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Commonwealth of Kentucky

Court of Appeals

NO. 2017-CA-001062-MR

LOUISA COMMUNITY BANK, INC.; GENE A. WILSON; KATHRYN REID; PAULETTA WILSON; AND HOWARD R. SANDERS — APPELLANTS

v.

APPEAL FROM LAWRENCE CIRCUIT COURT
HONORABLE C. DAVID HAGERMAN, SPECIAL JUDGE
ACTION NO. 16-CI-00229

KEVIN R. MULLINS; MONTE HAY; DAVID B. MCKENZIE, JR.; AND J. ROGER SMITH — APPELLEES

OPINION
AFFIRMING

** ** ** ** **

BEFORE: CLAYTON, CHIEF JUDGE; SMALLWOOD AND TAYLOR, JUDGES.

CLAYTON, CHIEF JUDGE: This appeal concerns the legality of the removal and replacement of the entire Board of Directors of the Louisa Community Bank,

Inc. ("the Bank"). The Lawrence Circuit Court granted judgment on the pleadings and a declaratory judgment in favor of the Appellees, who are members of the Board which was removed: Kevin R. Mullins, Monte Hay, David B. McKenzie, Jr., and J. Roger Smith. It also permanently enjoined and restrained the Appellants, Gene A. Wilson, Kathryn Reid, Pauletta Wilson and Howard R. Sanders,[1] from conducting business as the new Board of Directors of the Bank.

The Bank, which opened in August 2006, is a local community bank regulated by the Kentucky Department of Financial Institutions ("KDFI") and the Federal Deposit Insurance Corporation ("FDIC"). It was deemed a "troubled bank" by these regulators and is consequently subject to a Consent Order jointly issued by the KDFI and the FDIC in December 2014 and an Amended Consent Order issued on January 2016. These Orders stemmed from allegations of unsafe or unsound banking practices and violations of law or regulation committed by the Bank, including those related to the Bank Secrecy Act, 31 U.S.C. §§ 5311-5330. Both Orders were stipulated to and signed by all then-current members of the Bank's Board.

Of particular relevance to this appeal are provisions of the Orders concerning the directors of the Bank. In Section (1)(b) under the heading "Management" the Consent Order provides: "Prior to the addition of any

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[1] The Bank is also a named Appellant.

individual to the board of directors or the employment of any individual as a senior executive officer, the Bank shall request and obtain the written approval of the Regional Director of the FDIC Chicago Regional Office . . . and the KDFI."

In Section 1 under the heading "Board Membership," the Amended Order provides:

> [T]he Bank shall have and, at all times while this AMENDED ORDER is in effect, maintain a board of directors which is composed of at least five (5) directors, as required by KRS [Kentucky Revised Statutes] 286.3[-040], and shall contain at least two fifths (2/5) members who are independent directors. For purposes of this AMENDED ORDER, a person who is an independent director shall be an individual: (i) who is not an officer of the Bank unless otherwise approved by the Regional Director of the FDIC's Chicago Regional Office . . . and the KDFI; (ii) who is not related by blood or marriage to an officer or director of the Bank or to any shareholder who is a "principal shareholder" . . . and (iii) who does not otherwise share a common financial interest with such officer, director or shareholder. If necessary, the Bank shall, within sixty (60) days of losing any director, request and obtain the written approval of the Regional Director and the KDFI to add a new individual to the Board, as required by Paragraph 1(b) of the ORDER.

When the controversy leading to the present lawsuit commenced, the Board of the Bank (the "Old Board") was composed of seven directors: Kevin R. Mullins, who served as the President of the Bank; J. Roger Smith, who served as the Chairman; Monte Hay; David B. McKenzie, Jr.; Gallie Isaac, Jr.; Gene Wilson; and Kathryn Reid.

On July 29, 2016, eighteen shareholders of the Bank, led by Wilson and Reid, sent a Notice of a Special Meeting of Shareholders to be held on August 12, 2016. According to Wilson and Reid, the shareholders were alarmed by what they saw as mismanagement of the Bank by the Board. According to the Appellees, however, Wilson and Reid took this action when the Board asked them to resign after Wilson, with Reid's assistance, allegedly disclosed confidential Bank information to a third party. Wilson and Reid refused to resign, choosing instead to arrange the removal of the Old Board members who had sought their resignation.

The Notice of the Special Meeting stated that the shareholders would seek to amend the Bank's by-laws to reduce the number of directors; change the method of voting required to remove directors; remove the Old Board and elect new Board members.

Upon learning of the Notice, the KDFI and FDIC sent letters to the Board of Directors reminding them that the Bank was operating pursuant to a Consent Order. The first letter, dated August 5, 2016, stated "As such, the bank must notify the FDIC in writing at least 30 days **prior** to certain management changes. Applicable management changes relate to the addition or replacement of a board member[.]" On the same date, the FDIC and KDFI sent a letter to the Board stating that it had come to their attention "that confidential bank information

has been distributed by Director Gene Wilson to a third party, M. David Prater, absent the execution of a signed confidentiality agreement[,]" in violation of the Graham-Leach-Bliley Act. The letter directed the Board to pursue a full accounting from Prater and Wilson, requesting a response no later than August 20, 2016.

Smith, in his capacity as the Chairman of the Old Board, sent a letter to shareholders from the Bank's attorney which opined that "based in part upon conversations with the FDIC Chicago Regional Office, . . . removal of the existing Board and election of five Directors to replace the removed Directors will trigger this provision [Section 1(b) of the Consent Order] and require prior approval of such Directors by the Regional Director of the FDIC and KDFI before any such newly elected Directors will be legally entitled to act in the capacity of Board members." The letter warned that replacing the Board in such a manner would leave the Bank without any Board of Directors legally able to act on behalf of the Bank and would further violate the Consent Order unless at least two of the five new Directors were independent, as described in the Amended Consent Order. The letter also stated that violation of the Orders could subject the Board to the imposition of significant civil monetary penalties and fines.

The Commissioner of the KDFI and the Assistant Regional Director of the FDIC traveled to Louisa the day before the Special Meeting to warn Wilson

and Reid not to hold the election. The KDFI Commissioner hand-delivered another letter to the Old Board reiterating that any action by the Board or a shareholder to add individuals to the Board would be a violation of the Consent Orders. The Commissioner read the letter aloud to the Board and each director confirmed that he or she understood its contents.

The August 12 Special Meeting was held and all seven Directors of the Old Board were removed by simple majority vote. Using the cumulative voting procedure, the shareholders elected a new Board composed of five persons: Gene Wilson, his wife Pauletta Wilson, Kathryn Reid, Howard Sanders and J. Roger Smith. Gene Wilson was elected Chairman by his own vote and Reid's.

The KDFI filed charges and assessed lump-sum and continuing daily fines against the Bank for violating the Consent Orders. The KDFI's Notice of Assessment accused Gene Wilson and Reid of acting with a "total lack of good faith" and without concern for the Bank:

> The violations . . . are deemed to be significant and, if they continue, will cause genuine, tangible and irreparable harm to the Bank. The provisions of the Consent Order and Amended Consent Order that have been and are being violated were instituted to correct extreme deficiencies in oversight and management discovered at the Bank. The parties' willful and flagrant actions to undermine and thwart those corrective provisions demonstrate a willful disregard for the safety and soundness of the Bank.

The remaining members of the Old Board attempted to attend a board meeting but were forcibly removed. They were refused access to corporate documents and blocked from participation in the Bank's management.

On September 22, 2016, the Bank filed suit against Mullins, McKenzie, Hay, and Smith (formerly a member of the Old Board and now Director of the New Board). The complaint contained charges of tortious interference with prospective business relations and sought a declaration of rights that the Old Board was no longer valid and that the New Board was the valid Board, an injunction to prevent the defendants from conducting any business as the Board of Directors of the Bank, and punitive damages.

On September 26, 2016, Kevin R. Mullins, individually and as President, CEO and Director of Louisa Community Bank, Inc., Monte Hay, individually and as Director of the Bank, David B. McKenzie, Jr., individually and as Director of the Bank, and J. Roger Smith, individually and as Chairman and Director of the Bank, filed a complaint alleging that the Old Board could only have been legitimately removed by cumulative voting, not by a simple majority. As support for this, it cited the Bank's own corporate documents and Kentucky Revised Statutes (KRS) 271B.8-080. The complaint also alleged that the Consent Orders precluded the removal of the Old Board. The plaintiffs sought injunctive

relief, fees and costs, and a declaration of rights that the Old Board was not legally removed and remains the current Board.

The circuit court issued a temporary injunction against the Appellants. It subsequently issued a second order containing findings of fact and conclusions of law in favor of the Appellees and imposing a $1,000 injunction bond. The circuit court found that the removal of the Old Board resulted in meaningful and irreversible regulatory, business and other harm to the Appellees and the Bank; violated the Bank's Articles of Incorporation which require cumulative voting to elect directors; violated the Consent Orders; and violated statutory law requiring the Bank to maintain a Board of not fewer than five members. The appellants filed an appeal but it was subsequently dismissed for failure to name to a necessary party.

On May 18, 2017, the circuit court entered judgment on the pleadings in favor of the Appellees on all counts of their complaint. The circuit court also entered a declaratory judgment ruling that the Appellees were not legally removed as Bank Directors at the Special Meeting because of improper voting to remove them and because of regulatory prohibitions on the appointment of new directors contained in the Consent Orders. The judgment also held that the Old Board remained the current Board of the Bank. The circuit court issued a permanent injunction restraining the Appellants from conducting any further business as the

New Board and from interfering with the Old Board. They were ordered to provide full access to all documents and information relating to the Bank, to comply with all FDIC and KDFI requirements and restrictions, prohibited from participating as members of the Board, and prohibited from promoting, nominating or electing any new member of the Board without obtaining approval from the FDIC and KDFI. This appeal followed.

A judgment on the pleadings "is reserved for those cases in which the pleadings demonstrate that one party is conclusively entitled to judgment." *KentuckyOne Health, Inc. v. Reid*, 522 S.W.3d 193, 194 (Ky. 2017) (citing Kentucky Rules of Civil Procedure (CR) 12.03). It is intended "to expedite the termination of a controversy where the ultimate and controlling facts are not in dispute. It is designed to provide a method of disposing of cases where the allegations of the pleadings are admitted and only a question of law is to be decided. . . . The judgment should be granted if it appears beyond doubt that the nonmoving party cannot prove any set of facts that would entitle him/her to relief." *Id*. at 196-97 (quoting *City of Pioneer Village v. Bullitt Cnty. ex rel. Bullitt Fiscal Court*, 104 S.W.3d 757, 759 (Ky. 2003)).

The Appellants argue that the circuit court erred in holding that the Consent Orders precluded the removal of the Old Board. They contend there is an

FDIC regulation squarely on point that supports the validity of the election of the New Board at the Special Meeting.

The FDIC regulation sets forth the filing and notice procedures related to the change of director or senior executive officer. It provides that "[a]n insured state nonmember bank shall give the FDIC written notice, as specified in paragraph (c)(1) of this section, at least 30 days prior to adding or replacing any member of its board of directors, . . . if . . . [t]he bank is in troubled condition[.]" 12 Code of Federal Regulations (C.F.R.) § 303.102(a)(2).

The regulation also, however, provides the notice requirement may be waived automatically under the following circumstances:

> In the case of the election of a new director **not proposed by management** at a meeting of the shareholders of an insured state nonmember bank, the prior 30-day notice is automatically waived and the individual immediately may begin serving, provided that a complete notice is filed with the appropriate FDIC office within two business days after the individual's election.

12 C.F.R. § 303.102(c)(2) (emphasis added).

The Appellants argue that this automatic waiver provision recognizes the right of shareholders to replace bank management without first seeking the approval of the existing management. They describe the scenario of disgruntled shareholders of a troubled bank acting independently to remove the management that has "driven the bank into the ditch in the first place."

Gene Wilson and Reid, the initiators of the August 12 meeting, were substantial shareholders in the Bank; but they were also members of the Old Board and consequently constituted "management." The Bank's by-laws state that the Bank is managed by its Board of Directors. The Appellees argue that the Wilson and Reid were not disgruntled shareholders but rather board members seeking to entrench themselves in management after being asked to resign by the rest of the Old Board. Whatever their motives, the Appellants provide no authority to support the view that the waiver provision of 12 C.F.R. § 303.102(c)(2) supersedes the terms of the Consent Orders which imposed obligations that are independent of the regulatory framework. The provision serves to waive the notice obligation of the regulation but does not waive the independent obligations imposed by and agreed to in the Consent Orders.

The Appellants' next argument concerns the voting procedure used to remove the Old Board. The Board was removed by a simple majority vote, rather than by cumulative voting. The circuit court ruled that the Old Board was not legally removed because of improper voting. The Appellants contend that when shareholders are removing an entire board of directors, cumulative voting is not required because they are not targeting any specific director. The Appellees argue that requiring cumulative voting to remove the entire board makes sense because

otherwise a majority shareholder would be able singlehandedly to remove the entire board.

The Bank's Articles of Incorporation provide for cumulative voting under Article XII, which states:

> At each election for directors of the Bank, each shareholder entitled to vote at such election shall have the right to cast, in person or by proxy, as many votes in the aggregate as the shareholder shall be entitled to vote under the Articles, multiplied by the number of directors to be elected at such election. Each shareholder may cast the whole number of votes for one candidate or distribute such votes among two or more candidates. Directors shall not be elected in any other manner.

The Kentucky Business Corporation Act provides the following procedure for the removal of directors by shareholders:

> (1) The shareholders may remove one (1) or more directors with or without cause, unless the articles of incorporation provide that directors may be removed only for cause.
>
> (2) If a director is elected by a voting group of shareholders, only the shareholders of that voting group may participate in the vote to remove him or her.
>
> (3) **If cumulative voting is authorized, a director shall not be removed if the number of votes sufficient to elect him or her under cumulative voting is voted against his or her removal.** If cumulative voting is not authorized, a director shall be removed only if the number of votes cast to remove him or her exceeds the number of votes cast not to remove him or her.

> (4) A director shall be removed by the shareholders only at a meeting called for the purpose of removing him or her, and the meeting notice shall state that the purpose, or one (1) of the purposes, of the meeting is removal of the director.

KRS 271B.8-080 (emphasis added).

"In interpreting a statute, [w]e have a duty to accord to words of a statute their literal meaning unless to do so would lead to an absurd or wholly unreasonable conclusion. As such, we must look first to the plain language of a statute and, if the language is clear, our inquiry ends." *University of Louisville v. Rothstein*, 532 S.W.3d 644, 648 (Ky. 2017) (internal citations and quotation marks omitted).

The plain language of KRS 271B.8-080(3) provides that, under a cumulative voting regime as found in the Bank's Articles of Incorporation, a director may only be removed if the votes against him or her exceed the number necessary to elect the director under cumulative voting. No distinction is made in the statute between the procedure for removal of one director or the removal of the entire board. The Appellants nonetheless argue that a distinction must be made between a group of shareholders seeking to remove by majority vote a targeted director elected cumulatively by minority shareholders and a majority of shareholders seeking to remove all directors.

As support for this distinction, the appellants rely on the history of the Model Business Corporation Act ("MBCA") on which Kentucky's Business Corporation Act ("KBCA") is modeled. In regard to the removal of directors, the 1969 MBCA provided as follows:

> At a meeting of shareholders called expressly for that purpose, directors may be removed in the manner provided in this section. Any director or the entire board of directors may be removed, with or without cause, by a vote of the holders of a majority of the shares then entitled to vote at an election of directors. In the case of a corporation having cumulative voting, if less than the entire board is to be removed, no one of the directors may be removed if the votes cast against his removal would be sufficient to elect him if then cumulative at an election of the entire board of directors, or, if there be classes of directors, at an election of the class of directors of which he is part.

They point to the distinction between the removal of the entire board and the removal of individual directors made in KRS 271A.195, which was repealed in 1989 and provided:

> If less than the entire board is to be removed, no one of the directors may be removed if the votes cast against his removal be sufficient to elect him if then cumulatively voted at an election of the entire board of directors, or if there be classes of directors, at an election of the class of directors of which he is a part.

The Appellants argue that the authority of shareholders to remove an entire board by a simple majority vote as provided in the 1969 MBCA was never intended to be eviscerated by subsequent incarnations of the MBCA and

Kentucky's counterpart, KRS 271B.8-080. They contend that KRS 271B.8-080 is intended to apply only to the removal of individual directors and that majority voting for removal of the entire board has remained unaffected. As evidence, they argue that a dramatic change from majority to cumulative voting for the removal of the entire board would have been mentioned in the 1988 KBA Update on Kentucky's Business Corporation Act.

But if Kentucky had wished to retain this distinction regarding the removal of directors, i.e., an entire board of directors may be removed by the majority vote of shareholders whereas in a cumulative voting corporation an individual director or directors require a different process for removal, it could have done so. Delaware, for instance, has expressly retained the distinction; its pertinent statute provides in part as follows:

> Any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors, except . . . In the case of a corporation having cumulative voting, if less than the entire board is to be removed, no director may be removed without cause if the votes cast against such director's removal would be sufficient to elect such director if then cumulatively voted at an election of the entire board of directors, or, if there be classes of directors, at an election of the class of directors of which such director is a part.

Del. Code Ann. tit. 8, § 141 (k)(2).

If our legislature had intended to retain majority voting for the removal of the entire board in corporations with cumulative voting, it could have included language to that effect. It did not do so. We are bound by the plain language of KRS 271B.8-080.

For the foregoing reasons, the order of the Lawrence Circuit Court entered on May 18, 2017, is affirmed.

ALL CONCUR.

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