distributes cash or property to its shareholders. The Vermont rules governing distributions of corporate assets to shareholders are substantively complex, technically hazardous, and based on old-fashioned concepts. Because they are regulatory in form, these rules offer little opportunity for the law to adapt to contemporary business practices.

a. The interests at stake

A corporation raises capital by selling equity interests in the company to shareholders[59] and by borrowing money from creditors.[60] Generally, creditors, shareholders, and directors have different concerns regarding the corporation's ability to distribute its assets to shareholders. All creditors have a significant interest in making sure that the corporation has ample assets to meet its obligations as they mature. The state's grant of limited liability

---

58. A corporation's authority to redeem its stock is authorized by a redemption provision in the articles of incorporation. *See generally* HENN & ALEXANDER, *supra* note 10, § 335, at 937-38; 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 3.34, at 50 (3d ed. 1990).

59. Equity investors purchase shares of a corporation entitling the holders to a proportionate share of voting rights, dividends, and assets distributed on the liquidation of the corporation. Some shares may be non-voting; others, such as preferred, may be entitled to vote only on the occurrence of a predetermined event, such as the non-payment of dividends for a specified period of time. *See generally* HENN & ALEXANDER, *supra* note 10, §§ 157-160, at 396-408; ROBERT HAMILTON, FUNDAMENTALS OF MODERN BUSINESS §§ 15.1-15.7, at 349-60 (1989).

60. Creditors lend money to the corporation. Corporate creditors are of two general types: trade creditors and financial creditors. Trade creditors provide goods and services to the corporation with the expectation of being paid within a short period of time after delivery of the goods or services. WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 272 (4th ed. 1990). In some circumstances, trade credit may be an important source of a company's funds. Trade creditors will usually impose an interest charge on amounts outstanding over a predetermined period of time, usually thirty days. *Id.* Financial creditors lend money to the corporation with the expectation that they will be repaid the principal amount of the loan, plus interest. Loans may be either short-term debt, in the form of bank loans or commercial paper, or long-term debt, in the form of debt securities issued by the corporation, such as bonds or debentures. *Id.* at 216-18, 269-70.

to shareholders[61] permits creditors to satisfy their claims only from the assets of the corporation.[62]

The primary concern of trade creditors and creditors holding short-term obligations is whether the corporate cash flow is sufficient for the timely payment of debts.[63] These creditors consider whether the corporation's current assets—those that can readily be converted to cash—exceed the company's current liabilities—those that come due within the year. Long-term corporate debt holders have additional concerns. Although current assets must be sufficient to pay interest as it comes due on long-term obligations, the company must also have adequate funds to cover future interest payments and to repay the principal amount when the debt matures.[64] Thus, the company's total assets, future prospects, and current cash flow are of concern to long-term debt holders. Therefore, both types of creditors want the corporation to retain sufficient assets to meet its outstanding corporate obligations.

Shareholders, like creditors, invest in corporations to make money. Shareholders make money on their investment by receiving dividends, selling their stock, or both. Regular payment of dividends not only gives current shareholders an investment return, it also may increase the value of the stock in the eyes of prospective investors.[65] Therefore, it is generally in the shareholders' interest for the corporation to be able to pay dividends.[66]

---

61. VT. STAT. ANN. tit. 11, § 1871(a) (1984).

62. *See* BAYLESS MANNING & JAMES J. HANKS, JR., LEGAL CAPITAL 10-12 (3d ed. 1990). Common law doctrines such as "piercing the corporate veil" may be used to set aside limited liability when certain conditions are met. In addition, New York and Wisconsin impose a statutory limit on limited liability by making the 10 largest shareholders of privately held corporations personally responsible for unpaid wage claims. *See* KLEIN & COFFEE, *supra* note 60, at 130-33.

63. Richard O. Kummert, *State Statutory Restrictions on Financial Distributions by Corporations to Shareholders: Part I*, 55 WASH. L. REV. 359, 376 (1980).

64. *Id.* at 373.

65. *Id.* at 370.

66. There may be a significant difference between the interests of shareholders of a publicly traded company and those of a closely held corporation. In the former, shareholders will favor corporate distributions in the form of dividends. Shareholders who are corporations receive favorable tax treatment on dividend income. Shareholders who have invested in order to receive income will be similarly disposed, as will investors in companies with a substantial amount of debt. In contrast, shareholders in closely held corporations may prefer that the corporation retain its earnings rather than pay dividends.

Shareholders also make money when a corporation repurchases its own shares. The stock market performance of publicly traded companies that have judiciously repurchased some of their shares is reportedly better than that of those not engaging in such activity.[67] Reducing the number of outstanding shares improves corporate earnings per share for the remaining shareholders.[68] In addition, a corporation's ability to repurchase its shares is critical for shareholders of closely held corporations who do not have a ready market for their holdings.[69] Thus, shareholders benefit when a corporation has maximum flexibility to pay dividends and buy back its shares.

All shareholders, however, do not have identical interests. Interests vary with the type of stock held. Senior equity securities, such as preferred shares, have dividend and liquidation rights that are superior to those of junior equity, such as common stock.[70] Holders of senior stock resist the notion of distributing corporate assets to junior claimants unless these assets are adequate to satisfy their senior dividend and liquidation claims. On the other hand, senior equity holders want dividends to be paid to them even when higher priority obligations to creditors are outstanding. Holders of senior stock, like other shareholders, want the law to protect their claims while providing the corporation the flexibility to make distributions to them.

Corporate distribution provisions also affect directors, who are responsible for determining the propriety of paying dividends and repurchasing corporate shares.[71] They, too, prefer maximum opportunity to declare dividends and to repurchase corporate

---

Since shareholders of closely held corporations are often also employees of the company, there may be tax advantages to withdrawing money from the corporation as salary rather than as dividends. O'NEAL & THOMPSON, *supra* note 58, § 7.01.

67. Kummert, *supra* note 63, at 387.

68. *Id.* at 382.

69. *Id.* at 391.

70. *See generally* HENN & ALEXANDER, *supra* note 10, § 160, at 402-08.

71. Section 1882 vests the authority to manage the business and affairs of a corporation with the board of directors. VT. STAT. ANN. tit. 11, § 1882 (1984). Their management responsibilities include the declaration of dividends. *Id.* § 1889(a). Dividends are generally discretionary, rather than mandatory. *See* Keough v. St. Paul Milk Co., 285 N.W. 809 (Minn. 1939); HENN & ALEXANDER; *supra* note 10, § 327, at 913. Similarly, § 1853 authorizes the corporation to deal in its own shares subject to certain restrictions. VT. STAT. ANN tit. 11, § 1853 (1984).

shares to further valid corporate purposes. They may repurchase stock to liquidate a portion of the corporation, to invest in the company's own shares when the market has undervalued them,[72] or to transfer corporate control by repurchasing shares from a withdrawing shareholder.[73]

Directors are also potentially liable for making improper distributions of corporate assets.[74] The threat of personal liability becomes especially ominous when one considers that determining the propriety of a distribution is often a difficult matter. Such a determination involves complex issues of valuing corporate assets, applying accounting principles, and interpreting corporate statutory requirements.[75] In discharging this duty, directors want standards that are clear, relatively easy to apply, and relevant to the business context.

b. Vermont's present scheme

Vermont regulates the distribution of assets with a technical and complex statutory scheme. It is based on the concepts that distributions should be made only from corporate earnings and that the corporation should indefinitely retain an amount of "permanent capital."[76] This permanent, or legal, capital has several purposes: (1) to assist creditors with risk assessment at the time an investment is made; (2) to protect against transfers of corporate assets to shareholders when doing so would jeopardize the position of the creditors; (3) to assure senior shareholders that none of their equity investment will be distributed to a junior class of security holders; and, (4) to keep sufficient operating capital in the corporation to permit it to achieve its corporate

---

72. Kummert, *supra* note 63, at 382.

73. *See infra* notes 106-10 and accompanying text.

74. Vermont imposes personal liability on directors who improperly authorize corporate distributions, and imposes mandatory restrictions on when a corporation may repurchase its shares. VT. STAT. ANN. tit. 11, § 1853(a), (d) (1984). The code treats dividends similarly and imposes liability on directors who approve an improper declaration of a dividend or purchase of the company's own shares. *Id.* §§ 1889, 1891. This is true in all other states. *See* 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 8.33, at 1027 (Supp. 1992); Kummert, *supra* note 63, at 392.

75. Kummert, *supra* note 63, at 392.

76. *See* CLARK, *supra* note 21, § 17.1.2, at 707-15; 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 6.21, at 484.

purposes and conduct its business profitably.[77] Assets equal to the value of the permanent capital may not be distributed to shareholders. Instead, distributions to shareholders may be made only from the profits and surplus of the corporation.[78]

The statutory designation for this permanent capital is "stated capital."[79] Stated capital represents equity derived from selling the corporation's shares to its shareholders. The concept of stated capital is in turn based on the concept of par value, which is an arbitrarily assigned, minimum dollar value that a shareholder must pay for the stock.[80] For par value stock, the stated capital is calculated by multiplying the par value of the stock by the number of outstanding shares.[81] Stock also may not have a par value. When no par stock is issued, the directors determine both the amount to be paid for the stock[82] and the portion of the funds received to be allocated to the stated capital account.[83] When a shareholder pays more than par value for a

---

77. *See* CLARK, *supra* note 21, at 707; MANNING & HANKS, *supra* note 62, at 17-18; WILLIAM M. FLETCHER, 11 FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5329, at 774 (perm. ed. 1985); 1 PRENTICE HALL LAW & BUSINESS CORP. GUIDE ¶ 2527 (Supp. 1991) [hereinafter PRENTICE HALL].

78. 1 PRENTICE HALL, *supra* note 77, ¶ 2507; *see, e.g.*, Field v. Haupert, 647 P.2d 952 (Or. App. 1982) (repurchase of shares when corporation is insolvent is prohibited); American Heritage Inv. Corp. v. Illinois Nat'l Bank, 386 N.E.2d 905 (Ill. 1979) (repurchase of shares when capital impaired is prohibited); Graham v. Louisville Transit Co., 243 S.W.2d 1019 (Ky. 1951) (distributions may not be made from stated capital but may be made from earned surplus); Chesnell v. Ozier, 44 N.E.2d 464 (Ohio 1942) (distributions from stated capital are illegal).

79. VT. STAT. ANN. tit. 11, § 1802(10) (1984 & Supp. 1992).

80. VT. STAT. ANN. tit. 11, § 1865(a) (1984); 1946 VT. ATT'Y GEN. BIENNIAL REP. 270; MANNING & HANKS, *supra* note 62, at 23-24. The articles of association must designate whether shares are par shares and if so, the amount of the par value. VT. STAT. ANN. tit. 11, § 1862(a) (1984 & Supp. 1992).

Par may be any value; it may be, for example, $100 or $.01 per share. Stock also may not have a par value. Today, most corporations issue low par stock. At one time, Vermont restricted the range of permissible values for par to a maximum of $100 per share. 1940 VT. ATT'Y GEN. REP. 270.

81. VT. STAT. ANN. tit. 11, § 1802(10) (1984).

82. *Id.* § 1865(b).

83. *Id.* § 1867(b). The stated capital account is recorded in the equity section of the company's balance sheet. By way of example, assume that Corporation *X* was organized in 1981. At the time of its organization, it issued 5000 shares of $10 par stock to its five shareholders and received $50,000 cash in return. A value of $50,000 was assigned to stated capital, representing the value of par ($10) multiplied by the number of shares issued at that par value (5000). Corporation *X* used part of the $50,000 to buy a building. It financed $15,000 of the purchase price at 12% interest. In the ensuing years,

share of stock, the directors may either allocate all of the excess to stated capital, allocate all of it to an account called capital surplus,[84] or allocate some portion to each account.[85] Excess funds from the sale of no par shares are treated similarly.[86]

Distributions may be made from the corporation's earnings. On the balance sheet, earnings are represented by the "earned surplus" or "retained earnings" account.[87] The value in this account is cumulative.[88] It may be either a positive value, reflecting the overall profitability of the company, or a negative value, reflecting company losses. A negative value in the earned surplus account may represent either real losses, caused by an actual lack of profitability, or paper losses, caused by charges for

---

Corporation *X* accumulated some money and the building appreciated to $60,000. With the economic downturn in 1990 and 1991, Corporation *X* just broke even, but the real property held its value. At the end of 1991, Corporation *X* wanted to distribute to its five shareholders dividends totaling $2,000. At that time the corporation's balance sheet was the following:

ASSETS		LIABILITIES AND EQUITY	
Current Assets		*Liabilities*	
Cash	$20,000	Current Liabilities	$2,000
		Long-term Liabilities	
Fixed Assets		(15 yr. mort. @ 12% int.)	8,000
Real Property* $50,000			
Accumulated		Total Liabilities	$10,000
Depreciation (30,000)			
		Equity	
Net Real Property	$20,000	Stated Capital	
		(5000 shares @ $10 par)	$50,000
Total Assets	$40,000	Retained Earnings	(20,000)
	======		
*FMV $60,000		Net equity	$30,000
		Total Liabilities and Equity	$40,000
			======

84. The accounting terms for capital surplus include "additional paid in capital" and "capital in excess of par." DANIEL LIPSKY & DAVID A. LIPTON, A STUDENT'S GUIDE TO ACCOUNTING FOR LAWYERS 82 (1985).

85. VT. STAT. ANN. tit. 11, § 1867(a), (c) (1984); *see also* 19 FLETCHER, *supra* note 77, § 3.122, at 396.

86. VT. STAT. ANN. tit. 11, § 1867(b) (1984).

87. *Id.* § 1851(12); LIPSKY & LIPTON, *supra* note 84, at 79.

88. 19 FLETCHER, *supra* note 77, § 3.120, at 390.

such items as depreciation, or both.[89] Generally, directors may distribute corporate assets to shareholders only when the earned surplus account has a positive value and only to the extent of that value.[90] Distributions are prohibited if they would make the corporation insolvent.[91]

The Vermont statute establishes two important exceptions to the rule that distributions can be made only when the earned surplus account has a positive value and cannot be made from the corporation's permanent capital. The first exception permits a corporation with a negative earnings account to declare and pay dividends from its net profits for the current or immediately preceding fiscal year.[92] Thus, an unprofitable company that has current earnings may use these earnings to pay dividends instead of applying them to reduce the deficit in the earned surplus account.[93]

This exception is useful in several situations. Directors may believe it is appropriate to issue dividends when a company that has suffered losses in its early years becomes profitable or when a generally profitable company suffers short-term losses. Applying the exception permits the payment of dividends from the company's current earnings.

The second exception is useful when a corporation has a zero or negative value in earned surplus and no current earnings. If the capital surplus account has a positive value, the exception permits directors to apply some or all of that value to create a positive value in the earned surplus account.[94] If capital surplus

---

89. In the example given in note 83, *supra*, the negative value in the retained earnings account was caused by the $10,000 in earnings offset by the $30,000 charge for depreciation.

90. VT. STAT. ANN. tit. 11, § 1889(a) (1984); PRENTICE HALL, *supra* note 77, ¶ 2507; 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 6.21, at 364-65.

91. VT. STAT. ANN. tit. 11, §§ 1889(a), 1890(a)(1) (1984). In this context, insolvency is defined as the "inability of a corporation to pay its debts as they become due in the usual course of its business." *Id.* § 1802(14).

92. *Id.* § 1889(a)(1).

93. Two such situations are described in the Model Business Corporation Act. 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 6.40, at 487 (Supp. 1991).

94. VT. STAT. ANN. tit. 11, § 1942(c) (1984). The code permits distributions to be made from capital surplus so long as the decision is approved by the holders of two-thirds of the outstanding shares. *Id.* § 1890(a).

is inadequate, and if stated (permanent) capital includes payments for shares in excess of par value, the amount of the excess payment may be transferred from the stated capital account to the capital surplus account.[95] The ultimate result of these transfers is that value may be shifted among accounts to make it available for distributions to shareholders. The capital surplus and stated capital accounts represent proceeds from the sale of the company's shares and not company earnings.

These exceptions are examples of the tensions arising from the law's attempt to protect creditors with a mechanically applied, technical regulation, and its need to respond to the realities of the business environment in which the law applies.[96] Permitting transfers from either account significantly undermines the fundamental concept that corporate earnings are the proper source of value for corporate distributions and that distributions should not be made from the company's permanent capital.

c. Problems with Vermont's present scheme

Vermont's corporate code needs reform because it is outdated, difficult to apply, and fails to protect creditors. Its central concepts are that a corporation must retain permanent capital and make distributions only from earnings. These concepts are based on practices of an earlier time, when capital structures were simpler and shares generally were issued at a fairly high par value.[97] Today, corporate financial structures are often complex, business and accounting practices have changed significantly, and shares are commonly issued at no par or very low par. A substantial part of the capital raised when the corporation sells its shares is characterized as capital surplus rather than stated capital.[98] As a result, the value of the permanent capital may be low and provide little, if any, protection to creditors.

---

95. The transfer must be approved by a majority of shares entitled to vote. *Id.* §§ 1941, 1942.

96. MANNING & HANKS, *supra* note 62, at 82-83.

97. 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 6.40, at 483 (Supp. 1989); MANNING & HANKS, *supra* note 62, at 22-23.

98. 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 6.40, at 483 (Supp. 1989).

Moreover, Vermont, like other states, does not require a minimum amount of capital investment when a corporation is formed.[99] A corporation may begin with only a few dollars of assets and designate only a small portion of that value as stated capital. The exceptions permit the transfer of value from the stated capital and capital surplus accounts, further damaging the central concepts of the statutory scheme.[100] As a practical matter, these provisions offer little real protection to creditors.

Another fundamental problem with present law is the relationship between its substance and form. The provisions are substantively complex and their interrelationships are often unclear.[101] Even skilled practitioners find the provisions to be a hopeless tangle. Cast in a regulatory form, the provisions are applied rigidly. They lack the flexibility to adapt to changing business and accounting practices. The complexity of the provisions leads one to believe that they provide significant protection to corporate creditors and holders of senior securities. The opposite is often true. Companies formed with the help of sophisticated legal advice can be structured to minimize the application of the legal capital provisions.[102]

---

99. VT. STAT. ANN. tit. 11, ch. 17 (1984). Vermont law comports with the Model Business Corporation Act. *See* 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 6.21, at 366.

100. *See supra* notes 92-96 and accompanying text; 1 PRENTICE HALL, *supra* note 77, ¶ 2519; 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 6.21, at 366.

101. *Cf.* VT. STAT. ANN. tit. 11, §§ 1889(a)(1), 1890, 1941, 1942(c) (1984).

102. The easiest way to avoid the impact of the legal capital statutes is to have low par or no par stock so that a low value will be assigned to the stated capital account. Thus the stated capital of a corporation with 1000 shares authorized, issued, and outstanding of $1.00 par stock would be $1000. If, in the example given in note 83, *supra*, the shareholders had paid $10 per share but the par value had been $1 instead of $10, the stated capital account would have contained a value of $5000 (5000 outstanding shares multiplied by $1 par) and a $45,000 capital surplus account would have been created from which distributions could be made with the approval of at least two-thirds of the holders of the shares, provided certain conditions are met. *Id.* §§ 1802(11), 1802(13), 1890 (1984). This description is somewhat misleading in that it seems to pose a simple solution to the problem, when in reality the procedures necessary to accomplish the foregoing can be complicated and expensive for a corporation. Rather than invoke these procedures every time the board of directors believes it is economically sensible to issue dividends with a charge to the capital surplus account, it would be easier to reincorporate in another state. There are a number of other well-known and well-documented methods of avoiding the restrictions of legal capital statutes similar to Vermont's. MANNING & HANKS, *supra* note 62, ¶ 7, at 93-94.

Perhaps more important, the present system imposes excessive costs on making corporate distributions. Companies must consult lawyers and accountants to determine if a distribution is proper.[103] Compliance with the law may prevent financially healthy companies from making distributions that are not adverse to creditors' interests.[104] As a result, investors suffer financially and no benefit accrues to the creditors.

Although the chilling effect applies to all businesses, these overly restrictive prohibitions are particularly relevant to Vermont companies. Many Vermont corporations are privately held and have no ready market for their shares.[105] For companies such as these, the corporation's ability to repurchase its shares is critical. Shareholders of privately held corporations often enter into contracts requiring the corporation to purchase the shareholder's interest when the shareholder withdraws, retires, or dies.[106] This may be the only way shareholders or their estates can receive the value of their investment. Because repurchases must comply with the rules controlling corporate distributions,[107] an economically solid company may be unable to perform the buyout agreement. Alternatively, in the event of an installment repurchase of shares, the rules may cast substantial doubt as to the validity of the transaction.[108]

These situations arise when a company's worth is derived largely from fixed assets, like real estate, that have a high market value, but are recorded in financial statements at a low cost or a depreciated value.[109] Vermont corporations include hotels, resorts, and farming businesses that have significant holdings in real estate. Vermont law does not permit the directors to consider

---

103. *See generally* MANNING & HANKS, *supra* note 62, ¶ 1, at 91, ¶ 6, at 93.

104. *See supra* note 83.

105. *See supra* note 8.

106. *See generally* O'NEAL & THOMPSON, *supra* note 58, § 7.01.

107. Section 1853 provides that repurchases of corporate shares may be made only to the extent of earned surplus, or, if approved by the shareholders, to the extent of capital surplus. VT. STAT. ANN. tit. 11, § 1853 (1984). Compare § 1853 with §§ 1889(a)(1) and 1890(a), which permit dividends to be paid only from earned surplus and, with shareholder approval, from capital surplus. *Id.* §§ 1889(a)(1), 1890(a).

108. Kummert discusses the complexities of the application of the legal capital provisions to an installment repurchase of shares by a small corporation. Kummert, *supra* note 63, at 391-92.

109. *See supra* note 89.

the fair value of the assets when they determine whether distributions can be made.[110] The result may not only be misleading,[111] it also may prevent economically sensible distributions.

The fundamental problem with the present law is that it does not protect creditors. The entire stated capital construct is based on wholly arbitrary numbers: the par value of the shares and the value assigned to no par stock. Stated capital usually represents only part of the amount paid for stock and is often a record of transactions that occurred years ago.[112] In addition, the amount of permanent capital bears no relationship to the amount owed. It makes little sense for a corporation to be required to retain a $50,000 cushion for $10,000 of debt.[113] The converse is also true.

It is difficult to see how the present statutory scheme has any relevance to creditors' concerns because stated capital is an historical value.[114] Creditor groups, in fact, have shown little interest in changing the legal capital provisions of corporate acts to their benefit.[115] Instead, these groups use other mechanisms to secure protections that the legal capital provisions were intended to effect.[116]

---

110. Section 1889(a)(1) requires directors to consider the depreciated value of assets in determining whether dividends may be properly paid, but does not permit them to consider an increase in the value of the assets. VT. STAT. ANN. tit. 11, § 1889(a)(1) (1984). According to generally accepted accounting principles, fixed assets are usually carried on the books at cost with an adjustment for depreciation reflecting the diminution in value caused by the reduction in usefulness of the asset. LIPSKY & LIPTON, *supra* note 84, at 29-30, 42-44. The depreciated value of a fixed asset may have no relationship to the market value of the asset, which may have appreciated. The increase in market value will be reflected when the asset is sold. Tax laws approach the problem in a similar vein. *Id.*

111. *See* Zahn v. Transamerica Corp., 162 F.2d. 36 (3d Cir. 1947).

112. MANNING & HANKS, *supra* note 62, ¶ 3, at 92.

113. *See supra* note 83.

114. Stated capital represents equity derived from the corporation's sale of its shares to its shareholders. It does not reflect the corporation's current operations as a going concern.

115. MANNING & HANKS, *supra* note 62, at 96-97.

116. *See generally id.* at 98-114. Other mechanisms used by trade creditors include obtaining credit information from national professional credit agencies and using discounts to encourage early payment. Commercial creditors, such as banks, require full disclosure of the borrower's finances, collateral for the loan, and often require the business principals to co-sign or act as co-guarantors of the note. Holders of corporate debt securities rely for protection on the provisions of indentures, which are contracts between the corporation

d. The proposed reform

Creditors' apparent indifference to corporate legal capital provisions raises the question whether a corporation code should regulate distributions, or whether control should be left to the parties' course of dealing and negotiated contract terms. Creditors are likely to rely primarily on state corporation codes for protection only in a relatively narrow context. If a corporation is making money, it can pay creditors and make distributions to shareholders. When a business is failing, bankruptcy and fraudulent conveyance statutes protect creditors.[117] The corporate code provisions are helpful to creditors in situations where a company that is experiencing a downturn or is otherwise troubled wants to pay dividends or repurchase its stock.[118]

Despite creditor indifference, Vermont law should regulate corporate distributions because the code's policies have vitality even though the implementation is flawed. The state grants limited liability to corporate shareholders. To protect creditors, the law also should prevent the corporation from becoming an entity with no economic substance. In addition, not all corporate creditors can protect their interests through other legal mechanisms. Therefore, a corporation should not be permitted to make distributions to shareholders unless remaining assets cover obligations to creditors. Furthermore, restricting distributions and imposing liability for improper distributions can have a cautionary effect on corporate management, who will "psychologically feel themselves inhibited from distributing assets to shareholders indiscriminately."[119]

---

issuing the securities and the lenders, who are represented by an indenture trustee. Indentures restrict the corporation's ability to incur additional debt and make distributions to shareholders, and impose requirements, such as sinking funds, for the creditor's protection. The contract is entered into after a full examination of the corporation's financial situation and its prospects as a going enterprise. *Id.*

117. *See, e.g.*, Uniform Fraudulent Transfers Act, 15 U.S.C. § 1101(7)(d)(2)(a) (1988). *See generally* Burroughs v. Fields, 546 F.2d 215 (7th Cir. 1976).

118. The legal capital approach to control of distributions to shareholders is based on Justice Story's opinion in *Wood v. Dummer*, a case in which a corporation distributed most of its liquid assets to its shareholders immediately before becoming insolvent. 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,1944), *cited in* MANNING & HANKS, *supra* note 62, at 30. Today, such transfers would be subject to recapture under bankruptcy and fraudulent conveyance statutes.

119. MANNING & HANKS, *supra* note 62, at 96.

Creating legal rules for controlling distributions is difficult in both substance and form. "The problem of limiting distributions to shareholders arises fundamentally out of the economic pressure to make some distributions to shareholders while some creditors' claims remain outstanding and unpaid. That condition arises from the reality of the ongoing enterprise operating over time."[120] Therefore, the law must accommodate the diverging interests of creditors, shareholders, and directors. It also must recognize that the corporation is a dynamic, economic enterprise and not a static entity. The law must be predictable, relatively easy to apply, and adaptable to changes in business and accounting practices.

One of the substantive difficulties with present law is that it contains legal transpositions of accounting rules. Accounting rules record the history and particularize the financial and economic events of a company's life.[121] When legal rules become over-particularized and overtly historical, the result is a rigid and complex set of rules that either are applied mechanically or evaded through manipulation. Furthermore, when the law is based on accounting rules and fails to change when the accounting rules do, the two systems become asynchronous, creating additional cost, confusion, and error. Although the regulation of corporate distributions must acknowledge the relevance of financial events, it should maintain a level of generality that permits adaptation to change.

With respect to function, legal control of corporate distributions should combine regulatory provisions that define when distributions are permitted, and remedial provisions that impose liability for improper distributions. Regulatory provisions are appropriate because of the importance of the state's concern with protecting creditors. Statutory provisions should limit the circumstances when distributions can be made. The dangers of inflexibility can be mitigated with careful attention to the substance of the provision. The cautionary effect of remedial provisions will help keep corporate management from making distributions irresponsibly and will provide for recovery when a distribution is improper.

---

120. *Id.* at 33.

121. LIPSKY & LIPTON, *supra* note 84, at 3-4.

The Reform Act eliminates problems with present law through the use of both remedial and regulatory provisions. The Act makes all directors voting for an improper distribution personally liable to the corporation for the amount of the distribution that violates the Act.[122] The presence of the remedial provision will impress upon the directors the importance of complying with the categorical rules. The Act also allows the corporation to recover improperly distributed assets to make them available to satisfy creditor's claims.

The Reform Act's regulatory provisions eliminate the troublesome concepts of par and stated capital and the need to distinguish among different kinds of surplus in the equity portion of the balance sheet. Instead, the provisions establish two tests to determine when a distribution is proper. Both tests must be satisfied before a corporation may distribute assets to its shareholders. The term "distribution" is broadly defined so that the same standards apply to all corporate distributions, regardless of the circumstances in which they arise.[123]

The first statutory test prohibits distributions that would cause the corporation to be unable "to pay its debts as they become due in the usual course of business."[124] Known as the equity test for insolvency, this test requires the directors to determine whether the current and expected demand for the company's services or products will enable the corporation to generate enough funds to meet its known and anticipated obligations.[125] The corporation is regarded as a going concern, and not a static entity. The primary focus is on the corporation's liquidity. Although the test is important to all creditors, it particularly addresses the concerns of the company's general creditors, whose obligations are unsecured. Repayment of their debts depends on the company's overall profitability.

---

122. H. 265 (S. 1), *supra* note 1, § 8.33(a).

123. *Id.* § 1.40(6). All dividends, except share dividends, and all share purchases or redemptions are treated as distributions. *Id.*; 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 6.40 official cmt., at 466.

124. H. 265 (S. 1), *supra* note 1, § 6.40(c)(1). This test is comparable to the insolvency test found in present law. VT. STAT. ANN. tit. 11, § 1851(14) (1984).

125. 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 6.40 official cmt., at 477 (Supp. 1988).

The second test is known as the balance sheet[126] or bankruptcy insolvency test.[127] It prohibits distributions unless, after the distribution, total corporate assets equal or exceed liabilities, including the amount needed to satisfy the claims of holders of senior equity, such as preferred stock.[128] Based on the corporation's liquidation value, the "test asks what creditors would receive if all of the corporation's assets were sold and applied against all of its liabilities."[129] Applying this test, directors must consider the value of the company as a whole and the relationship between its assets and liabilities. Distributions may be made only when the value of the assets remaining after distribution will cover total liabilities.

The Reform Act requires a corporation to meet both tests before it can make a distribution. Satisfaction of only one test does not mean that a corporation is solvent in all circumstances. "A corporation might have an adequate cash flow to pay off its debts as they come due (equity solvency) but insufficient aggregate assets to pay off all liabilities were they to become due at once (bankruptcy insolvency) or *vice versa*."[130]

Although the Reform Act uses categorical rules to control corporate distributions, it mitigates the potential inflexibility of these rules. The Act permits directors to rely on financial statements based on accepted accounting principles to determine whether a distribution is proper.[131] In this way, the legal standard permits adaptation to changing accounting practices. The Act also permits directors to base their decisions on a fair valuation of the corporate assets.[132] This option will reduce the likelihood that a financially healthy company will be barred from making distributions because its assets are undervalued on the company's books.

---

126. *Id.* § 6.40 official cmt., ¶ 4 (Supp. 1988).

127. LIPSKY & LIPTON, *supra* note 84, at 216-17.

128. H. 265 (S. 1), *supra* note 1, § 6.40(c)(2); MANNING & HANKS, *supra* note 62, at 182 (also referred to as the Adjusted Net Worth Test).

129. LIPSKY & LIPTON, *supra* note 84, at 217.

130. *Id.*

131. H. 265 (S. 1), *supra* note 1, § 6.40(d).

132. *Id.*; *see, e.g.*, Bishop v. Prosser-Grandview Broadcasting, Inc., 472 P.2d 560 (Wash. App. 1970) (directors can use actual value rather than book value in determining whether distribution is proper); Randall v. Bailey, 43 N.E.2d 43 (N.Y. 1942).

The requirement that distributions meet only these two tests simplifies and clarifies the law. The Reform Act significantly increases the law's practicality without sacrificing the interests of creditors. It strikes a balance between prohibiting distributions that would jeopardize payment of obligations arising in the ordinary course of business, and providing corporations with the flexibility to stabilize their dividend practices even in times of poor earnings.[133] By eliminating distinctions between the stated capital and surplus accounts in the equity portion of the balance sheet,[134] the Act permits distributions to be made out of funds derived from any source, so long as the corporation's liabilities are covered. The proposed legislation, therefore, eliminates the potential entrapment of the unsophisticated and the need for artful manipulation by the technically savvy. It also should reduce the cost of professional advice given to directors by accountants and lawyers.[135] Finally, the Act accomplishes its objectives through the use of both remedial provisions that have a cautionary effect on directors, and regulatory rules that are adaptable to changing accounting and business practices.

2. Additional Areas Related to Corporate Finance in Need of Reform

The provisions controlling the corporation's financial structure and the grant of preemptive rights to shareholders also need reform. Present law uses a rigid approach to classifying shares in a corporation's capital structure and an overly broad approach to grant preemptive rights. Vermont law presently permits a corporate financial structure in which shares are designated as "common," "preferred," or "special."[136] Today, however, many companies have complex financial structures that often contain hybrid forms of securities, such as those having the attributes of both preferred and common shares. In these situations, rigid labeling of shares is artificial and misleading.

---

133. Richard O. Kummert, *State Statutory Restrictions on Financial Distributions by Corporations to Shareholders: Part II*, 59 WASH. L. REV. 185, 255 (1983).

134. These distinctions may be retained if the corporate directors or accountants wish to continue current practices, but they are not required.

135. Kummert, *supra* note 133, at 253.

136. VT. STAT. ANN. tit. 11, § 1862 (1984).

The voting preferred share is one example of a hybrid security. Preferred shares usually have priority dividend and liquidation rights, and limited voting rights that become effective only if the corporation does not pay dividends for a certain number of consecutive quarters.[137] However, in some corporations, preferreds have different attributes. In *Packer v. Yampol*,[138] for example, the preferred shares retained the preferential liquidation rights characteristic of preferreds, but also had multiple votes per share and control of the corporation, attributes usually associated with common shares. In another corporation, the preferred shares had only voting rights, and the common shares had only liquidation and dividend rights.[139]

As these examples suggest, the design of a corporation's equity structure is based on the investors' personal objectives, the corporation's financial objectives, constraints of tax and securities laws, changing business conditions, and new developments in corporate finance.[140] Using regulatory mechanisms to define a corporation's capital structure locks the corporation and its investors into inflexible forms which may rapidly become outdated and may not suit their particular needs. Enabling legislation permits structural flexibility both at the company's inception and at the time it responds to new business and economic conditions.

The proposed legislation adopts a flexible approach. Its sole requirements are that a corporation's authorized stock include at least one class of shares with unlimited voting rights and at least one class, which may be the same as the first, with liquidation rights.[141] The articles of incorporation must set forth the attributes of each class of stock.[142] If these requirements are met, a company may design its financial structure as it sees fit.

---

137. KLEIN & COFFEE, *supra* note 60, at 265-66.

138. Packer v. Yampol, 630 F. Supp. 1237 (S.D.N.Y. 1986).

139. 1948 OP. VT. ATT'Y GEN. 273; *see also* Hampton v. Tri-State Fin. Corp., 495 P.2d 566 (Colo. Ct. App. 1972).

140. New types of securities have developed in response to changes in the business and economic environments. HENN & ALEXANDER, *supra* note 10, at 15. For example, variable rate preferred shares have become popular during periods of high inflation. Their dividends fluctuate based on a variety of financial indices. *See also* HAMILTON, *supra* note 59, § 15.4.7, at 355.

141. H. 265 (S. 1), *supra* note 1, § 6.01(b).

142. *Id.* § 6.01(a).

Eliminating familiar labels will not harm the interests of current and prospective investors. Requiring disclosure of share attributes in the articles of incorporation will provide investors with the information needed to make informed investment decisions.

The preemptive rights provisions also need reform.[143] Present law contains an enabling provision permitting shareholders to elect preemptive rights in the articles of association.[144] However, the code does not include supplementary guidelines to the implementation of preemptive rights. The members of each corporation must draft their own statement to be included in the articles. Although this approach promotes maximum flexibility, it is costly in both time and money and causes duplication of drafting effort. The preferred approach provides corporate members with the option of either drafting their own statement or using a statutory definition of when preemptive rights apply. This approach will retain the broad flexibility of enabling legislation and provide an efficient alternative to repetitive drafting.

The Reform Act uses this approach[145] by combining enabling legislation that authorizes the shareholders to elect preemptive rights with supplementary provisions that define when these rights apply.[146] It also gives shareholders the option of including, modifying, or excluding any of the supplementary terms.[147] This approach preserves the principle of freedom of contract by allowing shareholders to fashion terms according to their needs. The approach is also more efficient than using enabling legislation alone.

In summary, the financial provisions of Vermont's current law need reform. The Reform Act is adaptable to changing business and accounting practices and eliminates the technical maze of

---

143. A grant of preemptive rights gives current shareholders the option to buy a predetermined percentage of new issues of stock of the same class(es) they currently own. The purchase percentage is based on shareholders' percentage of current ownership. The purpose of preemptive rights is to prevent the dilution of their ownership percentage through the issue of new shares of stock. *See* CLARK, *supra* note 21, § 17.1.4, at 719.

144. VT. STAT. ANN. tit. 11, § 1926(7) (1984).

145. H. 265 (S. 1), *supra* note 1, § 6.30.

146. *Id.* § 6.30(a), (b).

147. *Id.* § 6.40(b).

present law. Its flexible approach to defining a company's capital structure permits responsiveness to changing corporate needs. Finally, the use of supplementary provisions to complement enabling legislation increases the efficiency of the code's grant of preemptive rights.

B. Shareholders

In the traditional corporate structure,[148] decision making power is divided between directors and shareholders. Directors make management decisions[149] and shareholders exercise electoral and approval power.[150] Each component of this bifurcated structure both stimulates and limits the acts of the other. Together, shareholder and director approval constitutes the final authority for corporate action.[151]

This section considers the allocation and exercise of shareholders' voting power. It addresses the shareholder vote required to approve extraordinary corporate actions, the interplay of group or class voting with the level of required vote, and the mitigating influence of the availability of appraisal rights for dissenting shareholders. Issues of corporate management are discussed in part III.C.[152]

1. Shareholder Approval of Extraordinary Corporate Actions

Shareholder voting raises substantive questions of the allocation of power between shareholders and directors, and among groups of shareholders. The subject also raises issues of the proper implementation of the substantive rules.

---

148. The traditional corporate structure may be varied by corporations making a close corporation election and by corporations incorporated in jurisdictions that have adopted §§ 7.32 and 8.01 of the Revised Model Business Corporation Act. 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, §§ 7.32, 8.01; *see infra* notes 305-29 and accompanying text.

149. VT. STAT. ANN. tit. 11, § 1881 (1984).

150. Shareholders elect and remove directors and approve amendments to the articles of association, bylaws, mergers, consolidations, sales of substantially all of the corporate assets other than those in the ordinary course of business, reduction of capital surplus, and corporate dissolutions. *See, e.g., id.* §§ 1873, 1882, 1932, 1941, 1953, 2002, 2052, 2053; 5 FLETCHER, *supra* note 77, § 2097, at 501-02.

151. 5 FLETCHER, *supra* note 77, § 2096, at 498.

152. *See* discussion *infra* notes 200-329 and accompanying text.

a. Shareholders' interests in approving extraordinary corporate changes

Shareholders exercise voting rights to protect their investment interests and to monitor director behavior. Shareholders approve extraordinary corporate changes, which are changes to the corporation's structure and to its articles of incorporation.[153] Shareholder approval of fundamental changes to the corporate structure limits management's ability to make decisions that shareholders consider improper or unwise. This check on management protects the shareholders from decisions that may implicate management conflict of interest.[154] When structural changes are involved, management decisions may be motivated by desire for personal gain, prestige, and power as well as corporate considerations of what is best for the corporation.[155] According to Eisenberg:

> In many proposed structural changes, financial motives serve to reinforce the nonfinancial. For example, liquidation, contraction, or merger into an acquiring corporation may very well result in loss of the manager's job, while expansion through acquisition may enhance the manager's responsibility and therefore his salary. Conversely, management may support a structural change which runs counter to its nonfinancial interest, if it is provided with sufficient side payments in the way of employment contracts and the like.[156]

However, shareholder approval also restricts management's ability to respond to unexpected situations and to engage in beneficial activities posing uncertainty and risk. Undue restriction on management's discretion can adversely affect shareholders' desire to maximize the return on their investment. Statutory provisions controlling shareholders' voting rights

---

153. Extraordinary corporate actions include mergers, sale of substantially all of the corporation's assets other than in the ordinary course of business, dissolution, and amendment of the articles of incorporation. *See generally* Campbell v. Vose, 515 F.2d 256 (10th Cir. 1975); Barris Indus. v. Bryan, 686 F. Supp. 125 (E.D. Va. 1988); Naas v. Losas, 739 P.2d 1051 (Or. Ct. App. 1987); Berger v. Amana Soc'y, 95 N.W.2d 909 (Iowa 1959); Metzger v. George Washington Memorial Park, Inc., 110 A.2d 425 (Pa. 1955); Cowan v. Salt Lake Hardware, 221 P.2d 625 (Utah 1950).

154. MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 30 (1976).

155. *Id.* at 30-33.

156. *Id.* at 33.

therefore must balance shareholders' interests in prohibiting improper management conduct and providing management with the flexibility it needs to do its job.[157]

Shareholders also approve changes to the articles of incorporation, the document that defines a shareholder's relative control and economic power.[158] Because amendments to the articles can reduce shareholder power,[159] shareholder approval of these changes protects against involuntary transformation of a shareholder's rights. In this circumstance, shareholders are concerned as much with guarding against potential wrongdoing by other shareholders as with protecting against possible director misfeasance.

b. Available voting options

In the late nineteenth and early twentieth centuries, corporate law treated shareholders' expectations regarding a corporation's structure and characteristics as vested rights.[160] At that time, shareholder approval of extraordinary corporate transactions, like mergers, had to be unanimous.[161] Today, majoritarian rule is the norm.[162] However, in Vermont, at least two-thirds of shares entitled to vote must approve extraordinary corporate structural changes and changes to the articles of

---

157. *See infra* notes 200-329 and accompanying text (discussing the competing interests of shareholders and directors).

158. *See, e.g.*, H. 265 (S. 1), *supra* note 1, § 10.03(e). Provisions in the articles of association that affect control include: designations of voting rights of shares, cumulative voting, and preemptive rights. *See, e.g.*, VT. STAT. ANN. tit. 11, §§ 1879(a), (d), 1926(5), (6), (7) (1984). Provisions in the articles affecting economic power include the designations of shares' dividend and liquidation rights. *Id.* § 1926(5), (6).

159. *See generally* Providence & Worcester Co. v. Baker, 378 A.2d 121 (Del. 1977); Hampton v. Tri-State Fin. Corp., 495 P.2d 566 (Colo. Ct. App. 1972); Bowman v. Armour & Co., 160 N.E.2d 753 (Ill. 1959); Metzger v. George Washington Memorial Park, Inc., 110 A.2d 425 (Pa. 1955); Cowan v. Salt Lake Hardware, 221 P.2d 625 (Utah 1950); Goldman v. Postal Tel., 52 F. Supp. 763 (D. Del. 1943).

160. CLARK, *supra* note 21, § 10.6, at 443-44; PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, pt. IV, at 175, 943-44 (Proposed Final Draft, Mar. 31, 1992) (Adopted May 1992) [hereinafter ALI CORP. GOVERNANCE].

161. ALI CORP. GOVERNANCE, *supra* note 160, at 175, 943-44; 12B FLETCHER, *supra* note 77, § 5906.1, at 342.

162. ALI CORP. GOVERNANCE, *supra* note 160, at 943.

association.[163] In addition, a third option permits approval by less than a majority.

Both the super-majority and the less-than-majority approaches protect minority shareholders against potential oppression by the majority.[164] Both, however, also create problems. A super-majority vote gives the minority a powerful veto over actions deemed desirable by the majority.[165] Injudicious use of this veto power can lead to corporate deadlock.[166] A less-than-majority vote permits the minority to block the legitimate objectives of the majority and to impose its will disproportionally to its numerical power. Permitting approval of extraordinary corporate changes by less-than-majority vote is counter to principles of fair decision making. Such decisions should be made by enough shareholders to constitute a representative body.

Despite its potential for oppression of the minority, a majority vote is attractive. Although both the super-majority vote and a less-than-majority vote protect against majority misfeasance, the absence of simple majority control imposes significant obstacles to a corporation's ability to seize new business opportunities or react to a changing economic environment.[167] "The justifications for [a majority] system are both that it promotes economic efficiency by enabling the corporation to accept entrepreneurial risks that a minority might wish to veto and that alternative protection[s]—such as class voting and the appraisal remedy—[are] sufficient to protect minority rights."[168] Furthermore, although the potential for oppression is evident, majority approval presents no greater risk of disruption than super-majority or less-than-majority votes.

Nevertheless, in Vermont, a state with many small, privately owned corporations, a super-majority vote retains some appeal.

---

163. VT. STAT. ANN. tit. 11, §§ 1932(a)(3), 1953(b), 2002(3), 2052, 2053 (1984). Shareholders may, if they wish, elect to have higher voting requirements. *Id.* § 2210.

164. *See* Jones v. Ahmanson & Co., 460 P.2d 464 (Cal. 1969) (an example of such oppression).

165. HENN & ALEXANDER, *supra* note 10, § 266, at 719-22.

166. *Id.* at 722.

167. *See generally* Matteson v. Ziebarth, 242 P.2d 1025 (Wash. 1952).

168. *Id.*

Shareholders who are few in number, who derive their livelihood from the corporation, and who participate in corporate management and control, often need a structure that promotes consensus and strengthens the voice of the minority. At the same time, Vermont is also a state with large companies. Although a high voting requirement compels a level of consensus appropriate to an association of a few investors, it imposes undue burdens on an organization with many. Although a super-majority vote protects shareholders in small corporations, it makes operation of a large corporation needlessly cumbersome. A compromise approach is therefore desirable.

c. Implementation of the appropriate vote

Several options are available for implementing shareholder voting. One is enabling legislation that authorizes shareholder vote, but allows shareholders to determine the votes required for approval. A second approach is to mandate the required vote through the use of regulatory provisions. Both approaches are unsatisfactory.

Enabling legislation that fails to impose statutory minimum voting requirements may result in oppression by a powerful minority. Many investors in large corporations lack the sophistication to understand fully the implications of alternative voting structures.[169] A significant minority block of the stock of large corporations is often held by a relatively small number of sophisticated investors.[170] Often, these investors easily may act in concert, while widely dispersed investors with small holdings would find it difficult to do so. The use of enabling provisions alone would provide the opportunity for control by an active minority, an outcome that is undesirable. Such problems are compounded in small corporations as investors not only lack a market for their stock, but often depend on the corporation for their livelihood.[171] Giving affirmative control, rather than simply veto power, to a strong minority creates the potential for oppressive acts.

---

169. EISENBERG, *supra* note 154, at 68.

170. *See generally id.* at 43-53.

171. *See infra* notes 311-14 and accompanying text.

Vermont's present regulatory scheme requires all corporations to approve extraordinary corporate actions with a super-majority vote. However, a single standard is not appropriate for all corporations. In addition, shareholders lose the opportunity to structure a voting system suitable to their needs. In contrast, the Reform Act combines the two approaches by imposing minimum voting requirements while retaining flexibility in application. The Act distinguishes between those situations in which greater minority protection is needed and those in which a majority rule is appropriate. Privately held companies electing close corporation status retain at least a two-thirds voting requirement for certain extraordinary corporate actions.[172] They may, if they wish, require a higher vote. Majority vote applies to all other corporations unless the shareholders elect to have higher voting requirements.[173] This approach imposes a minimum vote requirement for all decision making. It provides flexibility and prevents a smaller-than-majority group from controlling the corporation. It also permits shareholders in any corporation to give the minority greater power by requiring a super-majority vote.

d. Group voting—a mechanism for alleviating majority rule

The availability of the enabling provisions for voting by "share class" or "group" also protects minority interests. In the proposed legislation, "[a] 'voting group' consists of all shares of one or more classes or series that under the articles of incorporation or the [state corporation law] are entitled to vote and be counted together collectively on a matter."[174]

---

172. H. 265 (S. 1), *supra* note 1, § 20.04(b) (approval by two-thirds required for existing corporation to make close corporation election); *id.* § 20.09(b) (unanimity of all shares required to amend articles to eliminate the board of directors); *id.* § 20.09(d) (approval by two-thirds of shares of each voting group required to amend articles to restore board of directors); *id.* § 20.10 (approval by two-thirds required to approve plan of merger that would either create or terminate close corporation status); *id.* § 20.12 (approval by two-thirds vote required to amend articles to eliminate close corporation status); *id.* § 20.13(d) (approval by two-thirds vote required to dissolve corporation).

173. *Id.* §§ 10.03(e), 10.21(a), 11.03(e), 12.02(e), 14.02(e).

174. 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 1.40 official cmt., at 78.

When class or group voting is used, corporate actions that may be adverse to the rights or interests of a particular class or group must be approved both by shares generally entitled to vote on the matter and by shares in the individual class or voting group.[175] In addition, the articles of incorporation can require that a particular director be elected by a certain class or voting group,[176] thereby assuring that the members of that group will have a representative on the board.

The provision for voting by class or group gives these members a greater voice on issues or in elections than they would have otherwise. In addition, because class or group voting may be used selectively, it offers greater flexibility in the corporate voting structure than is otherwise possible when a single voting requirement applies to all situations. This mechanism acts as a check on pure majority rule by protecting the minority without giving them the powerful veto that is part of a required super-majority vote.

2. Dissenting Shareholders' Appraisal Rights

The transition from requiring unanimous consent for fundamental corporate changes to majoritarian control led to the development of appraisal or dissenters' rights.[177] Shareholders who vote against fundamental changes ultimately approved by the majority can have their shares purchased by the corporation if they want to sever their relationship with the company.[178]

Appraisal rights are remedial. They provide dissenting shareholders with redress when fundamental corporate changes are involuntarily imposed on them by the majority. These provisions are also regulatory because they mandate the procedures to be used in exercising the rights. Their substantive component defines the nature and scope of the rights. Originally, the justification for providing appraisal rights was that, without such a remedy, dissenting shareholders would be forced involun-

---

175. *See, e.g.*, H. 265 (S. 1), *supra* note 1, § 10.03(e). *See generally* Scott v. Anderson Newspapers, Inc., 477 N.E.2d 553 (Ind. Ct. App. 1985).

176. H. 265 (S. 1), *supra* note 1, § 8.03.

177. *See* CLARK, *supra* note 21, § 10.6.1, at 443-49.

178. *See generally* EISENBERG, *supra* note 154, at 69.

tarily to have their investment property converted to a form they found objectionable.[179] Today, this defeated expectations rationale also includes shareholders' assumptions that they will have appraisal rights.[180]

The grant of appraisal rights, like class voting, limits the potentially adverse impact of majority rule on a shareholder's economic interests. Appraisal rights make it possible for unhappy shareholders to withdraw from the corporation and be paid the fair value of their shares.[181] The grant of appraisal rights, therefore:

> [I]s a mechanism admirably suited to reconcile, in the corporate context, the need to give the majority the right to make drastic changes in the enterprise to meet new conditions as they arise, with the need to protect the minority against being involuntarily dragged along into a drastically restructured enterprise in which it has no confidence.[182]

Additionally, the availability of appraisal rights acts as a secondary check on improper or incorrect management decisions. If enough dissenting shareholders exercise appraisal rights for a transaction approved by the majority, then the cost of purchasing dissenting shares may cause management to rethink its course of action.[183] The grant of appraisal rights is also central to protecting the investment interests of shareholders in privately held corporations. These shareholders usually have no ready market for their shares. By exercising their appraisal rights, they can withdraw from the corporation and recoup the value of their investment.[184]

---

179. 12B FLETCHER, *supra* note 77, § 5906.1, at 343; CLARK, *supra* note 21, § 10.6.1, at 443-49 (discussing the several rationales for affording appraisal rights); *see also* Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 228-29 (1962); ALI CORP. GOVERNANCE, *supra* note 160, at 945.

180. This expectation is supported by the fact that every state provides appraisal rights. ALI CORP. GOVERNANCE, *supra* note 160, at 944.

181. EISENBERG, *supra* note 154, at 69.

182. *Id.* at 78.

183. ALI CORP. GOVERNANCE, *supra* note 160, at 945; EISENBERG, *supra* note 154, at 72, 83.

184. EISENBERG, *supra* note 154, at 79. *See generally* Orchard v. Covelli, 590 F. Supp. 1548 (W.D. Pa. 1984) (exercise of appraisal rights by shareholder in close corporation).

On first impression, a grant of appraisal rights to shareholders of publicly traded corporations seems unnecessary. Dissenting shareholders can withdraw easily from a company by selling their shares on the market. However, a market sale does not guarantee that the shareholders will be paid the full value of their shares. A sale by a shareholder owning a large block of shares in itself may depress the market, as will a large number of concurrent sell orders.[185] Additionally, the corporate action objected to may cause the market price to drop if the change is generally considered to be unwise.[186] Therefore, a dissenting shareholder is protected from market loss because the corporation is obligated to purchase the dissenter's shares.

Vermont presently provides shareholders with appraisal rights.[187] Under Vermont law, the circumstances in which the remedy is available are limited, the procedures for exercising the rights are complex, and the burdens imposed on the dissenting shareholders may discourage them from exercising their rights. As a result, the effectiveness of the remedy is considerably undermined by the provisions' procedural complexity and substantive burdens.

In Vermont, appraisal rights are available only to dissenters from corporate mergers, consolidations, and the sale or exchange of substantially all of the corporate assets other than in the regular course of business.[188] Appraisal rights are not available in other situations that may threaten a shareholder's interest, as when an amendment to the articles of incorporation impairs the investor's rights.

---

185. EISENBERG, *supra* note 154, at 81.

186. *Id.* Clark discusses the situation in which "controlling insiders of a number of publicly held corporations took advantage of a depressed stock market to forcibly squeeze out public shareholders—through cash mergers and other techniques—at prices shareholders . . . widely felt to be unfair." CLARK, *supra* note 21, § 10.6, at 448. Clark observes that the market prices might not be truly reflective of the stock's value in those situations in which dissenting shareholders objected to a transaction. *Id.* at 448-49. Despite these potential problems, some states nevertheless have made appraisal rights unavailable for shares registered on a national security exchange. *See, e.g.*, ALA. CODE § 10-2A-162(c) (1991); ALASKA STAT. § 10.06.574(d) (1991); KAN. STAT. ANN. § 17-6712(K)(1) (1990).

187. VT. STAT. ANN. tit. 11, §§ 2003, 2004 (1984).

188. *Id.*

Present law also imposes undue burdens on the dissenting shareholders and discourages negotiated resolutions of disputes about valuation. Failure to comply with the statute's procedural complexities can cause a forfeiture of the dissenting shareholder's rights.[189] The code also allows only thirty days for negotiation if the dissenting shareholder and the corporation disagree about price.[190] The statute does not provide incentives for the corporation to satisfy the dissenter's claims promptly or to settle disputes without judicial resolution. Finally, if litigation is required, the corporation does not have to make any payment until final resolution of the matter.[191] Shareholders must finance a costly process to obtain a judicial determination of the value of their shares. Exercising their rights can be technically hazardous and costly, providing little assurance that the outcome will be successful. Thus, the procedures may be of little assistance to smaller shareholders.

The Reform Act addresses many of the problems with present law. It expands the availability of dissenters' rights to include amendments to the articles of incorporation adversely affecting a shareholder's rights, share exchanges, election or termination of

---

189. *See id.* § 2004. This provision requires the dissenting shareholder to file a notice of objection to the proposed corporate action before or at the meeting at which the vote is to be taken. The shareholder must then vote against the action and within 10 to 15 days of the vote (depending on the type of transaction), make written demand for payment of the full value of his or her shares. The fair value is determined as of the day before the date on which the vote was taken. *Id.* § 2004(a). Once made, a demand may not be withdrawn without the consent of the corporation. *Id.* § 2004(b). Within 20 days after making a written demand, the dissenting shareholder must submit his or her share certificates to the corporation so that the certificates reflect that a demand has been made. *Id.* § 2004(h). Within 10 days after the corporate action is completed, the corporation will give to each dissenting shareholder a written offer to pay for the shares at a price deemed to be fair value by the board of directors. *Id.* § 2004(c). If the dissenting shareholder and the corporation agree as to the fair value within 30 days of the completion of the corporate action, payment shall be made to the dissenting shareholder within 90 days of the completed corporate action upon surrender of the dissenting shareholder's certificates. *Id.* § 2004(d). If the shareholder and the corporation do not agree, then the corporation may seek judicial determination of the fair value of the shares. If the corporation fails to seek judicial relief, then the dissenting shareholder may do so. *Id.* § 2004(e).

Failure to comply with statutory procedures can cause forfeiture of rights. *See, e.g.*, Gibson v. Strong, Co., 708 S.W.2d 603 (Ark. 1986); McGowan v. Grand Island Transit, 437 N.Y.S.2d 158 (N.Y. App. Div. 1981); Waite v. Old Tucson Dev. Co., 528 P.2d 1276 (Ariz. Ct. App. 1974). *But see In re* Valuation of Common Stock of McLoon Oil Co., 565 A.2d 997 (Me. 1989).

190. VT. STAT. ANN. tit. 11, § 2004(c) (1984).

191. *Id.* § 2004(e).

close corporation status, and any other corporate action for which the articles of incorporation or bylaws provide dissenters' rights.[192] Permitting the corporation to make dissenters' rights available in other situations mitigates the rigidity of the mandatory provisions and presents an opportunity for adaptation and change not found in present law. A corporation, for example, may want to grant dissenters' rights to non-voting shareholders when these shareholders would otherwise oppose a corporate transaction by filing a lawsuit. Granting dissenters' rights may satisfy the shareholders and reduce or eliminate the possibility of costly litigation.[193]

The proposed law also streamlines the procedures for exercising appraisal rights and for imposing mandatory disclosure of information, making it easier for shareholders to understand and to comply with procedural requirements. The corporation must inform shareholders of their rights, the applicable law, and the procedures for exercising their rights.[194] Upon payment of the amount owed, the corporation must provide the shareholder with copies of the corporation's financial statements and a description of how the fair value was calculated.[195]

Under the Reform Act, shareholders receive payment sooner than under present law. The corporation will pay the fair value

---

192. H. 265 (S. 1), *supra* note 1, §§ 13.02, 20.04(c), 20.12(b).

193. 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, ¶ 1(5) official cmt.

194. *See* H. 265 (S. 1), *supra* note 1, § 13.20. This provision requires the notice of the meeting at which the action creating dissenters' rights will be voted on to include notice that shareholders may be entitled to assert dissenters' rights and to provide shareholders with a copy of the relevant law. *Id.* The dissenting shareholder must notify the corporation of the shareholder's intent to dissent and the shareholder must vote against the objected corporate action. *Id.* § 13.21. If the action in question is approved, the corporation must notify the dissenting shareholder within 10 days where the payment demand must be sent, what procedures must be followed for depositing shares, provide a form for making the demand, and set a deadline for receipt of the demand. *Id.* § 13.21. Again, the shareholder must be sent a copy of the applicable law. Upon receipt of a payment demand, the corporation must pay the dissenter the fair value of the shares plus accrued interest. The shareholder must also be provided with copies of the corporation's financial statements and an explanation of how the fair value was determined. *Id.* § 13.25. The dissenter may either provide the corporation with a written estimate of the fair value of the shares and demand payment of the difference between the amount paid by the corporation and the estimate, or reject the corporation's estimate and demand fair value. Within 60 days of the demand for payment, the corporation must either petition the court to determine fair value or pay the dissenter's demand. *Id.* § 13.28.

195. *Id.* § 13.25.

of the shares plus interest either upon receipt of a payment demand or when the proposed corporate action is taken.[196] If the shareholder objects to the amount paid, the shareholder may keep the payment made by the corporation and demand payment based on an estimate provided by the shareholder, or reiterate a demand for fair value.[197] The proposed change in the timing of the payments is central to the effectiveness of the remedy. Under the Reform Act, the shareholder will have funds which can be used to finance litigation. In contrast, under present law, if a dispute arises, payment is withheld until the final determination of the amount due. A shareholder without funds to finance litigation may be forced to accept a lesser amount.

Within sixty days of a shareholder's second demand, the corporation must either petition the court to determine fair value or pay the dissenter's demand.[198] Corporations that do not follow the statutory guidelines may have costs and attorneys' fees assessed against them in any litigation that results.[199]

The Reform Act significantly improves present law. It increases the statutorily mandated availability of appraisal rights and permits corporations to make the rights available under circumstances other than those prescribed by law. The Act makes compliance easier by requiring the corporation to provide shareholders with essential information about their rights and to act promptly in resolving claims. Finally, the corporation is required to pay shareholders the fair value of their shares, plus interest, after receiving their demand for payment. Therefore, the Reform Act makes it easier for shareholders to exercise appraisal rights, introduces flexibility in the appraisal process, and better serves the remedial purpose of the provisions.

---

196. *Id.*

197. *Id.* The provision of the information and the timing of the payments are key improvements because valuation of the dissenters' shares is a frequently litigated issue. *See, e.g., In re* Valuation of Common Stock of McLoon Oil Co., 565 A.2d 997 (Me. 1989); Columbia Management v. Wyss, 765 P.2d 207 (Or. Ct. App. 1988).

198. *See* H. 265 (S. 1), *supra* note 1, § 13.30. Ordinarily, the costs of the litigation, including the costs of appraisers appointed by the court, will be paid by the corporation unless the court finds the dissenters acted in bad faith. *Id.* Attorneys' fees also may be awarded if the corporation failed to follow the statutory procedures or some or all of the dissenters acted in bad faith. *Id.*

199. H. 265 (S. 1), *supra* note 1, § 13.31.

Under the Reform Act, provisions governing shareholders' approval of extraordinary corporate actions, class voting, and appraisal rights eliminate many of the problems found in current law. These provisions accomplish their objectives through the interplay of different functional types of provisions and increased flexibility in the substance of the law. In mandating a minimum voting requirement for extraordinary corporate actions, the proposed law distinguishes between the needs of general and closely held corporations. Majority rule applies to general corporations; a super-majority applies to many actions of closely held corporations. The Act, however, permits shareholders of both types of corporations to elect higher voting requirements.

The change from the present super-majority requirement for all corporations to majority vote for some does not jeopardize the rights of minority shareholders. Other mechanisms, like voting groups, can be used to accord extra weight to minority holdings. Finally, the expansion of the availability of dissenters' rights and the change in procedures make the remedy suitable both to unsophisticated shareholders with small holdings and shareholders of substantial means.

C. Corporate Management—Conduct and Structure

Corporate governance issues are some of the most difficult in corporate law.[200] Managing a corporation[201] is a complicated and dynamic process. Fallible human beings make influential decisions in uncertain and changing conditions.[202] The circumstances in which issues of corporate management arise are varied and complex. It is therefore difficult to develop prescriptive rules of general application that accommodate "strongly held but often competing values widely shared in our political culture: on the one hand, freedom of enterprise; on the other, accountability under the law."[203] These values express management's need for

200. The American Law Institute has just completed its work on its corporate governance project. ALI CORP. GOVERNANCE, *supra* note 160. It has been described as "a formidable treatment of a complex subject that has many controversial aspects." *Id.* at ix.

201. In this section of the article, "corporate management" refers to corporate directors and officers unless otherwise indicated.

202. ALI CORP. GOVERNANCE, *supra* note 160, at x.

203. *Id.*

flexibility in performing its duties and shareholders' need for management constraint. The standards for management conduct and the structure of the decision making body determine the extent to which shareholders decide, for themselves, how to accommodate competing values.[204]

1. Management Conduct

In an ideal world, corporate decision makers use appropriate processes and produce successful results. However, in reality, corporate managers sometimes make decisions that are flawed in substance or process. Yet, these managers, by state authority,[205] are entrusted with the care of other people's money. Incorrect decisions diminish shareholders' wealth. Successful operation of a corporation requires management discretion; directors and officers must have the freedom to conduct business as they see fit. As a result, shareholders, management, and the state are interested in setting appropriate standards for management decisions and for determining the extent of liability for decisions that are wrong.

As discussed earlier, although their money is at risk, shareholders do not participate in corporate control.[206] Shareholders therefore want to attract competent management,[207] the best security for their financial interests. Their paramount concern is to limit the opportunity for management abuse.

Controlling the conduct of corporate management is difficult for shareholders. In large companies, the authority to manage the

---

204. Some scholars have suggested that companies generally should be able to modify or opt out of corporate law rules. *See generally* Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982). *Cf.* Lucian A. Bebchuck, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989) (arguing that corporations' opportunity to opt out of corporate law rules should be limited).

205. VT. STAT. ANN. tit. 11, § 1881 (1984) (vesting the authority to manage the corporation in the board of directors).

206. *See supra* notes 148-204 and accompanying text.

207. "The law ought not make trusteeship so hazardous that responsible individuals and corporations will shy away from it." Dabney v. Chase Nat'l Bank, 196 F.2d 668, 675 (2d Cir. 1952) (per L. Hand, J.).

business is vested in a centralized board of directors[208] with whom the shareholders have little direct contact. The large number and passive nature of shareholders make it unlikely that they will negotiate management standards of conduct appropriate to their needs. The opportunity for freedom of contract yields to the shareholders' desire to hold management accountable. Shareholders rely on the state to provide the terms of the contract with management.

Shareholders of corporations with few investors can negotiate directly with corporate officers and directors. In fact, shareholders, officers, and directors are often the same people, as, for example, in one-shareholder, or family-owned companies.[209] Thus, ownership and control merge in individuals filling multiple roles. Nevertheless, the desire for managerial accountability remains strong, especially when a passive minority lacks access to control. If the standard for management conduct is left to negotiation among the parties, the interests of the passive minority will be underrepresented. Even when all shareholders participate in control, there is the possibility of unequal distribution of power.

Corporations are created only with state authorization. Although the relationship between directors and shareholders is at least partly contractual in nature, states have an interest in preventing corporate associations from becoming instruments of abuse. Statutory provisions requiring minimum standards of conduct will guard against management overreaching, just as the mandatory obligation of good faith imposed by the Uniform Commercial Code encourages principled conduct.[210]

Over the years, interrelated legal rules have developed to accommodate these interests. Regulatory provisions controlling management behavior protect shareholders from management excess. In contrast, indemnification and limitation of liability provisions usually are enabling. Freedom of contract holds sway;

---

208. Current law requires a corporation to have a board of directors to manage its affairs. VT. STAT. ANN. tit. 11, § 1881 (1984); *cf.* H. 265 (S. 1), *supra* note 1, § 8.01 (requiring a board of directors unless the corporation is a close corporation).

209. *See generally* O'NEAL & THOMPSON, *supra* note 58, § 1.05, at 11.

210. U.C.C. § 1-203 (1986 & Supp. 1992).

shareholders decide whether to indemnify and whether to limit management liability.

Most states have addressed these interests by establishing statutory standards for management conduct,[211] by permitting shareholders to limit management's personal liability for certain breaches of the standard,[212] and by allowing indemnification when management conduct is proper.[213] In these areas, Vermont law has not resolved critical issues of substance and implementation.

Vermont is one of the few remaining states that continues to define management's standard of conduct in case law.[214] Vermont should decide whether to follow the lead of other jurisdictions and codify this standard, or continue to leave the development of the standard to the incremental process of the common law. Additionally, Vermont has not determined whether shareholders should be able to limit management liability. If limitation is permitted, Vermont must determine whether the legislation should be a categorical rule or an enabling provision. Vermont's indemnification provisions are also deficient. Again, the state must decide whether the purposes of permitting indemnification are best served by enabling or regulatory provisions.[215]

a. The obligation of due care

Directors and officers are vested with the statutory authority to manage the corporation, a power that, under the concession theory, is derived from the state and not delegated by the

---

211. *See infra* note 230.

212. *See infra* notes 284-304.

213. *See infra* notes 264-83.

214. Although § 1891 imposes liability on directors who improperly approve a distribution of corporate assets to shareholders, the code otherwise does not deal with liability for incorrect corporate decisions. VT. STAT. ANN. tit. 11, § 1891 (1984 & Supp. 1991); *In re* Vermont Toy Works, Inc., 82 B.R. 258, 300 (Bankr. D. Vt. 1987); Lash v. Lash Furniture Co., 130 Vt. 517, 296 A.2d 207 (1972) (the only known recent cases dealing directly with the issue of director liability).

215. Section 1852 does little more than generally empower the corporation to indemnify officers and directors. VT. STAT. ANN. tit. 11, § 1852(15) (1984 & Supp. 1991).

shareholders.[216] In addition to the grant of authority, the state also requires that management's conduct conform to the obligations of due care, good faith, and loyalty.[217] In these situations, the state has, appropriately, used a regulatory approach to make minimum standards of conduct mandatory. Regulation protects shareholders from management abuse and at the same time provides management with guidelines for appropriate behavior. The issue is not whether the law should be regulatory in function, but how the regulation should be implemented.

Violations of the duty of care arise from a failure to act[218] or from careless behavior:[219]

> [Corporate managers] have been found to violate their duty of care when they failed to attend meetings, to learn the basic facts about the business of the corporation, to read a reasonable quantity of reports, to seek needed help when a danger signal appeared, or when they have otherwise neglected to go through the standard motions of diligent behavior.[220]

The obligation of due care emphasizes the decision making process, not the substance of the decision.[221] Corporate managers who satisfy the standard of due care, and act in good faith and with loyalty, will not be held liable for bad decisions.[222]

Although Vermont law requires management to act with due care, the case law offers little guidance as to the extent of this

---

216. HENN & ALEXANDER, *supra* note 10, § 207, at 562-64. In many states, however, their powers may be limited by provisions in the articles of incorporation, so long as the limitations do not exceed statutory guidelines. *Id.*

217. *See, e.g.*, Meyers v. Moody, 693 F.2d 1196 (5th Cir. 1982); Robinson v. Watts Detective Agency, Inc., 685 F.2d 729 (1st Cir. 1982); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Dotlich v. Dotlich, 475 N.E.2d 331 (Ind. Ct. App. 1985); Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981); *see* HENN & ALEXANDER, *supra* note 10, § 232, at 612-13.

218. *See, e.g.*, Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).

219. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

220. CLARK, *supra* note 21, § 3.4.1, at 125.

221. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 8.30 official cmt., at 929; HENN & ALEXANDER, *supra* note 10, § 234, at 621.

222. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 8.30 official cmt., at 929; HENN & ALEXANDER, *supra* note 10, § 234, at 621.

obligation.[223] Vermont's corporate code is also silent on this issue. Because management exposure to personal liability has increased since 1985, clarity in the law is essential. Codification of the standard will remedy the deficiencies in Vermont's law.[224]

Until the early 1960s, the definition of corporate directors' and officers' duty of care developed in common law.[225] Today, however, codification is the norm.[226] In thirty-eight jurisdic-

---

223. *See generally In re* Vermont Toy Works, Inc., 82 B.R. 258, 300 (Bankr. D. Vt. 1987); Lash v. Lash Furniture Co., 130 Vt. 517, 296 A.2d 207 (1972).

224. As originally introduced, the Reform Act did not include a statutory standard for the application of the business judgment rule, which is closely related to the duty of care. According to Clark:

> [T]he business judgment rule is just a corollary of the usual statutory provision that it is the directors who shall manage the corporation. The rule is simply that the business judgment of the directors will not be challenged or overturned by the courts or shareholders, and the directors will not be held liable for the consequences of their exercise of business judgment—even for judgments that appear to have been clear mistakes—unless certain exceptions apply.

CLARK, *supra* note 21, § 3.4, at 123; *see also* ALI CORP. GOVERANCE, *supra* note 160, § 4.01(c). The business judgment rule will not apply if, in making their decisions, the directors have failed to act in good faith, on an informed basis, and in the best interests of the corporation, or if their decision should be set aside because of fraud, illegality, or conflicts of interest. *See generally* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); CLARK, *supra* note 21, § 3.4, 124; HENN & ALEXANDER, *supra* note 10, § 242, at 661-63.

Although the articulation of the rule seems fairly straightforward, its application has been troublesome. CLARK, *supra* note 21, § 3.5, at 136-40, § 13.6.3, at 581-88, § 15.2, at 641; 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 8.30, at 933 (Supp. 1992); ALI CORP. GOVERNANCE, *supra* note 160, § 4.01, at 184-86. The scope of its application and its relationship to the duty of care are not always clear. ALI CORP. GOVERNANCE, *supra* note 160, § 4.01, at 227-28.

At the time of this writing, the Reform Act does not codify the Business Judgment Rule. This approach is consistent with the one taken by the drafters of the Revised Model Business Corporation Act, who originally sought to integrate codification of the Business Judgment Rule with the codification of the duty of care, but then thought better of it. The number and nature of the comments on the proposed Business Judgment Rule language led them to conclude that the issues "were too complex to be handled as part of the broad revision process, and that they should be left to continuing judicial interpretation and development." 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 8.30, at 933-34. The Rule's continuing development is particularly evident in its applicability to the duty of loyalty, to decisions made in the context of hostile takeovers, and to derivative actions. Commentators have applauded the soundness of the Revised Model Business Code Act decision to eschew codification of the Business Judgment Rule. *See, e.g.*, E. Norman Veasy & Julie M. S. Seitz, *The Business Judgment Rule in the Revised Model Act, the* Trans-Union *Case and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483, 1505 (1985); *see* ALI CORP. GOVERNANCE, *supra* note 160, pt. IV, at 176-78, 229-30 (additional discussion on the Business Judgment Rule).

225. ALI CORP. GOVERANCE, *supra* note 160.

226. *Id.*

tions, statutes define this obligation.[227] Although the trend toward codification is significant, there are other, more compelling reasons for Vermont to follow this lead.

According to some commentators, the past decade has been characterized by a significant rise in litigation against corporate managers[228] and an increased willingness by the judiciary to second-guess management decisions.[229] The 1985 Delaware Supreme Court decision in *Smith v. Van Gorkom*[230] was reportedly an important catalyst to the spate of litigation.[231] The court held the directors of the Trans-Union Corporation liable for failure to exercise due care in approving a cash out merger of the company.[232] One estimate pegged the directors' potential liability at approximately $50 million.[233]

As a result of the *Van Gorkom* decision and others which followed,[234] directors' and officers' liability insurance became expensive or, in some cases, not available at any price.[235] The reduced availability of liability insurance resulted in directors' resignations.[236] Today, liability insurance is available, but with more limited coverage and higher premiums than were characteristic of the policies issued before the mid-1980s.[237]

The increased exposure of corporate managers to personal liability has focused significant attention on the legal standards

---

227. 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, at 936. In contrast, Delaware, a state with considerable influence on the development of corporate law, has continued to rely on the common law. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

228. *See* JOSEPH W. BISHOP, JR., LAW OF CORPORATE OFFICERS AND DIRECTORS § 8.01, at 2 (Supp. 1992).

229. James J. Hanks, Jr., *Evaluation of Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988).

230. Smith v. Van Gorkom, 488 A.2d at 893.

231. *See, e.g.*, BISHOP, *supra* note 228, ch. 8, at 2; Hanks, *supra* note 229, at 1208.

232. Smith v. Van Gorkom, 488 A.2d at 893 (Del. 1985). The case ultimately settled.

233. Hanks, *supra* note 229, at 1208.

234. *See generally id.* at 1208.

235. BISHOP, *supra* note 228, ch. 8, at 2-8.

236. Hanks, *supra* note 229, at 1209.

237. BISHOP, *supra* note 228, § 8.01, at 3, § 8.02, at 4 (discussing both the amount of coverage and cost of coverage since the *Van Gorkom* decision).

that apply to the conduct of officers and directors.[238] The uncertainty in Vermont's present law impairs the interests of managers who must conform to the standard and of shareholders who want to attract able people. Clarity and predictability are essential if the law is to be effective. Codification will improve the law in both respects.

Although gradual, contextual development of the legal standard is arguably appropriate, it is unlikely Vermont courts will have the opportunity to develop the law any time soon. Vermont is not like Delaware, a state in which many corporate law cases are decided each year.[239] In Vermont, there have been only two known judicial decisions on the subject since 1972.[240] Codification will accelerate the law reform process without unduly infringing on the courts' role. Statutory provisions can be drafted to provide guidance and to permit flexibility in application. Because codification will make Vermont's law consistent with the law of other states, Vermont attorneys will be able to consult other jurisdictions for guidance on the application of the law. The opportunity to benefit from the experience of other states will enhance the predictability of Vermont's law.

The last, and perhaps most important, reason for codifying the duty of care is its relationship to the provisions limiting management liability and permitting indemnification. Generally, shareholders may limit the liability of management only for certain breaches of the duty of care and not for breaches of the duty of loyalty.[241] Similarly, management may have only limited indemnification in a proceeding brought by or on behalf of the corporation.[242] The standards for conduct, for limitation of liability, and for indemnification are an integrated whole that together define the reciprocal rights and obligations between management and the corporation. Codifying the duty of care will

---

238. One commentator has stated that "[i]t is generally recognized that the issues raised by [the standard of conduct for directors] and the scope of the 'business judgment rule' are among the most difficult and controversial issues in corporation law today." 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 8.30, at 933 (Supp. 1992).

239. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 141, 142 (1992).

240. *In re* Vermont Toy Works, Inc., 82 B.R. 258 (Bankr. D. Vt. 1987); Lash v. Lash Furniture Co., 130 Vt. 517, 296 A.2d 207 (1972).

241. H. 265 (S. 1), *supra* note 1, § 2.02(b)(4).

242. *Id.* § 8.51(d), (e).

make that relationship clear and is therefore the better approach.

The regulatory approach of the Reform Act requires corporate management to discharge its duties in good faith, with due care, and in a manner that is in the best interests of the corporation.[243] The applicable standard of care is "the care an ordinarily prudent person in a like position would exercise under similar circumstances."[244] This approach is consistent with the proposal of the American Law Institute, the Revised Model Business Corporation Act, and jurisdictions that have codified the standard of care.[245] The Reform Act also follows their lead in authorizing corporate management to rely on information and reports provided by company employees and outside professionals, such as lawyers, investment bankers, and accountants.[246] The codification of management's obligations will provide an added measure of certainty and predictability, and will facilitate the interplay

---

243. *Id.* § 8.30.

244. *Id.*

245. ALI CORP. GOVERNANCE, *supra* note 160, § 4.01(a), at 180-81 (articulating a standard consistent with the standard used in most jurisdictions); *cf.* 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 8.30, at 926 (Supp. 1992). "Thirty-nine jurisdictions follow the general Model Act pattern of imposing a statutory standard of care on directors in performing their duties." *Id.* at 936 (Supp. 1992); *see also* CLARK, *supra* note 21, § 3.4, at 123-36; HENN & ALEXANDER, *supra* note 10, § 234, at 621-25. According to one authority:

> [T]hirty-eight jurisdictions require that a director of a corporation discharge the duties of his office in good faith and with a stated standard of care, usually phrased in terms of the care that an ordinarily prudent person would exercise under similar circumstances . . . . [T]hirty-four of these jurisdictions also expressly require that a director perform his duties in a manner that he reasonably believes to be in the best interests of the corporation.

2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 8.30, at 936 (Supp. 1992). In contrast, the standard applied by the Delaware courts in *Van Gorkom* was one of gross negligence. *See generally* 3 FLETCHER, *supra* note 77, § 1011, at 728, § 1012, at 736; 3A *id.* § 1029, at 13-14, § 1034, at 29, § 1035, at 33, § 1037, at 38, § 1038, at 40.

246. H. 265 (S. 1), *supra* note 1, § 8.30(b); 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 8.30(b) (Supp. 1992); ALI CORP. GOVERNANCE, *supra* note 160, § 4.02; 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 8.30, at 936 (Supp. 1992). Under present law, directors' and officers' statutory authorization to rely on reports is limited to decisions regarding distributions of corporate assets, where they may rely on properly prepared financial statements. VT. STAT. ANN. tit. 11, § 1891(c) (1984); ALI CORP. GOVERNANCE, *supra* note 160, § 4.01; 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 8.42. Twenty-one jurisdictions provide statutory standards for officers, some of which are included in the standards applicable to directors. *Id.* at 1068 (Supp. 1992). In states lacking statutory definition, the common law duties of agents apply to officers to the extent of their authority. *Id.*

between this provision and those dealing with the limitation of directors' liability and indemnification of management.

b. The obligation of loyalty—conflict of interest

In addition to the obligation of due care, corporate management must satisfy a duty of loyalty to the corporation.[247] The duty of loyalty requires corporate managers to advance corporate interests and not their own.[248] It generally prohibits self-dealing, profiting at the expense of the corporation, and engaging in transactions involving a conflict of interest.[249] Although many aspects of the duty of loyalty have developed in the common law,[250] in most states, corporate codes regulate transactions between management and the corporation they serve.[251] Vermont is no exception.[252]

These statutory rules apply to transactions involving a conflict of interest. They "reflect the underlying obligation of [a manager] who is personally interested in a matter affecting the corporation, to act fairly toward the corporation and its shareholders."[253] The conflict may arise when a director contracts directly with the corporation, such as in lending the corporation money or providing it with services. It also may arise in the context of overlapping directorships in which an individual serves on both boards of two corporations contracting with each other.

---

247. *In re* Vermont Toy Works, Inc., 82 B.R. 258, 300 (Bankr. D. Vt. 1987); Lash v. Lash Furniture Co., Inc., 130 Vt. 517, 522, 296 A.2d 207, 211 (1972); VT. STAT. ANN. tit. 11, § 1888 (1984) (regulating directors' contracts with the corporation, a conflict of interest situation that implicates the duty of loyalty).

248. *In re* Vermont Toy Works, Inc., 82 B.R. 258, 300 (Bankr. D. Vt. 1987); Lash v. Lash Furniture Co., 130 Vt. 517, 522, 296 A.2d 207, 210 (1972); VT. STAT. ANN. tit. 11, § 1888 (1984).

249. *In re* Vermont Toy Works, Inc., 82 B.R. 258, 300 (Bankr. D. Vt. 1987); Lash v. Lash Furniture Co., 130 Vt. 517, 522, 296 A.2d 207, 211 (1972); VT. STAT. ANN. tit. 11, § 1888 (1984); *see also* Duane Jones v. Burke, 117 N.E.2d 237 (N.Y. 1954); Guth v. Loft, 5 A.2d 503 (Del. 1939); Southeast Consultants, Inc. v. McCrary Eng'g Corp., 273 S.E.2d 112 (Ga. 1980).

250. *See generally* HENN & ALEXANDER, *supra* note 10, §§ 235-238, at 625-44.

251. ALI CORP. GOVERNANCE, *supra* note 160, at 316-19.

252. VT. STAT. ANN. tit. 11, § 1888 (1984).

253. ALI CORP. GOVERNANCE, *supra* note 160, pt. V, at 263.

Vermont is one of forty-five states whose code addresses this issue.[254] Its regulatory provision[255] guards against overreaching by management and provides management with guidelines for appropriate behavior. Vermont's code is deficient in substance rather than form. Present law applies only to directors engaging in transactions with the corporation[256] and does not address corporate transactions with officers, although the potential conflict exists equally in both situations. Because officers are generally agents of the corporation,[257] traditional agency rules may alleviate some aspects of the problem. It is unlikely, however, that these common law rules will provide the necessary procedural protections. Codification will clarify the law.

Present law also applies only to directors' contracts with the corporation. It does not apply when management either has an indirect financial interest in the transaction, or serves on the boards of two corporations negotiating a contract or contemplating a merger.[258] Furthermore, Vermont does not require prior disclosure of the conflict to the directors who must ultimately approve the transaction.[259]

To correct these problems, the Reform Act uses the approach of the Delaware code.[260] It remedies the deficiencies of present law by expanding the scope of its coverage and providing procedural safe harbors. The proposed legislation applies to officers and directors, and covers transactions in which management has both a direct and an indirect financial interest.[261] It also provides procedural guidelines by which fully disclosed transactions may be authorized or ratified by disinterested directors or shareholders.[262] When appropriate procedures are not followed,

---

254. *Id.* at 312, 316-19.

255. VT. STAT. ANN. tit. 11, § 1888 (1984).

256. *Id.*

257. HENN & ALEXANDER, *supra* note 10, § 219, at 586.

258. VT. STAT. ANN. tit. 11, § 1888 (1984).

259. *Id.*

260. DEL. CODE ANN. tit. 8, § 144 (1974); Fleigler v. Lawrence, 361 A.2d 218 (Del. Super. Ct. 1976). Originally, the Revised Model Business Corporation Act contained a similar provision. 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 8.31 (Supp. 1992). The provision was subsequently deleted.

261. H. 265 (S. 1), *supra* note 1, § 8.31.

262. *Id.*

the fairness of the transaction will be subject to review.[263] The proposed legislation, therefore, protects shareholders' dual interests in having management deal fairly with the corporation and in permitting transactions that benefit the corporation despite the conflict of interest.

The rules that define management obligations of due care, good faith, and loyalty are regulatory in nature and mandatory in application. They protect shareholders' interests in establishing management accountability for improper conduct. They also provide directors with much needed guidelines as to the range of permissible conduct. These rules, however, are only two components of the legally defined relationships between shareholders and management. The other components define the extent of directors' and officers' financial liability in the event they become defendants in proceedings based on actions taken in their official capacity. Management may be protected by indemnification and by provisions in the articles of incorporation that limit their liability.

c. Indemnification

Indemnification and limitation of director liability highlight the competing theoretical concerns and policy considerations relevant to management conduct. If management authority is derived from the state, then the terms for exercising that authority should be determined by the state, and all provisions should be regulatory. If the relationship between management and shareholders is contractual in nature, then shareholders should be able to fashion the terms of the enterprise under enabling legislation. Similarly, a more flexible approach may be required if shareholders' primary concern is attracting qualified management, rather than if management accountability is paramount.

i. the interests at stake

Indemnification of corporate management requires shareholders to assume some of the economic burdens of management

263. *Id.*

conduct.[264] Indemnification assures corporate officials that the corporation will pay the expenses they incur in the successful defense against unjustified claims brought against them in their official capacity.[265] Corporate officers have indemnification rights under the common law of agency.[266] Directors, by virtue of their status, do not have such rights because they are not corporate agents.[267] Directors have indemnification rights only if they are permitted by statute and are affirmatively granted by the corporation.

Indemnification provisions complement the obligations of due care, good faith, and loyalty. When management's conduct is proper, shareholders will bear the cost of challenges to that conduct. Thus, indemnification furthers shareholders' interests in encouraging competent persons to act as corporate directors.[268] Qualified persons would not serve as directors if they had to bear the expense of defending the propriety of such conduct.[269] Because indemnification shifts economic risk to them, shareholders have an interest in controlling the terms of indemnification. Shareholders want to decide whether to indemnify, and, if so, to set the limits of indemnification and to tailor indemnification provisions to the particular needs of the corporation. These interests are best served by contractual freedom and flexibility.

However, indemnification should not be used to frustrate the public policy of civil or criminal law by shifting responsibility for liability from the individual to the corporation.[270] Nor should it

---

264. "Indemnification provides financial protection by the corporation for its directors, officers, and employees against expenses and liabilities incurred by them in connection with proceedings based on an alleged breach of some duty in their service to or on behalf of the corporation." 3 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, at 1081.

265. Wisener v. Air Express Int'l Corp., 583 F.2d 579 (2d Cir. 1978); Choate, Hall & Stewart v. SCA Services, Inc., 495 N.E.2d 562 (Mass. App. Ct. 1986); Fed-Mart Corp. v. Price, 168 Cal. Rptr. 525 (Cal. Ct. App. 1980); Hibbert v. Hollywood Park, Inc., 457 A.2d 339 (Del. 1983).

266. HAROLD G. REUSCHLEIN & WILLIAM A. GREGORY, HANDBOOK ON THE LAW OF AGENCY AND PARTNERSHIP § 89 (1979).

267. CLARK, *supra* note 21, § 3.3, at 114 (distinguishing between the "special status" of directors with respect to the corporations on whose boards they serve and the agency relationship of officers and employees to the corporation for which they work).

268. *See* Hibbert v. Hollywood Park, Inc., 457 A.2d 339 (Del. 1983).

269. 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, at 1081.

270. *Id.* at 1082.

nullify management responsibility to shareholders. Instead, indemnification should operate within a framework that permits flexibility, and should be consistent with management standards of conduct and shareholders' opportunity to limit management's liability.[271]

To accommodate the interests of the shareholders and the state, indemnification provisions should be enabling, regulatory, and supplementary in function. They should empower the corporation to indemnify if it chooses, but also limit the range of possibilities to avoid defeat of important state interests. These provisions also should provide default terms that apply when a corporation decides to indemnify, but fails to specify the method of implementation.

ii. the need for reform

Vermont,[272] like all other jurisdictions,[273] permits indemnification for management conduct performed in an official capacity. Vermont's legislation allows indemnification of corporate officers and directors for expenses incurred in the defense of any civil or criminal proceeding, except those in which the director is liable for "gross negligence or misconduct."[274] It also permits the corporation "to make any other indemnification that shall be authorized by the articles of incorporation or bylaws or resolution adopted after notice by the shareholders."[275] The provision is too general and permits interpretations that may be used to undermine state policies.

Enabling statutes like Vermont's provide corporate constituents with maximum flexibility in developing indemnification provisions consistent with statutorily defined limits.[276] Although flexibility furthers shareholders' interests in contractual freedom, it also imposes costs that could be avoided through the

271. 13 FLETCHER, *supra* note 77, § 6045.2, at 525-26.

272. VT. STAT. ANN. tit. 11, § 1852(15) (1984 & Supp. 1992).

273. ALI CORP. GOVERNANCE, *supra* note 160, pt. VII, § 7.20 cmt., at 905, at 929-36; *accord* 13 FLETCHER, *supra* note 77, § 6045, at 524.

274. VT. STAT. ANN. tit. 11, § 1852(15) (1984 & Supp. 1992).

275. *Id.*

276. *Id.*

use of supplementary provisions. The provision does not define fully the circumstances in which indemnification is authorized.[277]

Vermont's statute authorizing indemnification also is potentially subject to abuse because of its ambiguity. On the one hand, it prohibits indemnification for gross negligence or misconduct. On the other, it authorizes the corporation "to make any other indemnification" provided in the articles, bylaws, or approved by shareholders. The relationship between the two clauses is unclear. The first clause could be interpreted to be regulatory in function, setting the proper bounds for indemnification. Indemnification will be permitted except in situations of gross negligence or misconduct. This clause also could be interpreted as supplementary in function, merely establishing the terms that apply when the corporation does not provide its own. Under the second interpretation, other indemnification approved by the shareholders would be acceptable, even if it threatened state policies.[278] Indemnification, therefore, could be used to reimburse management for monetary penalties resulting from an improper official act.

The Reform Act's indemnification provisions are substantively comprehensive and functionally varied. The Act balances the interests of directors, shareholders, and the state and uses enabling, regulatory, and supplementary provisions to accomplish its objectives. It establishes the circumstances in which indemnification is permitted[279] and in which it is prohibited.[280] With-

---

277. The incompleteness of Vermont's indemnification provision is readily apparent when one compares it to similar provisions in other states. *Compare* 13 FLETCHER, *supra* note 77, § 6045.2.230 (Vermont's indemnification provision) *with* 13 FLETCHER, supra note 77, §§ 6045.2.205-6045.2.255 (indemnification provisions of other jurisdictions, including the District of Columbia).

278. This interpretation is suggested in the approach taken by the Massachusetts Appeals Court in Choate, Hall & Stewart v. SCA Servs., Inc., 495 N.E.2d 562 (Mass. App. Ct. 1986). The court, applying Delaware law, upheld an agreement indemnifying a director who had pled guilty to a charge of misrepresentation in violation of federal securities laws. *Id.* at 568. The Delaware statute made satisfaction of fiduciary obligations a prerequisite to indemnification but also permitted indemnification on terms acceptable to shareholders. *Id.* at 565.

279. H. 265 (S. 1), *supra* note 1, § 8.51. Indemnification is permitted only if the director acted in good faith and in the best interests of the corporation, and, in the case of a proceeding initiated by a governmental entity, the director either reasonably believed the conduct was lawful or did not engage in a reckless or intentional criminal act. *Id.*

in this framework, the corporate constituents can either fashion a standard for indemnification applicable to their situation or use the statutory standards. The Act also supplies supplementary provisions that apply unless the parties decide otherwise.[281] In addition, the Act establishes procedures for determining whether indemnification is proper, and empowers the corporation to purchase and maintain directors' and officers' liability insurance.[282] Finally, the proposed legislation requires the corporation to report to the shareholders, in writing, any indemnification or advance made to management in connection with a proceeding by, or on behalf of, the corporation.[283] The indemnification provisions of the Reform Act thus combine enabling, regulatory, and supplementary provisions to give the corporation the flexibility of contractual freedom within predefined limits.

d. Limitation of management's liability

In response to the directors' and officers' liability insurance crisis of the 1980s and the subsequent resignation of qualified directors, many states passed laws permitting shareholders to amend the corporate charter to limit or eliminate shareholder liability for management's breach of the duty of care.[284] Vermont law does not address the issue.

i. the interests at stake

Like indemnification, the issue of limiting management liability invokes the competing theoretical concerns and policy considerations related to management conduct. Limiting management liability can nullify both the state's mandate that management act carefully and the shareholders' desire for management

---

280. H. 265 (S. 1), *supra* note 1, § 8.51(d). Indemnification is prohibited if management either is found to be liable to the corporation or to have received an improper personal benefit. *Id.*

281. H. 265 (S. 1), *supra* note 1, §§ 8.52, 8.54, 8.56.

282. *Id.* §§ 8.55-8.57.

283. *Id.* § 16.21(a).

284. Forty-three states have passed some provision permitting shareholders to limit management liability. BISHOP, *supra* note 228, app. E., at 195. Both the Revised Model Business Corporation Act and the ALI Principles of Corporate Governance include such provisions. 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 102(b)(4); ALI CORP. GOVERNANCE, *supra* note 160, § 7.19.

accountability. Prohibiting the limitation on liability unduly restricts the contractual nature of the management/shareholder relationship, deprives shareholders of the power to allocate the economic burdens of the relationship, and restricts shareholders' ability to attract qualified persons.

The debate over the propriety of these provisions is based, in part, on diverging views of corporateness. Proponents base their arguments on the contractual nature of corporate relationships. Detractors argue that mandatory corporate rules are inconsistent with the contractual theory and that the procedures requiring less than unanimous shareholder consent are not contractual in nature.[285]

Regardless of the view of corporateness, the contract theory should apply to limiting management liability because it allocates the economic burden of management conduct between shareholders and corporate officials. This issue directly affects shareholders' investment interests and is suitable to resolution by shareholder approval. Shareholders should be able to allocate the risks of director decision making so long as important public policies and the rights of third parties are not implicated.[286] Furthermore, shareholders already are empowered to make decisions affecting fundamental corporate changes.[287] They approve amendments to the corporate charter, mergers, and the dissolution of the corporation.[288] The decision to limit the liability of directors is of a similar nature. It significantly affects shareholders' economic relationship to the corporation and the risk of their investment.

One may argue that the provision limiting liability tolerates, and even encourages, irresponsible behavior and may potentially nullify managers' standards of conduct. However, it is important to recall that the provision is usually optional and becomes

---

285. *See generally* Bebchuk, *supra* note 204, at 1821, 1823.

286. 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 2.02 official cmt., at 109-10; *see* Hanks, *supra* note 229, at 1231. The limitation applies only to management liability to shareholders and not liability to third parties. 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 2.02(b)(4).

287. Hanks, *supra* note 229, at 1234.

288. VT. STAT. ANN. tit. 11, §§ 1932, 1933, 1953, 2002, 2052, 2053 (1984).

effective only with shareholder approval. Furthermore, it applies only to a breach of due care and does not limit liability for breach of management's obligation of loyalty. Nor does it apply when a corporate official has received an improper benefit, made an improper distribution of corporate assets, or has intentionally or recklessly committed a wrongful act.[289] It also does not deprive shareholders of all remedies when management process is inadequate. Injunctive relief is still available to block or undo an unwise transaction.

Limiting management liability advances shareholders' interests in attracting qualified people and encouraging them to take necessary risks. The threat of liability makes people unduly cautious. This is particularly true in situations involving a breach of due care. The potential liability is disproportionately large in relation to the character of the wrongdoing and the economic benefits derived from serving on a corporate board.[290] The threat of large damage awards encourages directors to act with undue caution because "the risk of liability for due care violations tends to be one sided: directors can be held liable for excessively risky acts or decisions, but not, as a practical matter, for excessively cautious ones."[291] Unlimited liability reduces management's incentive to engage in sensible but risky behavior.[292]

Furthermore, states currently permit corporate indemnification for breaches of due care.[293] Limitation of liability accomplishes the same result. It will also reduce the cost of insurance and eliminate the need for indemnification with respect to that claim.[294] Vermont should, therefore, permit shareholders to limit management liability.

---

289. *See, e.g.*, 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 2.02(b)(4).

290. ALI CORP. GOVERNANCE, *supra* note 160, § 7.19, at 875.

291. *Id.* § 7.19 official cmt., at 875.

292. *Id.* § 7.19, at 875.

293. *See, e.g.*, VT. STAT. ANN. tit. 11, § 1852(15) (1984).

294. Hanks, *supra* note 229, at 1238; ALI CORP. GOVERNANCE, *supra* note 160, § 7.19, at 875.

ii. the method of implementation

If Vermont permits limitation of management liability, the state also must consider its implementation. Some jurisdictions use self-executing, regulatory provisions to impose automatic protection when statutory standards are met.[295] In others, enabling legislation makes limitation of liability provisions optional.[296] An argument can be made that the need to attract and keep qualified directors is so great that the limitation of liability should be accomplished by legislative fiat. Under this scheme, a regulatory provision makes the limitation mandatory. The better approach, adopted by the Reform Act, implements reform through enabling legislation rather than through regulatory legislation. A regulatory provision restricts the obligation of due care, even when shareholders do not want that result. An enabling provision is more effective because it limits liability only when shareholders so choose.

One commentator has suggested that implementing provisions like the limitation of liability by charter amendment may not protect shareholder interests adequately. "The main problem with the shareholder voting mechanism is the lack of information."[297] In most situations, "shareholders do not know whether the proposed amendment is value-decreasing or value-increasing" with respect to their financial interests.[298] This argument that shareholders may not understand whether a charter amendment will adversely affect their holdings sweeps too broadly.

Limiting management liability is a concept that investors readily can comprehend. In addition, federal securities laws require the management of public corporations to disclose information about amendments to provide shareholders with information necessary to make an informed choice.[299] Further-

---

295. BISHOP, *supra* note 228, app. E., at 196-99, § 7.18, at 99 (Supp. 1990).

296. *Id.* at 196-99.

297. Bebchuk, *supra* note 204, at 1836.

298. *Id.*

299. Securities Exchange Act of 1934, § 14(a), 15 U.S.C. § 78n(a) (1988); Securities Exchange Act Rule 14a-1, 17 C.F.R. § 240.14a-1 (1992). Section 14(a) of the Securities Exchange Act "was intended to promote 'the free exercise of the voting rights of stockholders' by ensuring that proxies would be solicited with 'explanation to the stockholder of the real nature of the questions for which authority to cast his vote is

more, in large corporations, the increased activism of institutional and other sophisticated investors makes it likely that a significant number of votes will be informed and not merely a rubber stamp approval of management's recommendation. Shareholders of small corporations are likely to have access to the information needed to make an informed decision because they usually are involved in running the business. As a practical matter, they may also be the directors who are protected by the limitation. The interests of passive shareholders are protected by the super-majority vote required to amend corporate charters of closely held corporations.[300]

The Reform Act uses the preferred enabling approach. It permits shareholders to include in the charter, either originally or by amendment, a provision limiting directors' liability for money damages. The limitation does not apply to actions in which the director derives an improper personal benefit, intentionally or recklessly harms the corporation or the shareholder, makes an improper distribution of corporate assets, or engages in an intentional or reckless criminal act.[301]

iii. the scope of the limitation

An additional consideration is whether shareholders should be authorized to eliminate management liability or to limit it only. The Reform Act permits shareholders to limit directors' liability for some or all damages.[302] Under the ALI approach, damages may not be limited to an amount less than the amount of the directors' annual compensation from the corporation.[303] This approach has been characterized as "a concept of mitigation

---

sought.'" Mills v. Electric Auto-Lite Co., 396 U.S. 375, 381 (1970) (citation omitted).

300. *See supra* notes 169-73 and accompanying text.

301. H. 265 (S. 1), *supra* note 1, § 2.02(b)(4). The section deviates from the Model Business Corporation Act in two important respects. 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 2.02(b)(4). First, H. 265 (S. 1) provides a cross reference to § 8.30 to make clear that limitation of liability for money damages is permissible only for breaches of the directors' obligations arising under § 8.30. H. 265 (S. 1), *supra* note 1, §§ 2.02(b)(4), 8.30. Second, limitation of liability is prohibited for reckless and intentional acts. *Id.*

302. H. 265 (S. 1), *supra* note 1, § 2.01(b)(4).

303. ALI CORP. GOVERNANCE, *supra* note 160, § 7.19.

of disproportionate liability, not abrogation of the duty of care."[304]

On first impression, the notion that directors should not be excused from all liability is appealing. Charter provisions should not be used to exculpate those who have failed to act properly. Equally compelling, however, is the argument that shareholders, the intended beneficiaries of the obligation of due care, should be able to allocate the risks of their investments.

In large corporations, restricting the limitation of liability may be unnecessary. Many shareholders are sophisticated investors who understand the implications of complete exculpation, yet feel it is in the corporation's best interests. The restriction on limiting liability also may not be appropriate for small corporations, which are prevalent in Vermont. In small corporations, the shareholders and the directors are likely to be the same people. Directors may serve without compensation or with only nominal compensation. Linking the minimum amount of liability to the amount of the directors' compensation may have the same result as empowering the shareholders to eliminate all liability. Small companies may be unable to obtain director and officer liability insurance and shareholders may be willing to exclude liability for faulty decision making to attract able directors. For Vermont, the better approach permits shareholders to decide the extent of directors' liability.

In summary, the Reform Act addresses management's standard of conduct and liability for breach of that standard through interrelated provisions. These provisions balance the shareholders' competing interests in attracting and keeping capable management with the need to avoid management misconduct. Regulatory provisions introduce certainty into the law and protect fundamental shareholder concerns. Enabling and supplementary provisions provide flexibility and promote shareholder freedom to contract. Together the provisions create a system that protects shareholders and management without undermining important public policies of the state.

---

304. *Id.* § 7.19, at 873.

2. Management Structure—Closely Held Corporations

Under current law, all Vermont corporations must have the same management structure. Regulatory provisions in Vermont's corporate code require all corporations to have a board of directors and officers.[305] Directors manage the company[306] and appoint officers, who are responsible for the day-to-day operation of the business.[307] Shareholders elect directors[308] and vote on fundamental corporate changes.[309] Traditionally, shareholders have been prohibited from managing the corporation without express statutory authority.[310]

This approach lacks the requisite flexibility to respond to management needs of different types of corporations. Although all corporations have common characteristics,[311] investors in large, publicly held corporations have relationships to the organization and to each other that differ from those of investors in small corporations. Large corporation shareholders are generally passive. They relinquish control to corporate management and are interested primarily in the corporation as a vehicle for earning a return on their investment. A formal structure is appropriate for corporations in which passive investors delegate management responsibility to directors.

Many Vermont corporations are privately owned businesses[312] that are smaller in size, number of revenues, assets, and

---

305. VT. STAT. ANN. tit. 11, § 1926 (1984) (requiring the articles to designate the aggregate number of shares the corporation is authorized to issue and the number of directors); *id.* § 1882 (requiring a board of directors); *id.* § 1892 (providing for a president, one or more vice presidents, a secretary, and a treasurer).

306. *Id.* § 1881.

307. *Id.* § 1892.

308. *Id.* § 1882.

309. *Id.* §§ 1932, 1933, 1953, 2001, 2002, 2052, 2053.

310. There are no known cases decided under present Vermont law that permit shareholders to manage a corporation. The classic New York cases on the issue of restricting shareholder involvement in management include: Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 77 N.E.2d 633 (N.Y. 1948); Clark v. Dodge, 199 N.E. 641 (N.Y. 1936); McQuade v. Stoneham, 189 N.E. 234 (N.Y. 1934); Manson v. Curtis, 119 N.E. 559 (N.Y. 1919). *See generally* CLARK, *supra* note 21, § 18.2.5, at 781-84.

311. Some of these include limited liability, equity interests in the business represented by shares of stock, and treatment as a legal entity with an identity separate and distinct from the individual investors.

312. *See supra* note 8 and accompanying text.

employees than publicly held corporations. Different relationships emerge in the closely held corporation.[313] The shareholders, directors, and officers are often the same persons and separation of the roles becomes impractical. The investors frequently work for the corporation, making decisions about its operation and depending on it for their livelihood. Their personal fortunes are inextricably linked with the success of the company.

Present law barely recognizes the needs of small corporations.[314] The law's greatest failure is that it imposes on small corporations a mandatory management structure that is cumbersome when shareholders and management are the same individuals. For example, to amend the articles of incorporation, the directors must hold a meeting to propose and vote on a resolution. Then they must submit this resolution to themselves, as shareholders, for approval at a shareholders meeting.[315] If the proper procedures are not satisfied, the corporate action may be challenged.[316]

---

313. O'NEAL & THOMPSON, *supra* note 58, §§ 1.07, 3.56, 7.02; 4 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 8.01, at 782, 785.

314. Present law contains only a few statutory provisions of special relevance to a small corporation. The first permits the articles of association to contain a provision restricting the transfer of shares. VT. STAT. ANN. tit. 11, § 1926(8) (1984). This is a useful provision for several reasons. Close corporation shareholders may use share transfer restrictions to maintain their Subchapter S election, to structure buyout arrangements that provide a market for their shares, and to limit share ownership to family members or a known group of people. Unlike the proposed legislation, the present code does not expressly permit such restrictions to be contained in shareholder agreements, a common form of implementation. Another provision permits shareholders of corporations with fewer than three shareholders to have fewer than three directors so long as the number of directors is equal to or greater than the number of shareholders. *Id.* § 1882. This provision relieves one and two-person shareholder corporations from the requirement of a three person board of directors.

315. *Id.* § 1932. The problem is only slightly alleviated by the procedure permitting shareholders to approve a corporate action by written unanimous consent in lieu of holding a meeting. *Id.* § 2211. This procedure may not be used if any shareholders oppose the proposed action. *Id.*

316. The action may be challenged by other shareholders. It also may be challenged by third parties relying on equitable doctrines, such as piercing the corporate veil, in which one of the factors considered is whether proper corporate formalities have been followed. O'NEAL & THOMPSON, *supra* note 58, § 3.62, at 107; HENN & ALEXANDER *supra* note 10, § 146, at 344-49, § 147, at 352-54. *See generally In re* Vermont Toy Works, Inc., 82 B.R. 258, 327 (Bankr. D. Vt. 1987); Zubik v. Zubik, 384 F.2d 267 (3d Cir. 1967), *cert. denied*, 390 U.S. 988 (1968); Sabine Towing & Transp. Co. v. Merit Ventures, Inc., 575 F. Supp. 1442 (E.D. Tex. 1983).

The regulatory approach of present law makes sense when it is applied to large corporations with passive shareholders. When shareholders are numerous, widely dispersed, and have little interest in participating in management, the state must act on their behalf to define permissible management structures and to allocate management power. This approach reflects a central purpose of general corporation law: to avoid the need for legislative approval of individual corporate charters. The state has an additional interest in establishing the form of governance so that investors and third parties can determine who is authorized to act on behalf of the corporation and whether proper decision making procedures have been followed. Procedural formalities also protect passive investors by requiring them to approve certain extraordinary corporate actions. This formalized process introduces appropriate safeguards when shareholders have little opportunity to monitor management decisions.

With regard to small corporations, the state continues to have an interest in making sure that investors and third parties know what constitutes a valid corporate act. The critical difference is that, in closely held corporations, investors are often active managers. They have the interest and opportunity to structure corporate management in a way that makes sense for them. Because state regulation is unnecessary, the principle of freedom of contract should apply.

The present law is inadequate because it fails to recognize that although some form of governance is essential, the traditional form need not be exclusive.[317] When there is significant overlap in the identity of the individuals acting as directors, officers, and shareholders, the requirement that they ignore this coincidence of identity serves no purpose. Furthermore, the statutory mandate that significant corporate actions be approved by two different groups, directors and shareholders, makes little sense if the very people the procedures are designed to protect, the shareholders, are involved in the decision making process as directors. In addition, if compliance with these procedural formalities requires the assistance of attorneys, the cost of doing business will increase. Furthermore, a rigid mechanistic ap-

317. 2 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 8.01 official cmt., at 782.

proach prevents corporate members from developing a management organization that suits their needs at the time of incorporation and allows them to adjust to subsequent events.

The Reform Act gives small corporations the opportunity to have a flexible management structure by electing close corporation status.[318] The close corporation election is available to privately held corporations with thirty-five or fewer shareholders.[319] The close corporation chapter of the Reform Act replaces regulatory legislation with enabling provisions that allow varied definitions of corporate management structure. Shareholders can limit the powers of the board of directors, or eliminate the board and manage the corporation themselves.[320] Thus, the shareholders may retain the traditional structure, operate the company like a partnership, or develop a management structure that combines features of both.

The Reform Act imposes notice obligations on shareholders who adopt a flexible management structure. The articles of incorporation must contain a provision stating that the board of directors has been eliminated or its powers restricted[321] to inform prospective investors and third parties that the management structure deviates from the norm. In addition, the corporate charter must contain a statement that the obligations, imposed by law on directors, are vested instead in each person assuming the board's powers.[322] Imposing these obligations on the shareholders making management decisions protects the remaining shareholders.

Other provisions of the Reform Act increase the flexibility of operating a closely held corporation.[323] The corporation is not required to hold an annual shareholders' meeting unless request-

---

318. H. 265 (S. 1), *supra* note 1, § 20.02.

319. *Id.*

320. *Id.* §§ 20.02, 20.07, 20.09. Shareholders, for example, may make decisions regarding dividends. O'NEAL & THOMPSON, *supra* note 58, § 3.60, at 101.

321. H. 265 (S. 1), *supra* note 1, § 20.02(a)(5)(C).

322. *Id.* § 20.07(c), (d).

323. *See* Appendix, *post.*

ed by one or more shareholders.[324] Because the primary purpose of the annual meeting is to elect directors, eliminating the board may make the meeting unnecessary. Shareholders, however, retain the right to call special meetings when the need arises.[325]

The proposed legislation also establishes relatively simple procedures for electing close corporation status. Electing close corporations must expressly identify themselves as such with statements in the corporate charter and on share certificates.[326] Election or termination of this status by an existing corporation requires approval of two-thirds of the holders of corporate shares.[327] When close corporation status either is elected or terminated by modification of the articles of incorporation, objecting shareholders are entitled to appraisal rights.[328] A change to or from close corporation status thus is accorded the significance of other fundamental corporate changes. Investors can be bought out at a fair value when there is no other market for their shares.[329]

The close corporation chapter of the proposed legislation is designed to give investors in small corporations additional flexibility in managing their businesses. The enabling provisions of the code provide options intended to allow corporate structure to suit the business context to which it applies. The proposed legislation, however, protects future investors and third parties by requiring the articles to include provisions indicating that the business is being operated as a close corporation and that its governing structure and options deviate from the norm. In addition, when the decision making power of the board of

---

324. H. 265 (S. 1), *supra* note 1, § 20.08 (one or more shareholders may request a meeting at least 30 days before the meeting date established by law or designated in corporate documents).

325. *Id.* § 7.02.

326. *Id.* §§ 20.02(a)(1), 20.02(a)(4), 20.04.

327. *Id.* § 20.12.

328. *Id.* §§ 20.04(c), 20.12(b).

329. Acquisition or loss of close corporation status through a merger is protected both in terms of the vote required and the availability of appraisal rights. *Id.* § 20.10. Appraisal rights are available through the Reform Act. *Id.* § 13.02(a)(1)(A). The articles of incorporation also may contain provisions establishing the qualifications of shareholders so that a transfer of shares will not disqualify the corporation from its close corporation election. *Id.* § 20.05.

directors is either restricted or eliminated, management liability is imposed on those actually making the decisions.

D. Forming, Restructuring, and Dissolving the Corporation

The provisions governing corporate formation, restructuring, and dissolution primarily reflect the concession theory of corporateness. Under these provisions, the state controls the circumstances under which a corporation becomes viable, changes its structure, and ceases to conduct business. In these sections, state interests are paramount, although corporate shareholders and directors continue to be concerned with the need for flexible and adaptable law.

Like other areas of present law, many of these provisions need reform.[330] In general, they suffer from overbroad application of regulatory law and a lack of relevance to the current business context. Two areas are particularly troublesome: the standard for selecting a corporate name and the procedures for corporate dissolution.

1. Registration of the Corporate Name

Registering the corporate name is an important part of the corporate formation process. It reserves to the registrant the use of the corporate name in Vermont, forbidding other partnerships and corporations from adopting it as their own. To qualify for registration, a corporate name must satisfy the standard codified in Vermont law.[331] Vermont uses a regulatory provision to establish the applicable standard. This approach is correct. This type of provision will not become outdated as a result of changing business practices. The standard should be fixed so that it protects relevant state interests and is applied uniformly. The problem with the present standard is that it misleads registrants into believing that registration offers broad protection and grants the exclusive right to use the name anywhere. Instead, registration means only that no other partnership or corporation can register the name in Vermont.

---

330. *See* Appendix, *post*.

331. VT. STAT. ANN. tit. 11, §§ 1855(3), 1857(a) (1984).

Although on first impression this problem may seem minor, it has significant practical consequences. When persons forming a company mistakenly believe that registration provides broad protection, they may forego securing protection of the corporate name under federal or state laws that grant proprietary rights. As a result, a Vermont company can invest substantial time and money to create goodwill in its corporate name, only to discover that someone else has a superior right to the use of that name. In the worst case, the Vermont company can be enjoined from using the name because it infringes another company's trade name, trademark, or service mark.

The registration process in Vermont requires that the name of a domestic corporation not be "the same as or deceptively similar to" the name of any other domestic or foreign corporation registered in the state.[332] The "same or deceptively similar" standard also applies to the registration of fictitious or assumed names used by entities or individuals conducting business under a name other than their own,[333] and to foreign corporations

---

332. *Id.*

333. *Id.* §§ 1621(c), 1623. An assumed name may not be deceptively similar to an existing business name of any type. Individuals must register when they use a name other than their own. Corporations must register only when the name they do business under is different from the one in the articles of association. Section 1621, however, requires every co-partnership, whether general or limited, to register under the trade name provision. *Id.* § 1621; *see* Wilson Bros. Garage v. Tudor, 89 Vt. 522 (1915) (applying the registration statute to general partnerships).

When one is operating under an assumed name, the potential for deception arises either because the true identity of the actor may not be known or because, in the case of a partnership, the legal nature of the relationship may not be clear. In either case:

> The purpose of these [registration] acts is universally recognized to be the prevention of fraud by providing potential customers and more especially potential creditors with information about those with whom they are dealing. Whether or not sanctions are enforced to a degree sufficient to compel compliance with a particular statute, it is apparent that no substantive protection is sought to be given to a name registered or certified under its terms; a corporation which complies, if it is permitted to do so, must still resort to non-statutory principles or other statutory protections to guard the value of its business name.

Fletcher L. Yarbrough, *Protection of Territorial Rights in Corporate Names and Trade Names*, 19 BUS. LAW. 925, 933 (1964) (citations omitted).

The Secretary of State has the statutory authority to enforce compliance with the chapter by enjoining the individual or business entity from continuing the prohibited action. VT. STAT. ANN. tit. 11, § 1626 (1984). In addition, a company operating under an assumed name that has not made the required registration is prohibited access to the Vermont courts unless it registers before filing the complaint. *Id.* § 1634.

applying for a certificate of authority in Vermont.[334] The emphasis on preventing deception is, however, also the central factor in determining the suitability of a trademark for registration in this state.[335] The problem is that these similar standards have different purposes. Corporate and assumed name registration serves state administrative and public notice purposes, whereas trademark registration grants proprietary rights.

The registration requirement for a domestic or foreign corporation and for a business using a fictitious name provides state officials and the public with information about the business and the identity of the business principals.[336] The mechanism of disclosure protects individuals from being misled about the nature of a business with which they are dealing.

The need to distinguish among registered business names is largely an administrative one.[337] Distinctive names will prevent misfiling in the records of the Departments of Taxation and the Secretary of State. Distinctive names will also prevent confusion by members of the public accessing the records. Easy identification of a business entity therefore will enhance the accuracy of official record keeping and the dissemination of information about that entity. In addition, distinctive names will make it easier to notify and to serve process on businesses named as defendants in lawsuits. The names must only avoid "confusion in an absolute or linguistic sense"[338] to prevent errors in filing, notice, retrieval, and dissemination of information about a particular business.[339]

---

334. VT. STAT. ANN. tit. 11, § 2103(3) (1984).

335. Title 9 prohibits registration of a trademark that "is likely to cause confusion or mistake or to deceive purchasers, or which so nearly resembles such trademark as to be likely to cause confusion or mistake in the minds of the public or to deceive purchasers." VT. STAT. ANN. tit. 9, § 2527(b) (1984).

336. The purpose of Chapter 15 is to "prevent people from being misled as to with whom they are dealing . . . . Any other person is then able to determine who is in charge of the firm." 1960-62 OP. VT ATT'Y GEN. 96.

337. 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 4.01 official cmt., ¶ 2, at 242. The discussion of the purposes of registration of business names in this paragraph was, to a significant extent, based on this source. *Id.*

338. *Id.*

339. *Id.*

A standard that implies a determination of deceptiveness is misleading because it indicates a level of review that is neither required nor accomplished. The responsibility for processing and filing registrations is within the purview of the Secretary of State, whose duties, in this situation, are ministerial in nature[340] and not discretionary, as suggested by the present standard. The standard leads persons registering a corporation to believe mistakenly that successful registration constitutes a finding that the corporate name is "not deceptively similar" for all purposes, and accords the registrant the exclusive right to use the name.[341]

The fact that the search is made through all the business name records in the Secretary of State's office suggests that the ensuing protection is broad. The legal effect of the search is, however, narrow. Registration of the name means only that another entity cannot subsequently register the same business name in Vermont. Successful registration of a business name does not prevent another business from challenging the use of the

---

340. H. 265 (S. 1), *supra* note 1, § 1.25. The Secretary of State's role in reviewing the contents of documents is ministerial in nature. 1 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 1.24, at 45. Paul Gillies, then-Deputy Secretary of State, has stated that the ministerial role "appears to be the established role of the secretary of state in corporation filings." Paul Gillies, *Summary of Chapters I, II, III, IV, V, and XVI of H. 265, in* INTRODUCTION TO H. 265 (S. 1): THE PROPOSED REVISION OF VERMONT'S BUSINESS CORPORATION LAW, Sept. 26, 1991, at 2 [hereinafter Gillies INTRO. TO H. 265 (S. 1)] (The materials were prepared for a Continuing Legal Education Program presented by the Vermont Bar Association Business Association Law Committee).

Gillies further stated that "[i]n Vermont, given its historic reservation of implied power within executive branch agencies, the possibility that a secretary could invent any substantive law affecting corporations by using this Section [11] is no longer cause for concern." *Id.* at 1.

Similarly, the Vermont Supreme Court held that the Commissioner of Banking and Insurance, in determining whether a foreign hospital service corporation could be licensed to do business in Vermont, was not also empowered to determine whether the applicant's acts would potentially infringe a trademark or trade name. Vermont Accident Ins. Co. v. Burns, 114 Vt. 143, 40 A.2d 707 (1944).

341. Lucian W. Beavers & William R. Laney, *Choosing and Protecting the Corporate Name*, 30 OKLA. L. REV. 507, 508, 518-22 (1977); *see also* Jerome Gilson, *Tortious Incorporation: Trap for the Unwary*, 24 BUS. LAW. 237 (1968); John P. Diamond, *Unfair Competition in the Use of Corporate Names*, 12 CLEV-MAR. L. REV. 146, 159 (1963); Yarbrough, *supra* note 333, at 930-32.

name as an infringement of a trade or service mark, or as a violation of the law of unfair competition.[342]

In contrast, the use of a trade name,[343] trademark,[344] or service mark[345] can afford the owner proprietary rights in the name or mark, including the right to prohibit others from using it in connection with their businesses, products, or services.[346] These rights protect the owner's goodwill and prevent public confusion or deception.[347] Proprietary rights arise under federal or state trademark law, under state unfair competition law, but

---

342. *See* Yarbrough, *supra* note 333, at 931 (the discussion in this article refers to the previous version of the Model Business Corporation Act, the basis for Vermont's present corporate law).

343. Trade names are names used to identify businesses, rather than products or services. 1 JEROME GILSON, TRADEMARK PROTECTION AND PRACTICE § 2.14, at 2-178 (1990). "The terms 'trade name and commercial name' mean any name used by a person to identify his or her business or vocation." 15 U.S.C. § 1127 (Supp. 1992).

344. A trademark refers to any symbol, word, or name used by a manufacturer "to identify and distinguish his or her goods, including a unique product, from those manufactured or sold by others and to indicate the source of the goods, even if that source is unknown." 15 U.S.C. § 1127 (Supp. 1992).

345. A service mark is:

> any word, name or symbol or device, or any combination thereof . . . (1) used by a person or (2) which a person has a bona fide intention to use in commerce and applies to register on the principal register established by this chapter, to identify and distinguish the services of one person, including a unique service, from the services of others and to indicate the source of the services, even if that source is unknown.

Id. Trademarks and service marks, therefore, are used to identify goods or services, and to distinguish them from other goods or services. *Id.*

346. Proprietary rights in trademarks and service marks may arise through the combination of use in commerce and registration under federal trademark laws. Lanham Act, 15 U.S.C. §§ 1501-1528 (1950). Proprietary rights also may arise under state trademark law. VT. STAT. ANN. tit. 9, §§ 2527-2575 (1984); *see* Vermont Maple Syrup Co. v. F.N. Johnson Maple Syrup, 272 F. 478 (D. Vt. 1921) (common law trademark right which is based on use, not adoption, of mark). Trade names that are not also trade or service marks may be protected under the common law of unfair competition. *See also* 15 U.S.C. § 1125(a) (Supp. 1991) (applies to actions arising under traditional common law trademark infringement and unfair competition claims); Howe Scale Co. v. Wyckoff, Seaens & Benedict, 198 U.S. 118 (1905); Brattleboro Pub. Co. v. Winmill Pub. Corp., 250 F. Supp. 215 (D. Vt.), *aff'd*, 369 F.2d 565 (2d Cir. 1966); Vermont Motor Co. v. Monk, 116 Vt. 309, 75 A.2d 671 (1950); Skaf Co. v. Premo Pharm. Lab., 625 F.2d 1055 (3d Cir. 1980); Holiday Inns, Inc. v. Trump, 617 F. Supp. 1443 (D.N.J. 1985); Estate of Presley v. Prussen, 513 F. Supp. 1339 (D.N.J. 1981).

347. 1 GILSON, *supra* note 343, § 1.03, at 1-143.

not under state corporate law.[348] "Substantive trade name protection is not available . . . under statutes or ordinances providing for local registration of assumed or fictitious names,"[349] or for registration of domestic or foreign corporations.[350] Instead, "only actual use of the corporate name in business can establish protectable rights that can be asserted against third parties, and priority begins with actual use."[351]

In addition, registration of a name with the Secretary of State cannot be used as a defense to a legal action based on unfair competition or infringement.[352] The determination of whether a trade name is likely to cause confusion is based on a number of factors including "channels of trade, level of purchaser knowledgeability, degree and areas of competition."[353] However, an employee of the Secretary of State's office, acting in a ministerial capacity, does not consider these factors. The Secretary of State's office considers only the similarity of the proposed name to the names already registered. The search will not reveal conflicts with federal trademark registrations, registrations in other states, or names of domestic sole proprietorships whose principals conduct business under their own name. Nor will the Secretary make a substantive determination that the name under consideration is not deceptively similar to one already on file.

As originally introduced, the Reform Act remedied the potentially misleading nature of the present standard by permitting registration if the corporate name is "distinguishable upon the records of the Secretary of State" from other corporate and business names registered with that office.[354] The "distinguishable" standard reflects the ministerial nature of the Secre-

---

348. *Id.* § 2.14, at 2-179. The "deceptively similar" standard is also an important factor in determining the suitability of a trademark for registration in this state. VT. STAT. ANN. tit. 9, § 2527(b) (1984).

349. 1 GILSON, *supra* note 343, § 2.14, at 2-179, § 2.14[1], at 2-182 to 2-183.

350. *Id.* § 2.14[1], at 2-182 to 2-183.

351. *Id.*

352. *Id.* § 2.14[1], at 2-183.

353. *Id*; *see also Howe Scale Co.*, 198 U.S. at 346 (in which the court considered the similarity of the names; whether the names contained geographic or descriptive terms or were fanciful or arbitrary; the type of commerce; the degree of competition; and the locations of the businesses).

354. H. 265 (S. 1), *supra* note 1, § 4.01(b). The original standard was restored by the legislature.

tary of State's function in registering such names. It does not suggest a broad discretionary power which the Secretary of State does not, in fact, have. The standard is also consistent with the recognized purpose of the filing requirement which is to identify, to maintain, and to provide information about the corporation.[355] This purpose can be distinguished readily from that of preventing one business from passing itself off as another, from misappropriating, to itself, the proprietary interest and goodwill associated with the name of another. Protection in these circumstances depends upon substantive rules of unfair trade practices, and federal and state trademark law, but not on the fact of registration under the state corporation statutes. The "distinguishable" standard is therefore consistent with the purposes of registration and with the ministerial nature of the Secretary of State. Further, the standard prevents registered corporations from being misled as to the protections registration affords.

2. Corporate Dissolution

Vermont's statutory provisions on corporate dissolution also need reform. Like the registration provisions, the dissolution sections of the code, in part, reflect the concession theory of corporateness.[356] The state that controls a corporation's life also controls its passing away.

Generally, the sections on dissolution establish the terms under which a corporation ceases to conduct business, pays its creditors, and liquidates its holdings by distributing its remaining assets to its shareholders. Corporations can be dissolved voluntarily by the incorporators,[357] or by the directors and shareholders.[358] Dissolution also may occur involuntarily as a result of a

---

355. *See* VT. STAT. ANN. tit. 11, § 1621 (history of the amendments) (1984). Before 1961, filings were made to the Commissioner of Taxes. The Secretary of State was substituted in 1961.

356. *See* 3 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, at 1453.

357. VT. STAT. ANN. tit. 11, § 2051 (1984) (this provision applies only to corporations that have not begun business and that have not issued any shares); *see also* H. 265 (S. 1), *supra* note 1, § 14.01.

358. VT. STAT. ANN. tit. 11, § 2052 (1984) (permitting the corporation to be dissolved by the written consent of all its shareholders); *id.* § 2053 (permitting dissolution upon approval by two-thirds of the shares of a resolution adopted by the directors recommending dissolution); *see also* H. 265 (S. 1), *supra* note 1, § 14.02.

judicial proceeding[359] or an administrative proceeding brought by the Secretary of State.[360]

A dissolving corporation must stop conducting all business except that which is necessary to conclude its affairs.[361] Dissolution does not terminate the corporate existence but simply requires the corporation thereafter to devote itself to winding up its affairs and liquidating its assets; after dissolution, the corporation may not carry on its business except as may be appropriate for winding-up.[362] Corporate existence continues throughout the liquidation process, which may be lengthy.[363] A corporation terminates upon the final resolution of outstanding claims and distribution of all its assets.

Corporate dissolution provisions express the state's interest in prohibiting the dissolution process from being used to avoid payment of legitimate claims or to foster coercive action either by or against a shareholder.[364] The provisions also are intended to protect shareholders' equally valid interest in establishing a time at which they will receive corporate assets free of creditors' claims. The Vermont Supreme Court confirmed these dual concerns by stating that:

> Although our statutes contain varying provisions and methods on the subject of dissolution of corporate entities, . . . each bears the dominant theme that corporate liabilities, whether in contract or in tort, are to be fulfilled. And the rights of

---

359. VT. STAT. ANN. tit. 11, § 2064 (1984) (permitting the court to order dissolution in an action filed by the attorney general); *id.* § 2067 (permitting the court to liquidate the assets and business of the corporation in an action brought by a shareholder or a creditor); *see also* H. 265 (S. 1), *supra* note 1, § 14.20.

360. VT. STAT. ANN. tit. 11, § 2607 (1984); H. 265 (S. 1), *supra* note 1, § 14.30.

361. VT. STAT. ANN. tit. 11, § 2055 (1984); H. 265 (S. 1), *supra* note 1, § 14.05.

362. 3 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 14.05(a) official cmt.

363. ALFRED F. CONARD, CORPORATIONS IN PERSPECTIVE § 128, at 234 (1976). Older statutes often provided that corporate existence would terminate upon judicial decree. The problem with that approach was that sometimes previously undiscovered corporate assets or claims against the corporation would emerge after the decree. *Id.* at 240.

364. *See, e.g., In re* Musilli, 523 N.Y.S.2d 120 (N.Y. App. Div. 1987) (in which a minority shareholder instituted a dissolution proceeding to coerce the purchase of its stock at a price higher than would be paid in the absence of the threat of corporate dissolution). *See generally* HENN & ALEXANDER, *supra* note 10, § 348, at 992.

> those concerned by the dissolution, whether creditors or stockholders, are to be protected.[365]

A dissolving corporation must deal with three types of claims: known claims, for which the corporation is aware of both the claim and the identity of the claimant; contingent claims, which are known but unmatured or conditional on the occurrence or non-occurrence of future events; and, claims that are unknown at the time of dissolution, but later become known. It is relatively easy to accommodate the interests of the shareholder and the state in resolving known claims against the corporation. Creditors must be notified of the dissolution, the procedure for submitting a claim, and the time in which the claim must be submitted or be barred.[366] There also must be a procedure for resolving disputed claims.[367]

The resolution of contingent and unknown claims is a different matter. Accommodating the competing interests is difficult. Claims based on harmful acts occurring before dissolution, like products liability[368] or environmental claims,[369] may become apparent long after they originally occur. In these situations, the dissolution process should not allow a corporation to avoid responsibility for harm it has caused, especially if it is aware of a potential problem. This concern is relevant to Vermont, where the state supreme court has recently construed the six-year limitation period for civil actions as beginning on the date of discovery rather than on the date the act complained of occurred.[370] These decisions afford injured parties maximum opportunity to seek redress for harm.

The countervailing concerns are those of shareholders who receive assets distributed in corporate liquidation. Shareholders

---

365. Hall v. Pilgrim Plywood Corp., 126 Vt. 224, 228, 227 A.2d. 285, 288 (1967).

366. VT. STAT. ANN. tit. 11, § 2055 (1984); H. 265 (S. 1), *supra* note 1, § 14.06.

367. VT. STAT. ANN. tit. 11, § 2055 (1984); H. 265 (S. 1), *supra* note 1, § 14.06.

368. 16A FLETCHER, *supra* note 75, § 8141, at 433.

369. *See, e.g.*, Joslyn Mfg. Co. v. James & Co., 893 F.2d 80 (5th Cir. 1990).

370. VT. STAT. ANN. tit. 12, § 511 (1973), *construed in* Congdon v. Taggart Bros., 153 Vt. 324, 571 A.2d 656 (1989); University of Vermont v. W.R. Grace & Co., 152 Vt. 287, 565 A.2d 1354 (1989). In addition, § 512 was amended in 1975 to apply the discovery rule to personal injury claims. VT. STAT. ANN. tit. 12, § 512(4) (1973 & Supp. 1992). The rule was also applied to claims based on radiation injury and malpractice. *Id.* §§ 518(a), 521.

need to know that, at some time, the assets will be secure from potential recapture by persons with claims against the corporation. The need for finality is especially important in Vermont, where many corporations are family-owned businesses, and the assets distributed to shareholders upon dissolution are the retirement fund for the owners of the business. While the mechanical application of a short limitation period can unfairly cut off a valid claim, unlimited post dissolution suits will impede the settlement of known claims and the final distribution of corporate assets to the shareholders.[371]

Current law can be interpreted to apply a mandatory limitation period to all claims that are contingent or unknown at the time of dissolution. It imposes a three-year limitation period from the date of dissolution on "any remedy available to or against such corporation . . . or any liability incurred, prior to such dissolution."[372] The language barring "any remedy" against such corporation is broad and seems to cover all claims of any type. This failure to deal specifically with contingent and unknown claims has been identified in early versions of the Model Business Corporation Act on which Vermont's corporation law is based.[373] In approach, the law is inconsistent with the Vermont Supreme Court's apparent desire to extend, rather than to limit, the opportunity for recovery in civil actions.

Unlike present law, the Reform Act provides procedures for resolving known,[374] unknown, and contingent claims against the

---

371. *See generally* 3 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 14.07 official cmt., at 1501.

372. VT. STAT. ANN. tit. 11, § 2075 (1984).

373. 3 MODEL BUSINESS CORP. ACT ANN., *supra* note 3, § 14.07 official cmt., at 1500 (stating that "[e]arlier versions of the Model Act did not recognize the serious problem created by possible claims that might arise long after the dissolution process was completed and the corporate assets distributed to shareholders").

374. Under the Reform Act, a corporation wishing to finalize known claims must provide the creditors with written notice of the dissolution, the procedures for filing a claim, and the deadline by which claims must be filed, which can be no sooner than 120 days from the date of the notice. H. 265 (S. 1), *supra* note 1, § 14.06. If recipients of written notice fail to respond in a timely manner, their claims will be barred. *Id.* In contrast, present law on the satisfaction of known claims provides that after filing the intent to dissolve with the Secretary of State, the corporation must notify known creditors of the impending dissolution. VT. STAT. ANN. tit. 11, § 2056 (1984). The corporation then is directed to collect its assets and wind up its business, including discharging its liabilities. The statute, however, does not specify the information that must be included

corporation.[375] It is important to understand that the Reform Act procedures apply only to claims in which the corporation is the defendant. They do not limit in any way suits against individual shareholders or managers for wrongs for which they are personally liable.

It is not surprising that the Reform Act's procedures for settling unknown and contingent claims are regulatory in function. They are unusual because they are optional rather than mandatory in application. The optional aspect is the central component of a statutory system that encourages corporations to settle outstanding claims promptly. If the corporation follows the optional procedures, a reduced limitation period applies to its outstanding claims and gives finality to the liquidation of its assets. If the optional procedures are not followed, ordinary limitation periods apply. The incentive is significant because the Vermont Supreme Court has applied the discovery rule to civil claims. When the statutory procedures are not used, assets distributed to shareholders during the liquidation process can be subject to recapture for a potentially indeterminate time to satisfy claims against the corporation.

Contingent claims will be settled if the corporation notifies the claimholders of dissolution and requests the presentation of their claims.[376] The corporation must offer security to each claimant, in an amount sufficient to compensate the claimant if the claim matures. If a claimant refuses the proffered settlement, the corporation may petition the superior court to fix the amount of security needed to compensate that claimant.[377] The corporation also may petition the court to fix compensation for "claimants whose claims are known to the corporation . . . but whose identities are unknown."[378]

---

in the notice or provide either incentives or penalties to the corporation for failing to follow the requisite procedures. *Id.*

375. H. 265 (S. 1), *supra* note 1, § 14.07.

376. *Id.* § 14.07(d)(1).

377. *Id.* § 14.07(d)-(g). These provisions are drawn from Delaware Code. DEL. CODE ANN. tit. 8, § 280(b)-(e) (1991).

378. H. 265 (S. 1), *supra* note 1, § 14.07(e)(2).

The Reform Act's treatment of claims that are unknown at the time of dissolution and become known subsequently[379] also attempts to strike a balance between affording claimants a remedy and providing closure to shareholders who have received corporate assets in the dissolution process. If a corporation publishes notice of dissolution and also notifies the Attorney General of Vermont, claims against the corporation that were unknown at the time of dissolution will be resolved in one of two ways. First, claims brought against the corporation more than five years after dissolution will be satisfied only from undistributed corporate assets.[380] Second, claims against the corporation brought within five years or within the applicable limitation period, whichever is shorter, can be satisfied from undistributed assets and, as necessary, from corporate assets previously distributed to shareholders during the liquidation process.[381] The recapture provisions apply only to the extent of the lesser of the shareholder's pro-rata share of the claim or the total amount of corporate assets distributed to the shareholder by the dissolved corporation. Thus, claims against dissolving corporations that notify creditors, settle claims, and distribute their assets according to the statutory procedures will be extinguished within a maximum of five years. Claims against corporations that do not comply with the procedures or that retain undistributed assets, will continue to be viable for the usual limitation period.

It may seem that creditors will have greater protection if corporate management acts in a dilatory manner[382] because the usual limitation periods apply and assets distributed to shareholders remain available for recapture. Although this may be the case in a few situations, it will not be true generally. Because a dissolving corporation has stopped conducting business, the value of some or all of its assets may depreciate over time, thereby lessening claimants' opportunity for full recovery. The time value of money also makes an earlier payment preferable. Additionally,

---

379. *Id.* § 14.07(a)-(c). Subsections (b) and (c) of the proposed legislation were adapted from California law. CAL. CORP. CODE § 2011 (West 1990); *see also* Penasquitos, Inc. v. Superior Court, 283 Cal. Rptr. 135 (Cal. 1991).

380. H. 265 (S. 1), *supra* note 1, § 14.07.

381. *Id.*

382. The disincentive for management to act in this fashion is that its fiduciary obligations to shareholders continue during dissolution. H. 265 (S. 1), *supra* note 1, § 14.05.

if too much time passes, shareholders also may be hard to locate. It is, therefore, usually in the best interests of creditors for the corporation to resolve outstanding claims quickly.

One also may think that the procedures should be mandatory rather than optional, since they are intended to protect both creditors and shareholders. Mandatory procedures prevent corporate management from determining, at the time of dissolution, the most sensible and cost effective way to proceed. It may be counter-productive for a corporation with few remaining assets to pursue judicial resolution of remote contingent claims. The incentive approach provides the flexibility that corporate managers need, and provides essential protections to creditors and shareholders.

A similar incentive is used for the payment of corporate tax liabilities.[383] If, at the time of dissolution, the corporation obtains a clearance from the Commissioner of Taxes, shareholders will be relieved of liability for corporate taxes. Shareholders of corporations that have not obtained a clearance will be liable to the extent of their pro-rata share of any unpaid taxes, or the total amount of the assets distributed to them, whichever is less.[384]

This approach advances the Reform Act's fundamental objectives. It modernizes the law to meet contemporary needs by directly dealing with the problems of contingent and unknown claims. It clarifies the rights and obligations of interested parties. Holders of unknown and contingent claims have the opportunity to seek redress, even if the claims become known after dissolution. Shareholders can determine when they hold corporate assets free of third parties' claims against the corporation. The Act's creative use of optional regulatory provisions provides an incentive to corporations to settle outstanding claims without unduly infringing on management's need for flexibility in determining the best way to proceed.

---

383. H. 265 (S. 1), *supra* note 1, § 14.09. These provisions are based on the Delaware Code. DEL. CODE ANN. tit 8, § 281 (1991).

384. H. 265 (S. 1), *supra* note 1, § 14.09(c). Subsection (d) caps the total amount of shareholder liability for all claims against the corporation at the total value of the assets distributed to the shareholder. *Id.* § 14.09(d); *see also id.* § 14.07(c) (limiting the liability of directors who have complied with the respective provisions of the chapter).

CONCLUSION

Vermont's business corporation code needs substantial reform. Many of its provisions are outdated and do not apply to the state's current business environment. In important areas, the Vermont code lacks the flexibility to adapt to inevitable changes in business practices. The current code's provisions are poorly organized and their language is often unclear.

The deficiencies in the code have a detrimental effect on Vermont's corporations and its economy. The code may make it more costly to do business in the state. It may discourage investors from investing in Vermont companies, new businesses from locating in Vermont, and Vermont-based businesses from staying. The code may make it difficult for Vermont to attract and retain companies to provide jobs for its residents.

The need for reform is best understood by considering the purpose of the law. Simply stated, business corporation law provides for the creation of a legal entity known as a corporation. State corporation law defines the corporation's decision making and financial structures and how its component parts fit together. The law controls how a corporation is formed, how decisions are made, and how action is taken. The law also describes how the corporation may change as it matures and, finally, dies. In this instance, the law's role is rather narrow. With limited exceptions, state corporation law does not control a company's interactions with third parties or define its role in society.

The narrow focus of state corporation law is best understood in the context of its origins. It was developed to remedy the inefficiencies of creating corporations by legislative approval of individual corporate charters. The result, over time, was the creation of statutory corporation law, a law of general application but relatively limited purpose.

Vermont's business corporation law provides for the creation of such a legal entity, but with a statutory scheme that is both too broad and too narrow. It is too broad because it applies the same regulatory structure to situations that arise in different contexts and have different policy concerns. One example is its imposition of a single management scheme on all types of corporations

without accounting for their considerable differences in size, number of investors, and the extent to which investors participate in corporate control. In this situation, the code has moved too far in the direction of providing a generalized structure. It is applicable to all but unsuitable to many.

The code is also too narrow because it often binds corporate constituents to rules that unduly restrict corporate operations. The technical rules governing distributions to shareholders are in this category. These provisions solved the problems of the day, but used a level of specificity that restricted the solution to the contexts of the past. This level of specificity is reminiscent of the days when particularized corporate charters were approved individually by the legislature.

A central problem with the present code is that it is often overly rigid in application. This is true both when the code overreaches and when it confines. The code should be adaptable to changing circumstances. The code's present rigidity is caused, in part, by the fact that its substantive provisions, and the mechanisms used to implement them, are not consistent with the primary objective of the code. Providing for the creation of a corporation is essentially an enabling function. Too often, individual code provisions are regulatory rather than enabling, even when regulation is not necessary. In circumstances where enabling legislation is used, its implementation is often costly. Generally, the code does not include companion supplementary provisions to provide standard default terms if individual tailoring is not needed.

If the Reform Act becomes law, it will solve many of these problems. Its increased use of enabling and supplementary provisions will make the law responsive to current business needs and will allow Vermont's corporate law to adapt to inevitable change. This flexibility does not sacrifice important state interests. Regulatory provisions continue to be used when needed, but they are generally simpler and less technical than many found in the present code. In this way, the proposed legislation balances the need for flexible operation and for security of critical state interests.

APPENDIX[385]

Business Corporation Law Reform Act—H. 265 (S. 1) Proposed Changes to Title 11, Vermont Statutes Annotated

Chapter One—General Provisions

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Filing documents and forms	Does not set standards for what constitutes acceptable filings, establish effective time and date, or provide for correction of documents.	Sets standards for filings, establishes effective time and date, and provides method for correcting documents.
2. Filing duty of Secretary of State	Not defined.	Establishes ministerial nature of Secretary's filing duty.
3. Evidentiary effect of documents in Secretary of State's records	Doesn't establish significance of absence of records in Secretary's files.	Lack of record certificate issued by Secretary of State is prima facie evidence of absence of documents in Secretary's file.
4. Certificate of good standing	Not covered.	Defines legal significance.
5. Penalty for filing false documents	Imposes $500 fine.	Imposes $1000 fine.
6. Powers of Secretary of State	Potentially over-broad statement of power.	Reflects ministerial nature of Secretary's duties.
7. Definitions	Contains definitions based on outdated concepts (e.g., surplus, treasury shares), incomplete in other areas.	Eliminates outdated definitions, adds definitions for completeness (e.g., "distribution" and "entity").
8. Notice	Not located in one section; needed clarification.	Centralized notice provision.

385. This Appendix is based on information prepared for the Vermont Legislature by the author and other members of the H. 265 (S. 1) Committee.

9. Number of shareholders	No provision for how shareholders are to be counted when shares are co-owned or owned by partnerships, etc.	Contains provision on counting shareholders.

Chapter Two—Incorporation

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Incorporators	Requires incorporators to be natural persons of majority age, at least one of whom is a resident.	Eliminates residency requirement.
2. Articles of incorporation	Requires statement of duration and purpose.	Optional—establishes simplified incorporation form.
	Shareholders not permitted to include provision regarding limitation of directors' liability. Absence of this provision makes liability insurance for directors and officers difficult to obtain and more expensive. Directors are reluctant to serve without insurance.	Shareholder provision permitted.
3. Effective date of incorporation	Effective when certificate issued. Problem with uncertainty caused by delays in Secretary's office.	Effective when filed.
4. Organizational meeting	Must be held by incorporators; procedure lacks flexibility.	May be held by incorporators or initial directors.
5. Adoption of bylaws	Adoption procedures inflexible, directors must adopt bylaws.	Greater flexibility, either directors or incorporators may adopt bylaws.

Chapter Three—Purposes and Powers

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Purposes	Asks for specifics, while most filers use general powers language anyway; modern trend not to limit.	Specifics are optional.
2. General powers	Narrower view of corporate powers than necessary; tighter rein on corporate liberty.	Enlarges scope of general powers, e.g., authorizing pension opportunities to former employees.

Chapter Four—Name

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Reservation of corporate name	Permits renewal.	Same as current law except renewal not permitted.
2. Registration	Does not permit name transfer.	Same, except it also allows corporation to transfer name to another corporation.

Chapter Five—Office and Agent

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Execution requirement	President or Vice President must sign and verify.	Routine filing okay.
2. Service of process	With Secretary of State as agent, no greater notice is achieved; merely circular.	Defines what constitutes effective service of process.

Chapter Six—Shares and Distributions

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Authorization of shares	Retains old designations of shares as being "common," "preferred," or "special." Does not provide that shares of one class may be converted into shares of a "higher" class or that directors may designate characteristics of shares.	Permits creation of any number of classes of stock. At least one class must have unlimited voting, distribution, and dissolution rights. Shares of one class may be converted to shares of a "higher" class. With prior shareholder approval, directors may designate characteristics of shares. (Sometimes used as an anti-takeover device).
2. Treasury shares	Retains concept of treasury shares—previously issued shares which are repurchased by the corporation. Creates uneasy and complex state between issued and unissued securities, from both corporate and accounting views.	Eliminates concept of treasury shares. Shares repurchased by the corporation become authorized but unissued shares unless cancelled.
3. Issuance of shares	When a corporation sells shares because the subscriber did not pay as promised, the corporation may retain only the unpaid amount and must distribute any excess proceeds to the delinquent subscriber.	When shares have not been paid for, the corporation may either rescind the subscription agreement or collect the amount owed.
	Doesn't expressly require board of directors to determine the adequacy of the consideration received for shares.	Requires directors to make adequacy determination.
4. Share options	Topic not covered.	Expressly permits Board of Directors to issue.
5. Form of share certificate	Doesn't expressly deal with disclosure of share transfer restrictions.	Expressly provides for disclosure of transfer restrictions.

6. Shares without certificates	Not permitted. Issuing shares without certificates is a modern practice.	Expressly permits shares to be issued without certificates, if required information provided to shareholder in writing.
7. Restrictions on transfers of shares	Not covered.	If statutory requirements are met, share transfer restrictions are permitted.
8. Shareholder pre-emptive rights	Permitted but not explained.	Provides standards for grant of pre-emptive rights.
9. Distributions to shareholders	Law regulating distributions is based on outmoded accounting principles. Statutory provisions are complex, unclear, and scattered. May prevent a financially healthy corporation from making distributions to shareholders.	Modernizes, clarifies, and simplifies the law. A corporation may make a distribution only if after the distribution the corporation is able to pay its current debts, and its assets are greater than its liabilities. Directors may rely on financial statements based on reasonable accounting procedures, on fair valuations, or other reasonable methods.

Chapter Seven—Shareholders

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Annual meeting	Failure to hold annual meeting could affect validity of corporate action.	Adds specific statement that failure to hold annual meeting will not affect validity of corporate action.
2. Special meetings	Present "related to" standard for definition of purpose is too broad.	Establishes the standards of "within the purpose" described in the notice.
3. Court-ordered meeting	No comparable provision.	Adds provision to give shareholders a method to force corporation to hold meetings.
4. Action without meeting	Unanimous written consent provides limited flexibility.	Allows corporation to elect to have less than unanimous but more than majority.

5. Notice of meeting	Maximum period too short for larger corporations.	Expands maximum number of days from 50 to 60.
	Non-voting shareholders do not get notice of meetings involving fundamental corporate changes, e.g., merger dissolution, sale of assets.	Requires notice to non-voting shareholders if fundamental corporate change.
	No provisions for notice requirements if meeting adjourned.	Covers notice requirements if meeting is adjourned.
6. Waiver of notice	Attendance at meeting does not constitute waiver of defective notice or consideration of a matter outside purpose of meeting.	Makes attendance at meeting a waiver of objection to notice and matters discussed, unless objections are raised at beginning of meeting or when issue is discussed.
7. Record date	Provision for closing stock transfer books to set record date can hamper corporation.	Provision for closing books deleted.
	Maximum period too short for larger corporations.	Expand maximum period to 70 days.
8. Shareholders list	Individual liability for officer responsible for preparing list.	Eliminates individual liability for officer who fails to prepare list, but who gives shareholders certain remedies in court.
9. Voting entitlement of shares	No clarification of handling of voting for redeemed shares.	Adds provision to clarify when redeemable shares cannot be voted.
	Corporations don't have specific right to vote shares held by the corporation in fiduciary capacity.	Gives corporations right to vote in fiduciary capacity.
10. Proxies	Lacks clear conditions for making proxies effective.	Clarifies when proxy is effective.
	No provision on irrevocable proxies.	Adds provisions on irrevocable proxies.

11. Shares held by nominees	No comparable provision.	Establishes provision to allow owner of shares held in "street name," i.e., brokerage house, to deal directly with corporation.
12. Corporation acceptance of votes	Defines acceptance of votes by stating who can vote.	Gives corporation guidelines (safe harbors) on when they can accept or reject a vote.
13. Quorum & voting requirements	Smaller voting groups (determined by class of stock) could have voting rights diluted by larger groups.	Quorum and voting requirements must be met within each class able to vote on a matter.
	Abstentions can have effect of a negative vote.	A matter is approved if there are more affirmative votes than negative votes, rather than present rule which requires affirmative votes by a majority of the quorum.
14. Action by single and multiple voting	Potential for large voting group (class of stock) always to out-vote smaller voting groups, and thus make the latter's voting rights ineffective.	If more than one voting group is entitled to vote on a matter, a majority of the quorum within each voting group must vote affirmatively on a matter for it to be adopted by the higher requirements existing or proposed.
15. Greater quorum or voting requirement	Greater requirements could only be adopted or amended by 2/3 vote, if not in original articles.	Any provision to increase or decrease quorum or voting requirements must be adopted by the higher of either the proposed or existing requirements.
16. Voting for directors; cumulative voting	Needs more specific guidelines for cumulative voting.	Clarifies guidelines for cumulative voting, and adds requirement that notice of cumulative voting must be given prior to meeting, if cumulative voting is to be used.

17. Voting trusts	Guidelines need clarification.	Clarifies and simplifies criteria.
	No provision for extension.	Adds language describing when trust agreement is effective, and allows for extension of ten years.
18. Voting agreements	No comparable provision.	Adds provision to give statutory authority to voting agreements that allocate representation on the Board of Directors.

Chapter Eight—Directors and Officers

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Variable size board	Not covered. Lack of flexibility in fixing size of board.	Provides shareholders with added flexibility by permitting them to elect to have a variable range board.
2. Staggered terms	Permits staggered terms only if there are at least nine directors.	No minimum number of directors required for staggering terms.
3. Procedure for resignation	Not covered.	Establishes procedures.
4. Removal of directors	Not covered.	Establishes procedures for removal of directors either by the shareholders or by judicial proceeding.
5. Vacancy on the board	Does not cover filling vacancy of director elected by a voting group of shareholders.	Vacancies for directors elected by voting group may be filled only by that voting group.
6. Conduct of meeting	Can be conducted with use of telecommunications equipment only if articles permit.	Can be so conducted unless articles prohibit.
7. Notice of meeting	Doesn't provide default requirement for notice to be used if bylaws fail to specify.	If not otherwise specified in the bylaws, two days notice is required.

8. Quorum	Doesn't provide for quorum for a variable range board.	Establishes method for determining quorum of a variable sized board. Provides director with option of dissenting to or abstaining from vote in writing as well as orally.
9. Committees	Defined scope of powers of committee incomplete.	Expands definition of scope of powers of committee.
10. Standards for directors' and officers' conduct	Not defined.	Defined. In fulfilling their duties, directors are permitted to rely, to a reasonable degree, on information furnished by corporate officers, employees, and experts.
11. Interested directors and officers	Prohibits directors contracting with corporation from attending directors' meeting at which contract is discussed. Prohibition may make it difficult to have a quorum. Applies only to directors and only to contracts with corporations.	Applies to directors and officers contracting with or having a financial interest in transactions with the corporation. Establishes procedures for determining validity of transaction.
12. Directors' liability for unlawful distributions	The applicable limitation period for the wrongful distribution is unclear.	A six-year limitation period applies.
13. Officers	Requires offices of president and secretary to be held by different persons, unless the corporation is a professional corporation. Does not establish procedures for resignation of officers, or define contract rights of officers. This requirement may be a problem for a small corporation.	Eliminates for all corporations the requirement that the president and secretary be different persons. Establishes procedures for resignation and removal of officers.

14. Indemnification	Authorizes indemnification, but does not clearly define standards and does not define applicable procedures. Does not define terminology related to indemnification.	Defines standards and procedures for indemnification: a. defines terms applicable to indemnification; b. determines when corporation may indemnify a director; c. establishes when indemnification is mandatory; d. defines procedures for payment of expenses in advance of a final disposition of the proceeding. The director is personally obligated to reimburse any expenses advanced if the director is not found to meet the required standard of conduct; e. defines standards for court-ordered indemnification; f. defines standards for indemnification, and procedures for determining when indemnification is appropriate; g. permits indemnification of officers and employees under certain circumstances; h. authorizes a corporation to maintain liability insurance on behalf of its directors, officers, and employees; i. limits corporations' ability to indemnify in manner consistent with subchapter. Permits indemnification of expenses of director who is a witness but not a defendant in a proceeding.

Chapter Ten—Amendment of Articles of Incorporation

Subject	*Problems With Title 11*	*Reform Act Solution*
1. Authority to amend	Authority to amend defined by laundry list of allowable amendments.	Any amendment is authorized if the provision could have been included or deleted from the original articles.
2. Amendment by board of directors	No comparable provision.	Allows the board to amend articles when "housekeeping" matters are involved, and to increase the number of authorized shares in a class.
3. Amendment by board of directors and shareholders	Formal board resolution needed.	Only board recommendation required.
	Two-thirds voting requirement for approval.	Majority vote required to pass amendment.
	Non-voting shareholders do not always get notice of meeting at which an amendment is considered.	Non-voting shareholders must receive notice of meeting at which an amendment is considered.
4. Voting on amendments by voting group	Par value is an obsolete concept.	Provision on par value is deleted.
	Need to clarify rules for non-voting shareholders who are allowed to vote as a class on an amendment.	Clarifies when and how series within a class or classes of shareholders (including non-voting) can vote on an amendment to the articles.
5. Amendment before issuance of shares	No comparable provision.	Allows incorporators or board to amend articles prior to existence of shareholders.
6. Articles of amendment.	Listing number of affirmative votes and negative votes could delay filing or amendment, if any vote is disputed.	As an alternative, can state that enough affirmative votes to pass the amendment were cast.

7. Restated articles of incorporation.	Board cannot handle, if no amendments requiring shareholder approval are involved.	Board can handle restatement of articles, if no amendment requiring shareholder approval is involved.
8. Amendment pursuant to reorganization.	No comparable provision.	Provision added to deal with federal court ordered amendments in reorganization process.
9. Effect of amendment	Effective date provision should be with provision on filing requirements.	Provision for when amendment is effective is now in Chapter 1.
10. Amendment of bylaws by board of directors or shareholders.	A shareholder's election to retain exclusive right to amend bylaws applies to all provisions.	Shareholders may elect to retain exclusive right to amend all or only a portion of the provisions of bylaws.
11. Bylaw increasing quorum or voting requirement for shareholders	No specific provisions on how bylaws can be amended to create or amend super-majority provisions for quorum or voting requirements for the election of directors.	Super-majority quorum and voting requirements in bylaws, for the election of directors, can be amended only by using the greater requirements.

Chapter Eleven—Merger and Share Exchange

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Share exchange	No provision permitting share exchange.	Provides procedure.
2. Shareholder approval	Requires 2/3 vote of shareholders of merged and surviving corporation giving minority automatic veto power.	Establishes threshold majority vote for approval, which can be changed by board of directors as condition of merger or by articles of association. Eliminates requirement that shareholder of surviving corporation vote unless materially effected by merger.
3. Effective date of merger	Merger currently effective only upon issuance of certificate from Secretary of State, creating cumbersome procedure.	Makes merger effective as of the effective date of articles of merger.

Chapter Twelve—Sale of Assets

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Mortgage or pledge of assets	Vermont is the only state that requires shareholder approval to mortgage or pledge assets.	Eliminates requirement.
2. Shareholder approval	Like mergers, requires 2/3 vote of shareholders giving minority automatic veto power.	Establishes threshold majority vote for approval, which can be changed by board of directors as condition of sale, or by articles of association.

Chapter Thirteen—Dissenters' Rights

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Right to dissent	Current law does not provide dissenters' rights if articles amended affect shareholders' rights adversely and materially.	Creates dissenters' rights for such amendments to articles, just as for mergers and sales of assets.
2. Procedure	Current law creates complex and cumbersome procedure for existing dissenters' rights.	Streamlines procedure.
3. Incentive to negotiate in good faith	Current law provides incentives for delay and insufficient time for negotiation.	Requires corporation to pay its estimate of fair value, provides 60 days for negotiation over difference, and requires corporation to initiate court appraisal if no agreement. Also provides for assessment of attorneys' fees and expenses against corporation or dissenter, if found to have acted in bad faith.

Chapter Fourteen—Dissolution

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Voluntary dissolution prior to commencement of business	Unduly restrictive provisions governing dissolution by incorporators prior to commencement of business.	Permits dissolution by incorporators or initial directors. Permits dissolution by incorporators if the corporation has not issued stock. Also removes the requirement that the Secretary of State determine that the Articles of Dissolution conform to law.
2. Approval required of board of directors and shareholders	Board of directors not permitted to condition approval (e.g., sale of the corporation). Vote of 2/3 of all shareholders required to approve dissolution, whether or not shares held are voting shares.	Board of directors permitted to condition approval of dissolution. Vote of a majority of voting shares required for approval. Establishes the same requirements for later revocation of dissolution.
3. Documents required to effect dissolution	Needless requirement that two separate documents be filed to effect dissolution (Statement of Intent to Dissolve and Articles of Dissolution). Title 11 does not indicate that the rights, powers, and duties of shareholders, officers, directors, and the registered agent are not affected by dissolution, and that suits by or against the corporation are not affected.	Requires only one document to be filed. Establishes rights, powers, and duties during dissolution.
4. Notice to creditors of dissolution	Title 11 requires notice of dissolution to all creditors, but does not provide penalties for noncompliance or incentive to comply. Title 11 does not provide any mechanism for dealing with unknown creditors or unknown claims.	Provides that if notice of dissolution is provided to known creditors, each creditor provided such notice must file a claim within 120 days or lose the right to pursue such claim.

		Title 11 also affords all creditors the same statute of limitations for bringing an action against a dissolved corporation (3 years) whether or not the creditor ever received notice of the dissolution.	Provides that if notice of dissolution is published in a newspaper of general circulation, in the county where the dissolved corporation's principal business office is located, the claims of unknown claimants are barred against shareholders of the dissolved corporation (not the corporation itself) if no action is commenced within five years of publication date or within the applicable limitation period, whichever is sooner.
5.	Contingent or unmatured claims of shareholders	Title 11 does not specify means of dealing with contingent or unmatured claims.	Provides such an optional procedure.
6.	Treatment of creditors	Title 11 does not require that creditors of equal rank be paid equal amounts on dissolution.	Incorporates such a requirement
7.	Involuntary termination	When involuntary termination of a corporation's existence is cured, it is not clear that the corporation is reinstated for all purposes.	Provides that when involuntary termination is cured, the corporation is treated as if in existence from the date of termination.
8.	Availability of judicial dissolution	Title 11 states that judicial dissolution is not available on corporate deadlock, unless irreparable injury to the corporation is threatened.	Permits judicial dissolution on a showing that the corporation's affairs can no longer be conducted to the advantage of shareholders.
9.	Appointment of custodians; procedures required upon judicial dissolution	Title 11 does not authorize the appointment of custodians as well as receivers. Title 11 also specifies procedures to be used in judicial dissolutions different from those used in voluntary dissolution.	Authorizes the appointment of a custodian. States that a judicially dissolved corporation is to follow the same dissolution procedures as any other corporation.

Chapter Fifteen—Foreign Corporations

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Definition of "doing business"	Definition is vague as to activities that appear to require registration.	Defines safe harbors, such as holding bank accounts and real property not used in business.
2. Consequence of not filing	Penalty of fees and fines, plus corporation is unable to enforce contracts in Vermont courts.	Remedial; fines and fees, but does not bar access to court.
3. Filing requirements	Old references to par value and capital stock; fees based on capital stock; fees based on capital stock not relevant today for many corporations organized elsewhere.	Updates and simplifies filing requirements.

Chapter Sixteen—Records and Reports

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Balance sheet	Present law doesn't require it to be kept or provided to shareholders.	Required.
2. Electronic copies	Present law doesn't recognize technology.	Addresses new technology.
3. Comprehensiveness	Present law is brief and unfocused.	Provides details of requirements.
4. Reports of indemnification or advances	Not covered by present law.	Requires reporting to shareholders.

Chapter Twenty—Close Corporations

Subject	*Problem with Title 11*	*Reform Act Solution*
1. Formation of close corporation	No existing statute.	Allows a small corporation to operate as a partnership by allowing the shareholders to operate the corporation pursuant to a shareholder agreement as opposed to following the strict formalities of larger corporations. Defines close corporation, and method of incorporating as close corporation. Bylaws are optional.
2. Operation of close corporation	No existing statute.	Corporation may develop shareholder agreement which eliminates necessity for bylaws, board of directors, annual meeting, and other rigid formalities. Shareholders may operate corporation, and eliminate the board of directors. Defines proceedings in the event of involuntary loss of close corporation status. Provides for judicial dissolution of close corporation.
3. Protection of minority shareholders	No existing statute.	Most major corporate actions (electing close corporation status, mergers, amendments, dissolution) require 2/3 vote of all shareholders. In some circumstances, shareholders may substitute majority approval.