CHAPTER 1

General Provisions

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MODEL BUSINESS CORPORATION ACT

Subchapter A.
SHORT TITLE AND RESERVATION OF POWER

§ 1.01. SHORT TITLE

This Act shall be known and may be cited as the "[name of state] Business Corporation Act."

CROSS-REFERENCES

Application of Act to existing domestic corporation, see § 17.01.
Application of Act to existing qualified foreign corporation, see § 17.02.
Effective date of Act, see § 17.06.
Saving provisions, see § 17.03.

OFFICIAL COMMENT

The short title provided by section 1.01 creates a convenient name for the state's business corporation act.

See the Introduction for a general description of the development of the Model Business Corporation Act, the purposes it is intended to serve, the principles under which the 1984 Model Act was prepared, and the roles of the Cross-References and Official Comments.

§ 1.02. RESERVATION OF POWER TO AMEND OR REPEAL

The [name of state legislature] has power to amend or repeal all or part of this Act at any time and all domestic and foreign corporations subject to this Act are governed by the amendment or repeal.

CROSS-REFERENCES

Application of Act to existing domestic corporation, see § 17.01.
Application of Act to existing qualified foreign corporation, see § 17.02.
Effective date of Act, see § 17.06.
Saving provisions, see § 17.03.

OFFICIAL COMMENT

Provisions similar to section 1.02 have their genesis in *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat) 518 (1819), which held that the United States Constitution prohibited the application of newly enacted statutes to existing corporations while suggesting the efficacy of a reservation of power similar to section 1.02. The purpose of section 1.02 is to avoid any possible argument that a corporation has contractual or vested rights in any specific statutory provision and to ensure that the state may in the future modify its corporation statutes as it deems appropriate and require existing corporations to comply with the statutes as modified.

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All articles of incorporation or certificates of authority granted under the Model Act are subject to the reservation of power set forth in section 1.02. Further, corporations “governed” by this Act—which includes all corporations formed or qualified under earlier, general incorporation statutes that contain a reservation of power—are also subject to the reservation of power of section 1.02 and bound by subsequent amendments to the Act.

Many states have constitutional provisions mandating the reservation of power to amend or modify corporate statutes and charters. In these states section 1.02 is also supported by specific constitutional authorization.

Subchapter B.
FILING DOCUMENTS

§ 1.20. REQUIREMENTS FOR DOCUMENTS; EXTRINSIC FACTS

(a) A document must satisfy the requirements of this section, and of any other section that adds to or varies these requirements, to be entitled to filing by the secretary of state.

(b) This Act must require or permit filing the document in the office of the secretary of state.

(c) The document must contain the information required by this Act. It may contain other information as well.

(d) The document must be typewritten or printed or, if electronically transmitted, it must be in a format that can be retrieved or reproduced in typewritten or printed form.

(e) The document must be in the English language. A corporate name need not be in English if written in English letters or Arabic or Roman numerals, and the certificate of existence required of foreign corporations need not be in English if accompanied by a reasonably authenticated English translation.

(f) The document must be signed:

(1) by the chairman of the board of directors of a domestic or foreign corporation, by its president, or by another of its officers;

(2) if directors have not been selected or the corporation has not been formed, by an incorporator; or

(3) if the corporation is in the hands of a receiver, trustee, or other court-appointed fiduciary, by that fiduciary.

(g) The person executing the document shall sign it and state beneath or opposite the person's signature the person's name and the capacity in which the document is signed. The document may but need not contain a corporate seal, attestation, acknowledgment, or verification.

(h) If the secretary of state has prescribed a mandatory form for the document under section 1.21, the document must be in or on the prescribed form.

(i) The document must be delivered to the office of the secretary of state for filing. Delivery may be made by electronic transmission if and to the extent permitted by the secretary of state. If it is filed in typewritten or printed form and not transmitted electronically, the secretary of state may require one exact or conformed copy to be delivered with the document (except as provided in sections 5.03 and 15.09).

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(j) When the document is delivered to the office of the secretary of state for filing, the correct filing fee, and any franchise tax, license fee, or penalty required to be paid therewith by this Act or other law must be paid or provision for payment made in a manner permitted by the secretary of state.

(k) Whenever a provision of this Act permits any of the terms of a plan or a filed document to be dependent on facts objectively ascertainable outside the plan or filed document, the following provisions apply:

(1) The manner in which the facts will operate upon the terms of the plan or filed document shall be set forth in the plan or filed document.

(2) The facts may include, but are not limited to:

(i) any of the following that is available in a nationally recognized news or information medium either in print or electronically: statistical or market indices, market prices of any security or group of securities, interest rates, currency exchange rates, or similar economic or financial data;

(ii) a determination or action by any person or body, including the corporation or any other party to a plan or filed document; or (iii) the terms of, or actions taken under, an agreement to which the

(iii) corporation is a party, or any other agreement or document.

(3) As used in this subsection:

(i) "filed document'' means a document filed with the secretary of state under any provision of this Act except chapter 15 or section 16.21; and

(ii) "plan'' means a plan of domestication, nonprofit conversion, entity conversion, merger, or share exchange.

(4) The following provisions of a plan or filed document may not be made dependent on facts outside the plan or filed document:

(i) The name and address of any person required in a filed document.

(ii) The registered office of any entity required in a filed document.

(iii) The registered agent of any entity required in a filed document.

(iv) The number of authorized shares and designation of each class or series of shares.

(v) The effective date of a filed document.

(vi) Any required statement in a filed document of the date on which the underlying transaction was approved or the manner in which that approval was given.

(5) If a provision of a filed document is made dependent on a fact ascertainable outside of the filed document, and that fact is not ascertainable by reference to a source described in subsection (k)(2)(i) or a document that is a matter of public record, or the affected shareholders have not received notice of the fact from the corporation, then the corporation shall file with the secretary of state articles of amendment setting forth the fact promptly after the time when the fact referred to is first ascertainable or thereafter changes. Articles of amendment under this subsection (k)(5) are deemed to be authorized by the authorization of the original filed document or plan to which they relate and may be filed by the corporation without further action by the board of directors or the shareholders.

CROSS-REFERENCES

Certificate of authority for foreign corporation, see § 15.03.
Corporate name, see ch. 4, § 15.06.
Correcting filed document, see § 1.24.
"Deliver," see § 1.40.
Effective time and date of filing, see § 1.23.
"Electronic transmission," see § 1.40.
Filing fees, see § 1.22.
Forms, see § 1.21.
Penalty for signing false document, see § 1.29.
"Secretary" of corporation, see § 1.40.
Secretary of state's filing duty, see § 1.25.
"Sign," see § 1.40.
Terms of classes or series of shares, see § 6.02(d).
Terms of merger, see § 11.02(d).
Terms of share exchange, see § 11.03(d).

OFFICIAL COMMENT

Section 1.20 standardizes the filing requirements for all documents required or permitted by the Model Act to be filed with the secretary of state. In a few instances, other sections of the Act impose additional requirements which must also be complied with if the document in question is to be filed. Section 1.20 relates only to documents which the Model Act expressly requires or permits to be filed with the secretary of state; it does not authorize or direct the secretary of state to accept or reject for filing other documents relating to corporations and does not treat documents required or permitted to be filed under other statutes.

The purposes of the filing requirements of chapter 1 are: (1) to simplify the filing requirements by the elimination of formal or technical requirements that serve little purpose, (2) to minimize the number of pieces of paper to be processed by the secretary of state, and (3) to eliminate all possible disputes between persons seeking to file documents and the secretary of state as to the legal efficacy of documents.

The requirements of section 1.20 may be summarized as follows.

1. Form

The Model Act permits a document to be filed in typewritten or printed form through physical delivery to the secretary of state or by electronic transmission. Electronic transmission is intended to include the evolving methods of electronic delivery, including facsimile transmissions, electronic transmissions via the Internet, and filings through delivery of computer diskettes, all as may be permitted by the secretary of state. To be eligible for filing, a document must be typed or printed or electronically transmitted in a format that can be retrieved or reproduced in typewritten or printed form and in the English language (except to the limited extent permitted by section 1.20(e)). The secretary of state is not authorized to prescribe forms (except to the extent permitted by section 1.21) and as a result may not reject documents on the basis of form (see section 1.25) if they contain the information called for by the specific statutory requirement and meet the minimal formal requirements of this section.

2. Signing

To be filed, a document must simply be signed by a corporate officer. Section 1.20(f). No specific corporate officer is designated as the appropriate officer to sign though the signing officer must designate the office or capacity in which the officer signs the document. Among the officers who are expressly authorized to sign a document is the chairman of the board of directors, a choice that may be appropriate if the corporation has a board of directors but has not appointed officers. If a corporation has not been formed or has neither officers nor a board of directors, an incorporator may execute the document. See the Official Comment to section 1.40 for a description of the manner in which a document may be "signed" by the officer.

The requirement in earlier versions of the Model Act and in many state statutes that documents must be acknowledged or verified as a condition for filing has been eliminated. These requirements serve little purpose in connection with documents filed under corporation statutes. (See section 1.29, which makes it a criminal offense for any person to sign a document for filing with knowledge that it contains false information.) On the other hand, many organizations, like lenders or title companies, may desire that specific documents include acknowledgments, verifications, or seals; section 1.20(g) therefore provides that the addition of these forms of execution does not affect the eligibility of the document for filing.

3. Contents

A document must be filed by the secretary of state if it contains the information required by the Model Act. The document may contain additional information or statements and their presence is not grounds for the secretary of state to reject the document for filing. These documents must be accepted for filing even if the secretary of state believes that the language is illegal or unenforceable. In view of this very limited discretion granted to secretaries of state under this section, section 1.25(d) defines the secretary of state's role as "ministerial" and provides that no inference or presumption arises from the fact that the secretary of state accepted a document for filing. See the Official Comments to sections 1.25 and 1.30.

4. Number of Copies

Earlier versions of the Model Act required that "duplicate originals" (each being signed as an original document) be submitted with filings made with the secretary of state. This requirement was eliminated from the Model Act and replaced with the requirement that "one exact or conformed copy" accompany the document filed with the secretary of state. The Model Act now permits the secretary of state to require an exact or conformed copy if the document is being filed in typewritten or printed form, providing the secretary of state flexibility to determine whether or not such copies serve any purpose. There is no such requirement with respect to documents transmitted electronically.

Under section 1.20(i) an "exact" copy is a reproduction of the executed original document; a "conformed" copy is a copy on which the existence of signatures is entered or noted on the copy. The substitution of exact or conformed copies for duplicate originals reflects advances in the art of office copying machines that permit the routine reproduction of exact copies of executed documents. However, a person submitting "duplicate originals" meets any requirement for an exact or conformed copy since the secretary of state may treat the duplicate original as a "conformed copy."

5. Reference to Extrinsic Facts

Section 1.20(k) permits any of the terms of a filed document or a plan to be made dependent on facts outside the document or plan with the exceptions provided in section 1.20(k)(4). Terms of a filed document or plan may be made dependent on a fact outside the control of the corporation. Common examples are references to an interest rate such as the federal funds rate or to securities market prices. Section 1.20(k)(2) also provides that the facts on which a filed document or plan may be made dependent include facts within the control of the corporation in order to make clear that those facts do not need to occur independently. In addition to a determination or action by the corporation, references to extrinsic facts may also include, without limitation, references to determinations or actions by the board of directors, a committee of the board, an officer, employee or agent of the corporation, or any other person.

The only limitations on referring to extrinsic facts in a filed document or plan are that the facts must be objectively ascertainable and that the filed document or plan must state the manner in which the facts will operate. The purpose of these requirements is to avoid disputes over whether an extrinsic fact has occurred or its effect.

If the terms of a filed document or plan are made dependent on an agreement or other document as authorized by section 1.20(k)(2)(iii), care should be taken to identify the agreement or document appropriately. The agreement or document must be identified in a manner that satisfies the objectively ascertainable standard, and the manner in which the terms or events under it are to operate must be specified. Consideration should also be given to the intended effects of an amendment to the agreement or document. A simple reference to an agreement will presumably include subsequent amendments, while a reference to the same agreement as in effect on a specified date presumably will not.

Chapters 9 and 11 generally require the board of directors to adopt a plan and section 6.21 requires the board to determine the adequacy of consideration for shares to be issued by the corporation. If the terms of such a plan or share issuance are determined by reference to extrinsic facts, the board should take care to establish appropriately defined parameters for such terms in order to discharge its statutory duties.

Where the terms of a filed document are dependent on extrinsic facts, section 1.20(k)(5) establishes a procedure that will permit the shareholders to determine what those facts are in the following manner:

1. If the facts are ascertainable by reference to one of the generally available sources of information described in section 1.20(k)(2)(i), a shareholder may determine the facts by reference to that source.

2. If the facts are set forth in a document of public record, a shareholder may determine the facts by consulting the public record. Documents that are a matter of public record will include, without limitation, filings with the secretary of state under the Act and those filings with the Securities and Exchange Commission that are publicly available either on the EDGAR electronic filing system or in hard copy.

3. If the corporation has provided notice of the facts to those shareholders affected by the provision of the filed document that is dependent on the facts, those shareholders may refer to the notice. Other shareholders will also have access to the notice pursuant to sections 16.01(e)(1) and 16.02(a).

4. In all other cases, the corporation is required to file articles of amendment when a fact referred to in a filed document is first ascertainable or thereafter changes. To simplify the filing of the articles of amendment, section 1.20(k)(5) provides that separate approval of the amendment is not required. If there is any doubt as to whether the filing of articles of amendment is necessary, the corporation should err on the side of filing articles of amendment.

§ 1.21. FORMS

(a) The secretary of state may prescribe and furnish on request forms for: (1) an application for a certificate of existence, (2) a foreign corporation's application for a certificate of authority to transact business in this state, (3) a foreign corporation's application for a certificate of withdrawal, (4) and the annual report. If the secretary of state so requires, use of these forms is mandatory.

(b) The secretary of state may prescribe and furnish on request forms for other documents required or permitted to be filed by this Act but their use is not mandatory.

CROSS-REFERENCES

Annual report, see § 16.21.
Application for certificate of authority, see § 15.03.
Application for certificate of withdrawal, see § 15.20.
Certificate of existence, see § 1.28.
Effective time and date of filing, see § 1.23.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.

OFFICIAL COMMENT

As described in the Official Comment to section 1.20, documents are entitled to be filed under the Model Act if they meet the substantive and formal requirements of the Act; they may also contain additional information if the person submitting the document so elects. See the Official Comments to sections 1.20 and 1.25. In these circumstances it is not appropriate to vest the secretary of state with general authority to establish mandatory forms for use under the Model Act. Certain types of reports and requests for documents may be processed efficiently only if uniform forms are prescribed by the secretary of state. Certificates of existence, for example, should require specific information located at specific places on the form; similarly, processing of large-volume, largely routine filings is expedited if standardized forms are required. Also, the disclosure requirements of the annual report may be administered on a systematic basis if a standardized form is mandated. Section 1.21(a) recognizes that these considerations may exist in limited cases, and expressly enumerates those forms for which the secretary of state is authorized to establish mandatory forms.

Section 1.21(b) authorizes (but does not require) the secretary of state to prepare forms suitable for use for other documents required or permitted to be filed under the Act. However, the use of these forms is permissive and cannot be required by the secretary of state.

§ 1.22. FILING, SERVICE, AND COPYING FEES

(a) The secretary of state shall collect the following fees when the documents described in this subsection are delivered to the secretary of state for filing:

Document			Fee
(1)	Articles of incorporation	$	________.
(2)	Application for use of indistinguishable name	$	________.
(3)	Application for reserved name	$	________.
(4)	Notice of transfer of reserved name	$	________.
(5)	Application for registered name	$	________.
(6)	Application for renewal of registered name	$	________.
(7)	Corporation's statement of change of registered agent or registered office or both	$	________.
(8)	Agent's statement of change of registered office for each affected corporation not to exceed a total of ________	$	________.

(9)	Agent's statement of resignation		No fee.
(9A)	Articles of domestication	$	________.
(9B)	Articles of charter surrender	$	________.
(9C)	Articles of nonprofit conversion	$	________.
(9D)	Articles of domestication and conversion	$	________.
(9E)	Articles of entity conversion	$	________.
(10)	Amendment of articles of incorporation	$	________.
(11)	Restatement of articles of incorporation with amendment of articles	$	________.
(12)	Articles of merger or share exchange	$	________.
(13)	Articles of dissolution	$	________.
(14)	Articles of revocation of dissolution	$	________.
(15)	Certificate of administrative dissolution		No fee.
(16)	Application for reinstatement following administrative dissolution	$	________.
(17)	Certificate of reinstatement		No fee.
(18)	Certificate of judicial dissolution		No fee.
(19)	Application for certificate of authority	$	________.
(20)	Application for amended certificate of authority	$	________.
(20A)	Application for certificate of withdrawal	$	________.
(21)	Application for transfer of authority	$	________.
(22)	Certificate of revocation of authority to transact business		No fee.
(23)	Annual report	$	________.
(24)	Articles of correction	$	________.
(25)	Application for certificate of existence or authorization	$	________.
(26)	Any other document required or permitted to be filed by this Act	$	________.

(b) The secretary of state shall collect a fee of $ ______ each time process is served on the secretary of state under this Act. The party to a proceeding causing service of process is entitled to recover this fee as costs if such party prevails in the proceeding.

(c) The secretary of state shall collect the following fees for copying and certifying the copy of any filed document relating to a domestic or foreign corporation:

(1) $______a page for copying; and
(2) $_____ for the certificate.

CROSS-REFERENCES

Agent's change of registered office, see § 5.02.
Agent's resignation, see § 5.03.
Amended certificate of authority, see § 15.04.
Amendment of articles of incorporation, see §§ 6.03, 6.31, 10.06, 10.08.
Annual report, see § 16.21.
Certificate of authority, see § 15.03.

Certificate of withdrawal, see § 15.20.
Corporation's change of registered agent or office, see § 5.02.
Correction, see § 1.24.
Dissolution:
administrative, see § 14.21.
judicial, see § 14.30.
reinstatement, see § 14.22.
revocation, see § 14.04.
voluntary, see §§ 14.01 & 14.03.
Evidentiary effect of certified copy, see § 1.27.
Existence, see § 1.28.
Incorporation, see § 2.03.
Merger, see § 11.05.
Name of corporation, see § 4.01.
Registered name, see § 4.03.
Renewal of registered name, see § 4.03.
Reserved name, see § 4.02.
Restatement of articles of incorporation, see § 10.07.
Revocation of certificate of authority, see § 15.31.
Service on secretary of state, see §§ 11.07, 15.20, 15.31.
Share exchange, see § 11.06.
Transfer of registered name, see § 4.03.

OFFICIAL COMMENT

Section 1.22 establishes in a single section the filing fees for all documents that may be filed under the Model Act. The dollar amounts for each document should be inserted by each state as it adopts the Act.

The list of documents in section 1.22 includes all documents that are authorized to be filed with the secretary of state under the Model Act. The catch-all in subdivision (26) will apply to any document for which a state does not establish a specific filing fee plus any document that later amendments to the statute may authorize or direct be filed with the secretary of state without establishing a specific filing fee.

Subdivision (9) states that no fee is applicable to filing the resignation of a registered agent. This provision permits a person who is named as a registered agent without such person's consent, or who agrees to serve as registered agent for a fee and the fee is not paid, to eliminate any reference to such person in the records of the secretary of state without expense.

Subdivision (8) contains a maximum fee for filing a change of address of a registered agent. Since corporation service companies serve as registered agents for thousands of corporations in many jurisdictions, their change of address may require a very large number of filings. Hence, the fee is broadly based on the number of corporations affected but a maximum fee is specified to reflect that as the number of changes increases the cost per change should decrease.

Sections 11.07, 15.20, and 15.31 require the secretary of state to serve process on foreign corporations under the circumstances there specified. The fee for this service is set forth in section 1.22(b).

Section 1.22(c) establishes standard fees for copying filed documents and certifying that copies are true copies under section 1.27.

§ 1.23. EFFECTIVE TIME AND DATE OF DOCUMENT

(a) Except as provided in subsection (b) and section 1.24(c), a document accepted for filing is effective:

(1) at the date and time of filing, as evidenced by such means as the secretary of state may use for the purpose of recording the date and time of filing; or

(2) at the time specified in the document as its effective time on the date it is filed.

(b) A document may specify a delayed effective time and date, and if it does so the document becomes effective at the time and date specified. If a delayed effective date but no time is specified, the document is effective at the close of business on that date. A delayed effective date for a document may not be later than the 90th day after the date it is filed.

CROSS-REFERENCES

Effective date:
amendment or restatement of articles of incorporation, see § 10.09.
merger or share exchange, see § 11.06.
voluntary dissolution, see § 14.03.
Filing duty of secretary of state, see § 1.25.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.

OFFICIAL COMMENT

Section 1.23(a) provides that documents accepted for filing become effective at the date and time of filing, or at another specified time on that date, unless a delayed effective date is selected under section 1.23(b). This section gives express statutory authority to the common practice of most secretaries of state of ignoring processing time and treating a document as effective as of the date it is submitted for filing even though it may not be reviewed and accepted for filing until several days later.

Section 1.23(a) requires secretaries of state to maintain some means of recording the date and time of filing of documents and provides that documents become effective at the recorded time on the date of filing. This provision should eliminate any doubt about situations involving same-day transactions in which documents, for example articles of merger, are filed on the morning of the date the merger is to become effective. Section 1.23(a) contemplates that the time of filing, as well as the date, will be routinely recorded.

Section 1.23(b) provides an alternative method of establishing the effective date of a document. The document itself may fix as its effective date any date within 90 days after the date it is filed; it may also fix the time it becomes effective on that date. If no time is specified, the document becomes effective as of the close of business on the specified date. The Model Act also allows the effective date fixed in a document to be corrected to a limited extent. See the Official Comment to section 1.24.

Section 1.23(b) does not authorize or contemplate the retroactive establishment of an effective date before the date of filing.

§ 1.24. CORRECTING FILED DOCUMENT

(a) A domestic or foreign corporation may correct a document filed with the secretary of state if (1) the document contains an inaccuracy, or (2) the document was defectively signed, attested, sealed, verified, or acknowledged, or (3) the electronic transmission was defective.

(b) A document is corrected:

- (1) by preparing articles of correction that
  - (i) describe the document (including its filing date) or attach a copy of it to the articles,
  - (ii) specify the inaccuracy or defect to be corrected, and
  - (iii) correct the inaccuracy or defect; and
- (2) by delivering the articles to the secretary of state for filing.

(c) Articles of correction are effective on the effective date of the document they correct except as to persons relying on the uncorrected document and adversely affected by the correction. As to those persons, articles of correction are effective when filed.

CROSS-REFERENCES

“Deliver,” see § 1.40.
Effective time and date of filing, see § 1.23.
“Electronic transmission,” see § 1.40.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.

OFFICIAL COMMENT

Section 1.24 permits making corrections in filed documents without refiling the entire document or submitting formal articles of amendment. This correction procedure has two advantages: (1) filing articles of correction may be less expensive than refiling the document or filing articles of amendment, and (2) articles of correction do not alter the effective date of the underlying document being corrected. Indeed, under section 1.24(c), even the correction relates back to the original effective date of the document except as to persons relying on the original document and adversely affected by the correction. As to these persons, the effective date of articles of correction is the date the articles are filed.

A document may be corrected either because it contains an inaccuracy or because it was defectively executed (including defects in optional forms of execution that do not affect the eligibility of the original document for filing). In addition, the document may be corrected if the electronic transmission was defective. This is intended to cover the situation where an electronic filing is made but, due to a defect in transmission, the filed document is later discovered to be inconsistent with the document intended to be filed. If no filing is made because of a defect in transmission, articles of correction may not be used to make a retroactive filing. Therefore, a corporation making an electronic filing should take steps to confirm that the filing was received by the secretary of state.

A provision in a document setting an effective date (section 1.23) may be corrected under this section, but the corrected effective date must comply with section 1.23 measured from the date of the original filing of the document being corrected, i.e., it cannot be before the date of filing of the document or more than 90 days thereafter.

§ 1.25. FILING DUTY OF SECRETARY OF STATE

(a) If a document delivered to the office of the secretary of state for filing satisfies the requirements of section 1.20, the secretary of state shall file it.

(b) The secretary of state files a document by recording it as filed on the date and time of receipt. After filing a document, except as provided in sections 5.03 and 15.09, the secretary of state shall deliver to the domestic or foreign corporation or its representative a copy of the document with an acknowledgement of the date and time of filing.

(c) If the secretary of state refuses to file a document, it shall be returned to the domestic or foreign corporation or its representative within five days after the document was delivered, together with a brief, written explanation of the reason for the refusal.

(d) The secretary of state's duty to file documents under this section is ministerial. The secretary's filing or refusing to file a document does not:

(1) affect the validity or invalidity of the document in whole or part;

(2) relate to the correctness or incorrectness of information contained in the document; or

(3) create a presumption that the document is valid or invalid or that information contained in the document is correct or incorrect.

CROSS-REFERENCES

Appeal from rejection of document, see § 1.26.

"Deliver," see § 1.40.
Effective time and date of filing, see § 1.23.
Filing requirements:
    fees, see § 1.22.
    generally, see § 1.20.
    resignation of registered agent, see §§ 5.03 & 15.09.
    service on foreign corporation, see § 15.10.
Powers of secretary of state, see § 1.30.

OFFICIAL COMMENT

1. Filing Duty in General

Under section 1.25 the secretary of state is required to file a document if it "satisfies the requirements of section 1.20." This language should be contrasted with earlier versions of the Model Act (and many state statutes) that required the secretary of state to ascertain whether the document "conformed with law" before filing it. The purpose of this change is to limit the discretion of the secretary of state to a ministerial role in reviewing the contents of documents. If the document submitted is in the form prescribed and contains the information required by section 1.20 and the applicable provision of the Model Act, the secretary of state under section 1.25 must file it even though it contains additional provisions the secretary of state may feel are irrelevant or not authorized by the Model Act or by general legal principles. Consistent with this approach, section 1.25(d) states that the filing duty of the secretary of state is ministerial and provides that filing a document with the secretary of state does not affect the validity or invalidity of any provision contained in the document and does not create any presumption with respect to any provision. Persons adversely affected by provisions in a document may test their validity in a proceeding appropriate for that purpose. Similarly, the attorney general of the state may also question the validity of provisions of documents filed with the secretary of state in an independent suit brought for that purpose; in neither case should any presumption or inference be drawn about the validity of the provision from the fact that the secretary of state accepted the document for filing.

2. Mechanics of Filing

Section 1.25(b) provides that when the secretary of state files a document, the secretary of state records it as filed on the date and time of receipt, retains the original document for the state's records, and delivers a copy of the document to the corporation or its representative with an acknowledgement of the date and time of filing. In the case of a document transmitted electronically, delivery may be made by electronic transmission. The copy returned will be the exact or conformed copy if one has been required by the secretary of state, or will be a copy made by the secretary of state if an exact of conformed copy was not required. Consideration was given to dispensing with a document copy and providing only for the return of a fee receipt or equivalent document. Several states currently follow this practice with respect to articles of incorporation and other documents. It was felt to be important, however, to continue a practice by which each corporation receives back from the secretary of state for its records a document that on its face shows that it is a copy of the document that was filed with the secretary of state. This copy is usually placed in the minute book and is available for informal inspection without requiring a person to examine the records of the secretary of state. Of course, a person desiring a certified copy of any filed document may obtain it from the office of the secretary of state by paying the fee prescribed in section 1.22(c).

3. Elimination of Certificates of Incorporation and Similar Documents

Section 1.25(b) provides that acceptance of articles of incorporation or other documents is evidenced merely by the issuance of a fee receipt or acknowledgment of receipt if no fee is required. Earlier versions of the Model Act and the statutes of many states provided that acceptance by the secretary of state is evidenced by a "certificate" (e.g., of incorporation, of merger, or of amendment). This older practice was not retained in the revised Model Act because it was felt desirable to reduce the number of pieces of paper issued by the secretary of state. Under the older practice most state offices routinely issued both fee receipts and certificates. A single document—the fee receipt or acknowledgment—should sufficiently indicate that the document has been accepted for filing, and in fact many states in recent years have dispensed with the formal certificate.

4. Rejection of Document by Secretary of State

Because of the simplification of formal filing requirements and the limited discretion granted to the secretary of state by the Model Act, it is probable that rejection of documents for filing will occur only rarely. Section 1.25(c) provides that if the secretary of state does reject a document for filing, the secretary of state must return it to the corporation or its representative within five days together with a brief written explanation of the reason for rejection. In the case of a document transmitted electronically, rejection of the document may be made electronically by the secretary of state or by a mailing to the corporation at its registered office. A rejection may be the basis of judicial review under section 1.26.

§ 1.26. APPEAL FROM SECRETARY OF STATE'S REFUSAL TO FILE DOCUMENT

(a) If the secretary of state refuses to file a document delivered for filing, the domestic or foreign corporation may appeal the refusal within 30 days after the return of the document to the [name or describe] court [of the county where the corporation's principal office (or, if none in this state, its registered office) is or will be located] [of ______ county]. The appeal is commenced by petitioning the court to compel filing the document and by attaching to the petition the document and the secretary of state's explanation of his refusal to file.

(b) The court may summarily order the secretary of state to file the document or take other action the court considers appropriate.

(c) The court's final decision may be appealed as in other civil proceedings.

CROSS-REFERENCES

"Deliver," see § 1.40.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.

"Principal office":
  defined, see § 1.40.
  designated in annual report, see § 16.21.
Registered office:
  designated in annual report, see § 16.21.
  requirement, see §§ 2.02 & 5.01.
Secretary of state's filing duty, see § 1.25.

OFFICIAL COMMENT

1. The Court with Jurisdiction to Hear Appeals from the Secretary of State

The identity of the specific court with jurisdiction to hear appeals from the secretary of state under section 1.26 must be supplied by each state when enacting this section. It is intended that this should be a court of general civil jurisdiction. It may either be the court located in the capital of the state or the court in the county where the corporation's principal business office is located in the state or, if the corporation does not have a principal office in the state, the court located in the county in which its registered office is located. The annual report of the corporation must state where the principal office of the corporation (which need not be within the state) is located. See section 16.21. Other sections of the Model Act also contemplate that the court with jurisdiction over substantive corporate matters will be designated in the statute. See, for example, section 7.03, relating to the ordering of a shareholders' meeting after the corporation fails to hold such a meeting. It is expected that jurisdiction over litigation with respect to substantive matters will normally be vested in the court in the county of the corporation's principal or registered office. See the Official Comment to section 7.03.

2. "Summary" Orders

In view of the limited discretion of the secretary of state under the Act, a "summary" order appears to be appropriate in section 1.26. Throughout the Model Act the term "summarily order" or similar language is used where courts are authorized to order action taken and the person charged with taking the original action has little or no discretion. The word "summary" is not used in a technical sense but to refer to a class of cases where the court might appropriately order that action be taken on the face of the pleadings or after an oral hearing but without any need to resolve disputed factual issues.

3. Burden of Proof and Review Standard

The revised Model Act, unlike earlier versions, does not address either the burden of proof or the standard for review in judicial proceedings challenging action of the secretary of state. It is contemplated that these matters will be governed by general principles of judicial review of agency action in each adopting state.

§ 1.27. EVIDENTIARY EFFECT OF COPY OF FILED DOCUMENT

A certificate from the secretary of state delivered with a copy of a document filed by the secretary of state, is conclusive evidence that the original document is on file with the secretary of state.

CROSS-REFERENCES

Certifying fee, see § 1.22.
Forms, see § 1.21.
Secretary of state's filing duty, see § 1.25.

OFFICIAL COMMENT

The secretary of state may be requested to certify that a specific document has been filed with him upon payment of the fees specified in section 1.22(c). Section 1.27 provides that the certificate is conclusive evidence only that the document is on file. The limited effect of the certificate is consistent with the ministerial filing obligation imposed on the secretary of state under the Model Act. The certificate from the secretary of state, as well as the copy of the document, may be delivered by electronic transmission.

§ 1.28. CERTIFICATE OF EXISTENCE

(a) Anyone may apply to the secretary of state to furnish a certificate of existence for a domestic corporation or a certificate of authorization for a foreign corporation.

(b) A certificate of existence or authorization sets forth:

(1) the domestic corporation's corporate name or the foreign corporation's corporate name used in this state;

(2) that

(i) the domestic corporation is duly incorporated under the law of this state, the date of its incorporation, and the period of its duration if less than perpetual; or

(ii) that the foreign corporation is authorized to transact business in this state;

(3) that all fees, taxes, and penalties owed to this state have been paid, if

(i) payment is reflected in the records of the secretary of state and

(ii) nonpayment affects the existence or authorization of the domestic or foreign corporation;

(4) that its most recent annual report required by section 16.21 has been filed with the secretary of state;

(5) that articles of dissolution have not been filed; and

(6) other facts of record in the office of the secretary of state that may be requested by the applicant.

(c) Subject to any qualification stated in the certificate, a certificate of existence or authorization issued by the secretary of state may be relied upon as conclusive evidence that the domestic or foreign corporation is in existence or is authorized to transact business in this state.

CROSS-REFERENCES

Certificate of existence for nonqualified foreign corporation, see § 15.03.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.
Forms, see § 1.21.
"Principal office":
  defined, see § 1.40.
  designated in annual report, see § 16.21.
Registered office:
  designated in annual report, see § 16.21.
  requirement, see §§ 2.02, 5.01, 15.07.

OFFICIAL COMMENT

Section 1.28 establishes a procedure by which anyone may obtain a conclusive certificate from the secretary of state that a particular domestic or foreign corporation is in existence or is authorized to transact business in the state. The certificate will probably be a standardized form. The secretary of state is to make the judgment whether or not the corporation is in existence or is authorized to transact business from public records only and is not expected to make a more extensive investigation. In appropriate cases, the secretary of state may issue a certificate subject to specified qualifications.

Section 1.28(b)(3) refers only to taxes, fees, or penalties collected by the secretary of state or collected by other agencies and reported to the secretary of state. In some states the secretary of state may ascertain from other agencies that franchise or other taxes have been paid and include this information in the certificate. In states where this procedure does not unduly delay the issuance of certificates, section 1.28 may be revised appropriately. Section 1.28(b)(3) relates only to taxes, fees, or penalties to the extent their nonpayment affects the existence or authorization to transact business of the corporation.

A certificate of existence or authorization that may be relied on as binding and conclusive is of material assistance to attorneys who may be required to give formal legal opinions in connection with corporate transactions.

§ 1.29. PENALTY FOR SIGNING FALSE DOCUMENT

(a) A person commits an offense by signing a document that the person knows is false in any material respect with intent that the document be delivered to the secretary of state for filing.

(b) An offense under this section is a [ ] misdemeanor [punishable by a fine of not to exceed $[ ].

CROSS-REFERENCES

"Deliver," see § 1.40.
Judicial dissolution, see § 14.30.
Revocation of certificate of authority of foreign corporation, see § 15.30.
"Sign," see § 1.40.

OFFICIAL COMMENT

Section 1.29 makes it a criminal offense for any person to sign a document that the person knows is false in any material respect with intent that the document be submitted for filing to the secretary of state. As provided in section 1.40(22A), "sign" includes any manual, facsimile, conformed, or electronic signature.

Section 1.29(b) is keyed to the classification of offenses provided by the Model Penal Code. If a state has not adopted this classification, the dollar amount of the fine should be substituted for the misdemeanor classification.

Subchapter C.
SECRETARY OF STATE

§ 1.30. POWERS

The secretary of state has the power reasonably necessary to perform the duties required of the secretary of state by this Act.

CROSS-REFERENCES

Administrative dissolution, see § 14.20.
Judicial dissolution, see § 14.30.
Revocation of certificate of authority of foreign corporation, see § 15.30.
Secretary of state's filing duty, see § 1.25.

OFFICIAL COMMENT

Section 1.30 is intended to grant the secretary of state the authority necessary for the efficient performance of the filing and other duties imposed on the secretary of state by the Act but is not intended as a grant of general authority to establish public policy. The most important aspects of a modern corporation statute relate to the creation and maintenance of relationships among persons interested in or involved with a corporation; these relationships basically should be a matter of concern to the parties involved and not subject to regulation or interpretation by the secretary of state. Further, even in situations where it is claimed that the corporation has been formed or is being operated for purposes that may violate the public policies of the state, the secretary of state generally should not be the governmental official that determines the scope of public policy through administration of his filing responsibilities under the Act. Rather, the attorney general may seek to enjoin the illegal conduct or to dissolve involuntarily the offending corporation.

Section 1.30 is more narrowly drafted than earlier versions of the Model Act and the statutes of many states.

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Subchapter D.
DEFINITIONS

§ 1.40. ACT DEFINITIONS

In this Act:

(1) "Articles of incorporation" means the original articles of incorporation, all amendments thereof, and any other documents permitted or required to be filed by a domestic business corporation with the secretary of state under any provision of this Act except section 16.21. If an amendment of the articles or any other document filed under this Act restates the articles in their entirety, thenceforth the "articles" shall not include any prior documents.

(2) "Authorized shares" means the shares of all classes a domestic or foreign corporation is authorized to issue.

(3) "Conspicuous" means so written that a reasonable person against whom the writing is to operate should have noticed it. For example, printing in italics or boldface or contrasting color, or typing in capitals or underlined, is conspicuous.

(4) "Corporation," "domestic corporation" or "domestic business corporation" means a corporation for profit, which is not a foreign corporation, incorporated under or subject to the provisions of this Act.

(5) "Deliver" or "delivery" means any method of delivery used in conventional commercial practice, including delivery by hand, mail, commercial delivery, and electronic transmission.

(6) "Distribution" means a direct or indirect transfer of money or other property (except its own shares) or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect of any of its shares. A distribution may be in the form of a declaration or payment of a dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness; or otherwise.

(6A) "Domestic unincorporated entity" means an unincorporated entity whose internal affairs are governed by the laws of this state.

(7) "Effective date of notice" is defined in section 1.41.

(7A) "Electronic transmission" or "electronically transmitted" means any process of communication not directly involving the physical transfer of paper that is suitable for the retention, retrieval, and reproduction of information by the recipient.

(7B) "Eligible entity" means a domestic or foreign unincorporated entity or a domestic or foreign nonprofit corporation.

(7C) "Eligible interests" means interests or memberships.

(8) "Employee" includes an officer but not a director. A director may accept duties that make the director also an employee.

(9) "Entity" includes domestic and foreign business corporation; domestic and foreign nonprofit corporation; estate; trust; domestic and foreign unincorporated entity; and state, United States, and foreign government.

(9A) The phrase "facts objectively ascertainable" outside of a filed document or plan is defined in section 1.20(k).

(9AA) "Expenses" means reasonable expenses of any kind that are incurred in connection with a matter.

(9B) "Filing entity" means an unincorporated entity that is of a type that is created by filing a public organic document.

(10) "Foreign corporation" means a corporation incorporated under a law other than the law of this state; which would be a business corporation if incorporated under the laws of this state.

(10A) "Foreign nonprofit corporation" means a corporation incorporated under a law other than the law of this state, which would be a nonprofit corporation if incorporated under the laws of this state.

(10B) "Foreign unincorporated entity" means an unincorporated entity whose internal affairs are governed by an organic law of a jurisdiction other than this state.

(11) "Governmental subdivision" includes authority, county, district, and municipality.

(12) "Includes" denotes a partial definition.

(13) "Individual" means a natural person.

(13A) "Interest" means either or both of the following rights under the organic law of an unincorporated entity:

(i) the right to receive distributions from the entity either in the ordinary course or upon liquidation; or

(ii) the right to receive notice or vote on issues involving its internal affairs, other than as an agent, assignee, proxy or person responsible for managing its business and affairs.

(13B) "Interest holder" means a person who holds of record an interest.

(14) "Means" denotes an exhaustive definition.

(14A) “Membership” means the rights of a member in a domestic or foreign nonprofit corporation.

(14B) “Nonfiling entity” means an unincorporated entity that is of a type that is not created by filing a public organic document.

(14C) “Nonprofit corporation” or “domestic nonprofit corporation” means a corporation incorporated under the laws of this state and subject to the provisions of the [Model Nonprofit Corporation Act].

(15) “Notice” is defined in section 1.41.

(15A) “Organic document” means a public organic document or a private organic document.

(15B) “Organic law “means the statute governing the internal affairs of a domestic or foreign business or nonprofit corporation or unincorporated entity.

(15C) “Owner liability” means personal liability for a debt, obligation or liability of a domestic or foreign business or nonprofit corporation or unincorporated entity that is imposed on a person:

(i) solely by reason of the person’s status as a shareholder, member or interest holder; or

(ii) by the articles of incorporation, bylaws or an organic document under a provision of the organic law of an entity authorizing the articles of incorporation, bylaws or an organic document to make one or more specified shareholders, members or interest holders liable in their capacity as shareholders, members or interest holders for all or specified debts, obligations or liabilities of the entity.

(16) “Person” includes an individual and an entity.

(17) “Principal office” means the office (in or out of this state) so designated in the annual report where the principal executive offices of a domestic or foreign corporation are located.

(17A) “Private organic document” means any document (other than the public organic document, if any) that determines the internal governance of an unincorporated entity. Where a private organic document has been amended or restated, the term means the private organic document as last amended or restated.

(17B) “Public organic document” means the document, if any, that is filed of public record to create an unincorporated entity. Where a public organic document has been amended or restated, the term means the public organic document as last amended or restated.

(18) “Proceeding” includes civil suit and criminal, administrative, and investigatory action.

(18A) “Public corporation” means a corporation that has shares listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national securities association.

(18B) “Qualified director” is defined in section 1.43.

(19) “Record date” means the date established under chapter 6 or 7 on which a corporation determines the identity of its shareholders and their shareholdings for purposes of this Act. The determinations shall be made as of the close of business on the record date unless another time for doing so is specified when the record date is fixed.

(20) “Secretary” means the corporate officer to whom the board of directors has delegated responsibility under section 8.40(c) for custody of the minutes of the meetings of the board of directors and of the shareholders and for authenticating records of the corporation.

(21) “Shareholder” means the person in whose name shares are registered in the records of a corporation or the beneficial owner of shares to the extent of the rights granted by a nominee certificate on file with a corporation.

(22) “Shares” means the units into which the proprietary interests in a corporation are divided.

(22A) “Sign” or “signature” includes any manual, facsimile, conformed or electronic signature.

(23) “State,” when referring to a part of the United States, includes a state and commonwealth (and their agencies and governmental subdivisions) and a territory and insular possession (and their agencies and governmental subdivisions) of the United States.

(24) “Subscriber” means a person who subscribes for shares in a corporation, whether before or after incorporation.

(24A) “Unincorporated entity” means an organization or artificial legal person that either has a separate legal existence or has the power to acquire an estate in real property in its own name and that is not any of the following: a domestic or foreign business or nonprofit corporation, an estate, a trust, a state, the United States, or a foreign government. The term includes a general partnership, limited liability company, limited partnership, business trust, joint stock association and unincorporated nonprofit association.

(25) “United States” includes district, authority, bureau, commission, department, and any other agency of the United States.

(26) “Voting group” means all shares of one or more classes or series that under the articles of incorporation or this Act are entitled to vote and be counted together collectively on a matter at a meeting of shareholders. All shares entitled by the articles of incorporation or this Act to vote generally on the matter are for that purpose a single voting group.

(27) “Voting power” means the current power to vote in the election of directors.

CROSS-REFERENCES

Annual report, see § 16.21.
Nominee certificate, see § 7.23.
Special definitions:
“affiliate,” see § 13.01.
“beneficial shareholder,” see § 13.01.
“claim,” see § 14.06.
“conflicted director,” see § 8.60.
“control,” see § 8.60.
“corporation,” see §§ 8.50 & 13.01.
“derivative proceeding,” see § 7.40.
“director’s conflicting interest transaction,” see § 8.60.
“fair to the corporation,” see § 8.60
“fair value,” see § 13.01.
“interest,” see § 13.01.
“interested transactions,” see § 13.01.
“interests,” see § 11.01.
“liability,” see § 8.50.
“material financial interest,” see § 8.60.
“merger,” see § 11.01.
“officer,” see § 8.50.
“official capacity,” see § 8.50.
“organic documents,” see § 11.01.
“other entity,” see § 11.01.
“outstanding shares,” see § 6.03.
“party,” see § 8.50.
“party to a merger,” or “party to a share exchange,” see § 11.01.
“preferred shares,” see § 13.01.
“proceeding,” see § 8.50.’
record shareholder,” see § 13.01.
“related person,” see § 8.60.
“relevant time,” see § 8.60.
“required disclosure,” see § 8.60.
“senior executive,” see § 13.01.
“share exchange,” see § 11.01.
“shares,” see §§ 6.27 & 6.30.
“shareholder,” see § § 7.40 & 13.01.
“survivor,” see § 11.01.

OFFICIAL COMMENT

Section 1.40 collects in a single section definitions of terms used throughout the Model Act. Subchapters and sections of the Act in a few instances contain specialized definitions applicable only to those subchapters or sections.

Most of the definitions of section 1.40 are drawn directly from earlier versions of the Model Act and are reasonably self-explanatory. A number of definitions: however: are new or deserve further explanation.

1. Conspicuous

"Conspicuous" is defined in section 1.40(3) basically as defined in section 1-201(10) of the Uniform Commercial Code. Even though the definition indicates some of the methods by which a provision may be made attention-calling, the test is whether attention can reasonably be expected to be called to it.

2. Corporation, Domestic Corporation, Domestic Business Corporation, and Foreign Corporation

"Corporation," "domestic corporation," "domestic business corporation," and "foreign corporation" are defined in sections 1.40(4) and (10). The word "corporation," when used alone, refers only to domestic corporations. In a few instances, the phrase "domestic corporation" has been used in order to contrast it with a foreign corporation. The phrase "domestic business corporation" has been used on occasion to contrast it with a domestic nonprofit corporation.

3. Distribution

The term "distribution" defined in section 1.40(6) is a fundamental element of the financial provisions of the Model Act as amended in 1980. Section 6.40 sets forth a single, unitary test for the validity of any "distribution." Section 1.40(6) in turn defines "distribution" to include all transfers of money or other property made by a corporation to any shareholder in respect of the corporation's shares, except mere changes in the unit of interest such as share dividends and share splits. Thus, a "distribution" includes the declaration or payment of a dividend, a purchase by a corporation of its own shares, a distribution of evidences of indebtedness or promissory notes of the corporation, and a distribution in voluntary or involuntary liquidation. If a corporation incurs indebtedness in connection with a distribution (as in the case of a distribution of a debt instrument or an installment purchase of shares), the creation, incurrence, or distribution of the indebtedness is the event which constitutes the distribution rather than the subsequent payment of the debt by the incorporation.

The term "indirect" in the definition of "distribution" is intended to include transactions like the repurchase of parent company shares by a subsidiary whose actions are controlled by the parent. It also is intended to include any other transaction in which the substance is clearly the same as a typical dividend or share repurchase, no matter how structured or labeled.

4. Electronic Transmission

"Electronic transmission" or "electronically transmitted" includes both communication systems which in the normal course produce paper, such as facsimiles, as well as communication systems which transmit and permit the retention of data which is then subject to subsequent retrieval and reproduction in written form. Electronic transmission is intended to be broadly construed and include the evolving methods of electronic delivery, including electronic transmissions via the Internet, as well as data stored and delivered on computer diskettes. The phrase is not intended to include voice mail and other similar systems which do not automatically provide for the retrieval of data in printed or typewritten form.

5. Entity

The term "entity," defined in section 1.40(9), appears in the definition of "person" in section 1.40(16) and is included to cover all types of artificial persons. Estates and trusts and general partnerships are included even though they may not, in some jurisdictions, be considered artificial persons. "Trust," by itself, means a nonbusiness trust, such as a traditional testamentary or inter vivos trust.

The term "entity" is broader than the term "unincorporated entity" which is defined in section 1.40(24A). See also the definitions of "governmental subdivision" in section 1.40(11), "state" in section 1.40(23), and "United States" in section 1.40(25).

A form of co-ownership of property or sharing of returns from property that is not a partnership under the Uniform Partnership Act (1997) will not be an "unincorporated entity." In that connection, section 202(c) of the Uniform Partnership Act (1997) provides, among other things, that:

> In determining whether a partnership is formed, the following rules apply:
>
> (1) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not by itself establish a partnership, even if the co-owners share profits made by the use of the property.
>
> (2) The sharing of gross returns does not by itself establish a partnership, even if the persons sharing them have a joint or common right or interest in property from which the returns are derived.

5.1. EXPENSES

The Act provides in a number of contexts that expenses relating to a proceeding incurred by a person shall or may be paid by another, through indemnification or by court order in specific contexts. See sections 7.46, 7.48, 8.50(3), 8.53(a), 13.31(b) and (c), 14.32 (e), 16.04(c) and 16.05(c). In all cases, the expenses must be reasonable in the circumstances. The type or character of the expenses is not otherwise limited. Examples include such usual things as fees and disbursements of counsel, experts of all kinds, and jury and similar litigation consultants; travel, lodging, transcription, reproduction, photographic, video recording, communication, and delivery costs, whether included in the disbursements of counsel, experts, or consultants, or directly incurred; court costs; and premiums for posting required bonds.

Historically, before the inclusion in section 1.40 of the Act of the definition of "expenses," a number of the affected sections explicitly contained the phrase "including counsel fees," or similar words, after "expenses." The exclusion of other elements of expenses was not intended in these sections (see the definition of "includes" in subsection (12)). With the current universal definition, singling out this one example of expenses in the statutory text was deemed unnecessary and stylistically inconsistent. The current formulation, referring to expenses "of any kind" and eliminating the example of counsel fees, also more clearly avoids any possible incorrect negative inference that other elements of expenses, not specified, might be excluded if one example were specified.

5.2. MEMBERSHIP

"Membership" is defined in section 1.40(14A) for purposes of this Act to refer only to the rights of a member in a nonprofit corporation. Although the owners of a limited liability company are generally referred to as "members," for purposes of this Act they are referred to as "interest holders" and what they own in the limited liability company is referred to in this Act as an "interest."

5.3. ORGANIC DOCUMENTS, PUBLIC ORGANIC DOCUMENTS AND PRIVATE ORGANIC DOCUMENTS

The term "organic documents" in section 1.40(15A) includes both public organic documents and private organic documents. The term "public organic document" includes such documents as the certificate of limited partnership of a limited partnership, the articles of organization or certificate of formation of a limited liability company, the deed of trust of a business trust and comparable documents, however denominated, that are publicly filed to create other types of unincorporated entities. An election of limited liability partnership status is not of itself a public organic document because it does not create the underlying general or limited partnership filing the election, although the election may be made part of the public organic document of the partnership by its organic law. The term "private organic document" includes such documents as a partnership agreement of a general or limited partnership, an operating agreement of a limited liability company and comparable documents, however denominated, of unincorporated types of other entities.

5.4. OWNER LIABILITY

The term "owner liability" is used in the context of provisions in Chapters 9 and 11 that preserve the personal liability of shareholders, members and interest holders when the entity in which they hold shares, memberships or interests is the subject of a transaction under those chapters. The term includes only liabilities that are imposed pursuant to statute on shareholders, members or interest holders. Liabilities that a shareholder, member or interest holder incurs by contract are not included. Thus, for example, if a state's business corporation law were to make shareholders personally liable for unpaid wages, that liability would be an "owner liability." If, on the other hand, a shareholder were to guarantee payment of an obligation of a corporation, that liability would not be an "owner liability." The reason for excluding contractual liabilities from the definition of "owner liability" is because those liabilities are constitutionally protected from impairment and thus do not need to be separately protected in Chapters 9 and 11.

5.5. UNINCORPORATED ENTITY

The term "unincorporated entity" is a subset of the broader term "entity."

There is some question as to whether a partnership subject to the Uniform Partnership Act (1914) is an entity or merely an aggregation of its partners. That question has been resolved by section 201 of the Uniform Partnership Act (1997), which makes clear that a general partnership is an entity with its own separate legal existence. Section 8 of the Uniform Partnership Act (1914) gives partnerships subject to it the power to acquire estates in real property and thus such a partnership will be an "unincorporated entity." As a result, all general partnerships will be "unincorporated entities" regardless of whether the state in which they are organized has adopted the new Uniform Partnership Act (1997).

The term "unincorporated entity" includes limited liability partnerships and limited liability limited partnerships because those entities are forms of general partnerships and limited partnerships, respectively, that have made the additional required election claiming that status.

Section 4 of the Uniform Unincorporated Nonprofit Association Act gives an unincorporated nonprofit association the power to acquire an estate in real property and thus an unincorporated nonprofit association organized in a state that has adopted that act will be an "unincorporated entity." At common law, an unincorporated nonprofit association was not a legal entity and did not have the power to acquire real property. Most states that have not adopted the Uniform Act have nonetheless modified the common law rule, but states that have not adopted the Uniform Act should analyze whether they should modify the definition of "unincorporated entity" to add an express reference to unincorporated nonprofit associations.

"Business trust" includes any trust carrying on a business, such as a Massachusetts trust, real estate investment trust, or other common law or statutory business trust. The term "unincorporated entity" expressly excludes estates and trusts (i.e., trusts that are not business trusts), whether or not they would be considered artificial persons under the governing jurisdiction's law, to make it clear that they are not eligible to participate in a conversion under subchapter E of chapter 9 or a merger or share exchange under chapter 11.

6. Principal Office

Section 1.40(17) defines the principal office of a corporation to be the office within or without the state, where the principal executive office of the corporation is located. Many corporations maintain numerous offices, but there is usually one office, sometimes colloquially referred to as the home office, headquarters, or executive suite, where the principal corporate officers are located. The corporation must designate its principal office address in the annual report required by section 16.21. In case of doubt as to which corporate office is the principal office, the designation by the corporation in its annual report should be accepted as establishing the principal office of the corporation.

6.1. PUBLIC CORPORATION

The term "public corporation" defined in section 1.40(18A) is used in sections 7.29, 7.32, 8.01, and 10.22 to distinguish publicly held corporations from other corporations. The definition establishes the distinction by reference to the existence of an organized trading market in the corporation's shares as an indication of broad share ownership. The reference to markets comes from the securities law governing regulation of securities trading markets.

7. Shareholder

The definition of "shareholder" in section 1.40(21) includes a beneficial owner of shares named in a nominee certificate under section 7.23, but only to the extent of the rights granted the beneficial owner in the certificate—for example, the right to receive notice of, and vote at, shareholders' meetings. Various substantive sections of the Model Act also permit holders of voting trust certificates or beneficial owners of shares (not subject to a nominee certificate under section 7.23) to exercise some of the rights of a "shareholder." See, for example, section 7.40 (derivative proceedings).

8. Secretary

The term "secretary" is defined in section 1.40(20) since the Model Act does not require the corporation to maintain any specific or titled officers. See section 8.40. However, some corporate officer, however titled, must perform the functions described in this definition, and that officer is referred to as the "secretary" in various sections of the Act that impose such a duty.

9. Sign

The definition of "sign" or "signature" includes manual, facsimile, conformed or electronic signatures. In this regard, it is intended that any manifestation of an intention to sign or authenticate a document will be accepted. Electronic signatures are expected to encompass any methodology approved by the secretary of state for purposes of verification of the authenticity of the document.

This could include a typewritten conformed signature or other electronic entry in the form of a computer data compilation of any characters or series of characters comprising a name intended to evidence authorization and signing of a document.

10. Person

The term "person" is defined in section 1.40(16) to include an individual or an entity. In the case of an individual the Model Act assumes that the person is competent to act in the matter under general state law independent of the corporation statute.

11. Voting Group

Section 1.40(26) defines "voting group" for purposes of the Act as a matter of convenient reference. A "voting group" consists of all shares of one or more classes or series that under the articles of incorporation or the revised Model Act are entitled to vote and be counted together collectively on a matter. Shares entitled to vote "generally" on a matter under the articles of incorporation or this Act are for that purpose a single voting group. The word "generally" signifies all shares entitled to vote on the matter by the articles of incorporation or this Act that do not expressly have the right to be counted or tabulated separately. "Voting groups" are thus the basic units of collective voting at a shareholders' meeting, and voting by voting groups may provide essential protection to one or more classes or series of shares against actions that are detrimental to the rights or interests of that class or series.

The determination of which shares form part of a single voting group must be made from the provisions of the articles of incorporation and of this Act. In a few instances under the Model Act, the board of directors may establish the right to vote by voting groups. On most matters coming before shareholders' meetings, only a single voting group, consisting of a class of voting or common shares, will be involved, and action on such a matter is effective when approved by that voting group pursuant to section 7.25. See section 7.26(a). If a second class of shares is also entitled to vote on the matter, then a further determination must be made as to whether that class is to vote as a separate voting group or whether it is to vote along with the other voting shares as part of a single voting group.

Members of the board of directors are usually elected by the single voting group of shares entitled to vote generally; in some circumstances, however, some members of the board may be selected by one voting group and other members by one or more different voting groups. See section 8.03.

The definition of a voting group permits the establishment by statute of quorum and voting requirements for a variety of matters considered at shareholders' meetings in corporations with multiple classes of shares. See sections 7.25 and 7.26. Depending on the circumstances, two classes or series of shares may vote together collectively on a matter as a single voting group, they may be entitled to vote on the matter separately as two voting groups, or one or both of them may not be entitled to vote on the matter at all.

12. Voting Power

Under section 1.40(27) the term "voting power" means the current power to vote in the election of directors. Application of this definition turns on whether the relevant shares carry the power to vote in the election of directors as of the time for voting on the relevant transaction. If shares carry the power to vote in the election of directors only under a certain contingency, as is often the case with preferred stock, the shares would not carry voting power within the meaning of section 1.40(27) unless the contingency has occurred, and only during the period when the voting rights are in effect. Shares that carry the power to vote for any directors as of the time to vote on the relevant transaction have the current power to vote in the election of directors within the meaning of section 1.40(27) even if the shares do not carry the power to vote for all directors.

§ 1.41. NOTICE

(a) Notice under this Act must be in writing unless oral notice is reasonable under the circumstances. Notice by electronic transmission is written notice.

(b) Notice may be communicated in person; by mail or other method of delivery; or by telephone, voice mail or other electronic means. If these forms of personal notice are impracticable, notice may be communicated by a newspaper of general circulation in the area where published, or by radio, television, or other form of public broadcast communication.

(c) Written notice by a domestic or foreign corporation to its shareholders, if in a comprehensible form, is effective (i) upon deposit in the United States mail, if mailed postpaid and correctly addressed to the shareholder's address shown in the corporation's current record of shareholders, or (ii) when electronically transmitted to the shareholder in a manner authorized by the shareholder.

(d) Written notice to a domestic or foreign corporation (authorized to transact business in this state) may be addressed to its registered agent at its registered office or to the secretary of the corporation at its principal office shown in its most recent annual report or, in the case of a foreign corporation that has not yet delivered an annual report, in its application for a certificate of authority.

(e) Except as provided in subsection (c), written notice, if in a comprehensible form, is effective at the earliest of the following:

(1) when received;

(2) five days after its deposit in the United States mail, if mailed postpaid and correctly addressed;

(3) on the date shown on the return receipt, if sent by registered or certified mail, return receipt requested, and the receipt is signed by or on behalf of the addressee.

(f) Oral notice is effective when communicated, if communicated in a comprehensible manner.

(g) If this Act prescribes notice requirements for particular circumstances, those requirements govern. If articles of incorporation or bylaws prescribe notice requirements, not inconsistent with this section or other provisions of this Act, those requirements govern.

CROSS-REFERENCES

Annual report, see § 16.21.
Application for certificate of authority, see § 15.03.
"Deliver," see § 1.40.
"Electronic transmission," see § 1.40.
"Householding," see § 1.44
"Principal office:"
  defined, see § 1.40.
  designated in annual report, see § 16.21.
Record of shareholders, see § 16.01.

Special notice requirements:
derivative proceedings, see § 7.40.
resignation of registered agent, see §§ 5.03 & 15.09.
service on corporation, see §§ 5.04 & 15.10.

OFFICIAL COMMENT

Section 1.41 establishes rules for determining how notice may be given and when notice is effective for a variety of purposes under the Model Act.

1. Notice by a Corporation to Its Shareholders

Section 1.41(c) provides that notice by a corporation to its shareholders is effective when mailed if correctly addressed with sufficient postage. The correct address for this purpose is the address shown in the corporation's shareholder records. Written notice includes notice by electronic transmission, but notice may be provided through electronic transmission only if specifically authorized by the shareholder. This allows corporations to provide notices by electronic means, but only when, and in the manner, authorized by the shareholder. Absent such authorization, notice must be provided to the shareholder in the traditional manner consistent with the other provisions of section 1.41.

Written notice to shareholders by persons other than the corporation is effective as provided in section 1.41(e). Notice by the corporation to its shareholders that is not addressed to the record address of the shareholder is effective when received under section 1.41(e).

2. Notice to the Corporation

Section 1.41(d) provides that notice to a corporation may be addressed to the registered agent of the corporation at its registered office or to the corporation or its secretary of the corporation at the principal office of the corporation as shown in its most recent public filing. An officer, director, or shareholder of a corporation will normally give written notice to the corporation by delivering or mailing a copy of that notice to the corporation or to the secretary of the corporation at its principal office. Such a notice is effective when it is received. Such notice may be given for a variety of purposes under this Act, e.g., giving notice of intent to dissent (section 13.21), notice of a demand to inspect books and records (section 16.02), and notices of resignation (sections 8.07 and 8.43). This method of giving notice to the corporation, however, is not exclusive, and an officer, director, or shareholder may give notice in other ways as well.

Persons who have no prior relationship with the corporation may give notice either to the registered agent of the corporation, or, if they wish, to the corporation or to the corporation's secretary at its principal office.

Section 1.41(d) provides that notice to a corporation may be addressed to the registered agent of the corporation at its registered office or to the secretary of the corporation at the principal office of the corporation as shown in its most recent public filing. An officer, director, or shareholder of a corporation will normally give written notice to the corporation by delivering or mailing a copy of that notice to the corporation or to the secretary of the corporation at its principal office. Such a notice is effective when it is received. Such notice may be given for a variety of purposes under this Act, e.g., giving notice of intent to assert appraisal rights (section 13.21), notice of a demand to inspect books and records (section 16.02), and notices of resignation (sections 8.07 and 8.43). This method of giving notice to the corporation, however, is not exclusive, and an officer, director, or shareholder may give notice in other ways as well.

Persons who have no prior relationship with the corporation may give notice either to the registered agent of the corporation or to the corporation's secretary at its principal office.

3. Miscellaneous Provisions

Section 1.41 also contains a variety of general provisions dealing with notice. It recognizes, for example, that notice on some occasions may be given orally if that is reasonable under the circumstances, which would include oral notice through voice mail or other similar means. It also deals with situations where notice may be sought to be given to persons for whom no current address is available, or where personal notice is impractical. Notice delivered to the person's last known address is effective as described in section 1.41(e) even though never actually received by the person. Section 1.41(b) also authorizes notice by publication in some circumstances, including radio, television, or other form of public wire or wireless communication.

Section 1.41(g) recognizes that other sections of the Act prescribe specific notice requirements for particular situations—e.g., service of process on a corporation's registered agent under section 5.04—and that these specific requirements, rather than the general requirements of section 1.41, control. Finally, the second sentence of subsection 1.41(g) permits a corporation's articles of incorporation or bylaws to prescribe the corporation's own notice requirements, if they are not inconsistent with the general requirements of this section or specific requirements of other sections of the Act.

The rules set forth in section 1.41 permit many other sections of the Model Act to be phrased simply in terms of giving or delivering notice without repeating details with respect to how notice should be given and when it is effective in various circumstances.

§ 1.42. NUMBER OF SHAREHOLDERS

(a) For purposes of this Act, the following identified as a shareholder in a corporation's current record of shareholders constitutes one shareholder:

(1) three or fewer co-owners;

(2) a corporation, partnership, trust, estate, or other entity;

(3) the trustees, guardians, custodians, or other fiduciaries of a single trust, estate, or account.

(b) For purposes of this Act, shareholdings registered in substantially similar names constitute one shareholder if it is reasonable to believe that the names represent the same person.

CROSS-REFERENCES

"Entity" defined, see § 1.40.
Exception to appraisal rights, see § 13.02. Record of shareholders, see §§ 7.20 & 16.01.
"Shareholder" defined, see § 1.40.
Shareholder proceeding for judicial dissolution, see § 14.30. Voting trusts, see § 7.30.

OFFICIAL COMMENT

Section 1.42 provides rules for determining the number of shareholders in a corporation. The Model Act generally avoids provisions that are based on the number of shareholders of a corporation, since these provisions may encourage individual shareholders to divide or combine their holdings for private strategic advantage. But the number of shareholders is important in determining: (i) whether the market out exception to appraisal rights is available under section 13.02(b)(2) and (ii) whether a shareholder may bring a proceeding for judicial dissolution under section 14.30(a) (2). The determination of the precise number of shareholders may also become important in other contexts in the future.

§ 1.43. QUALIFIED DIRECTOR

(a) A "qualified director" is a director who, at the time action is to be taken under:

(1) section 7.44, does not have (i) a material interest in the outcome of the proceeding, or (ii) a material relationship with a person who has such an interest;

(2) section 8.53 or 8.55, (i) is not a party to the proceeding, (ii) is not a director as to whom a transaction is a director's conflicting interest transaction or who sought a disclaimer of the corporation's interest in a business opportunity under section 8.70, which transaction or disclaimer is challenged in the proceeding, and (iii) does not have a material relationship with a director described in either clause (i) or clause (ii) of this subsection (a)(2);

(3) section 8.62, is not a director (i) as to whom the transaction is a director's conflicting interest transaction, or (ii) who has a material relationship with another director as to whom the transaction is a director's conflicting interest transaction; or

(4) section 8.70, would be a qualified director under subsection (a)(3) if the business opportunity were a director's conflicting interest transaction.

(b) For purposes of this section:

(1) "material relationship" means a familial, financial, professional, employment or other relationship that would reasonably be expected to impair the objectivity of the director's judgment when participating in the action to be taken; and

(2) "material interest" means an actual or potential benefit or detriment (other than one which would devolve on the corporation or the shareholders generally) that

would reasonably be expected to impair the objectivity of the director's judgment when participating in the action to be taken.

(c) The presence of one or more of the following circumstances shall not automatically prevent a director from being a qualified director:

(1) nomination or election of the director to the current board by any director who is not a qualified director with respect to the matter (or by any person that has a material relationship with that director), acting alone or participating with others;

(2) service as a director of another corporation of which a director who is not a qualified director with respect to the matter (or any individual who has a material relationship with that director), is or was also a director; or

(3) with respect to action to be taken under section 7.44, status as a named defendant, as a director against whom action is demanded, or as a director who approved the conduct being challenged.

CROSS-REFERENCES

Advance for expenses, see § 8.53.
Business opportunities, see § 8.70.
Determination and authorization for indemnification, see § 8.55.
Directors' action in director's conflicting interest transaction, see § 8.62.
Dismissal of derivative proceeding, see § 7.44.

OFFICIAL COMMENT

The definition of the term "qualified director" identifies those directors: (i) who may take action on the dismissal of a derivative proceeding (section 7.44); (ii) who are eligible to make, in the first instance, the authorization and determination required in connection with the decision on a request for advance for expenses (section 8.53(c)) or for indemnification (sections 8.55(b) and (c)); (iii) who may authorize a director's conflicting interest transaction (section 8.62); and (iv) who may disclaim the corporation's interest in a business opportunity (section 8.70(a)).

The judicial decisions that have examined the qualifications of directors for such purposes have generally required that directors be both disinterested, in the sense of not having exposure to an actual or potential benefit or detriment arising out of the action being taken (as opposed to an actual or potential benefit or detriment to the corporation or all shareholders generally), and independent, in the sense of having no personal or other relationship with an interested director (e.g., a director who is a party to a transaction with the corporation) that presents a reasonable likelihood that the director's objectivity will be impaired. The "qualified director" concept embraces both of those requirements, and its application is situation-specific; that is, "qualified director" determinations will depend upon the directly relevant facts and circumstances, and the disqualification of a director to act arises from factors that would reasonably be expected to impair the objectivity of the director's judgment. On the other hand, the concept does not suggest that a "qualified director" has or should have special expertise to act on the matter in question.

1. Disqualification Due to Conflicting Interest

The "qualified director" concept prescribes significant disqualifications, depending upon the purpose for which a director might be considered eligible to participate in the action to be taken. In each context in which the definition applies, it excludes directors who should not be considered disinterested:

- In the case of action on dismissal of a derivative proceeding under section 7.44, the definition excludes directors who have a material interest in the outcome of the proceeding, such as where the proceeding involves a challenge to the validity of a transaction in which the director has a material financial interest. As defined in subsection (b)(2), a "material interest" in the outcome of the proceeding involves an actual or potential benefit (other than one that would devolve on the corporation of the shareholders generally) that would arise from dismissal of the proceeding and would reasonably be expected to impair the objectivity of the director's judgment in acting on dismissal of the proceeding.

- In the case of action to approve indemnification or advance of funds for expenses, the definition excludes directors who are parties to the proceeding (see section 8.50(6) for the definition of "party" and section 8.50(7) for the definition of "proceeding"). It also excludes a director who is not a party to the proceeding but as to whom a transaction is a director's conflicting interest transaction or who sought a disclaimer of the corporation's interest in a business opportunity, where that transaction or disclaimer is challenged in the proceeding.

- In the case of action to approve a director's conflicting interest transaction, the definition excludes any director whose interest, knowledge or status results in the transaction being treated as a "director's conflicting interest transaction." See section 8.60(1) for the definition of "director's conflicting interest transaction."

- Finally, in the case of action under section 8.70(a) to disclaim corporate interest in a business opportunity, the definition excludes any director who would not be considered a "qualified director" if the business opportunity were a "director's conflicting interest transaction."

Whether a director has a material interest in the outcome of a proceeding in which the director does not have a conflicting personal interest is heavily fact-dependent. Such cases lie along a spectrum. At one end of the spectrum, if a claim against a director is clearly frivolous or is not supported by particularized and well-pleaded facts, the director should not be deemed to have a "material interest in the outcome of the proceeding" within the meaning of subsection (a) (1), even though the director is named as a defendant. At the other end of the spectrum, a director normally should be deemed to have a "material interest in the outcome of the proceeding" within the meaning of subsection (a) (1) if a claim against the director is supported by particularized and well-pleaded facts which, if true, would be likely to give rise to a significant adverse outcome against the director. Whether a director should be deemed to have a "material interest in the outcome of the proceeding" based on a claim that lies between these two ends of the spectrum will depend on the application of that test to the claim, given all the facts and circumstances.

2. Disqualification Due to Relationships with Interested Persons

In each context in which the "qualified director" definition applies, it also excludes a director who has a "material relationship" with another director who is not disinterested for one or more of the reasons outlined in the preceding paragraph. Any relationship with such a director, whether the relationship is familial, financial, professional, employment or otherwise, is a "material relationship," as that term is defined in subsection (b)(1), where it would reasonably be expected to impair the objectivity of the director's judgment when voting or otherwise participating in action to be taken on a matter referred to in subsection (a). The determination of whether there is a "material relationship" should be based on the practicalities of the situation rather than on formalistic considerations. For example, a director employed by a corporation controlled by another director should be regarded as having an employment relationship with that director. On the other hand, a casual social acquaintance with another director should not be regarded as a disqualifying relationship. See Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1050 (Del. 2004).

Although the term "qualified director" embraces the concept of independence, it does so only in relation to the director's interest or involvement in the specific situations to which the definition applies. Thus, the term "qualified director" is distinct from the generic term "independent director" used in section 8.01(c) of the Act to describe a director's general status. As a result, an "independent director" may in some circumstances not be a "qualified director," and vice versa. For example, in action being taken under section 8.70 concerning a business opportunity, an "independent" director who has a material interest in the business opportunity would not be a "qualified director" eligible to vote on the matter. Conversely, a director who does not have "independent" status may be a "qualified director" for purposes of voting on that action. See also the Official Comment to section 8.01(c).

3. Elimination of Automatic Disqualification in Certain Circumstances

- Subsection (c) of the definition of "qualified director" addresses three categories of circumstances that, if present alone or together, do not automatically prevent a director from being a qualified director.

- Subsection (c) (1) makes it clear that the participation of nonqualified directors (or interested shareholders or other interested persons) in the nomination or election of a director does not automatically prevent the director so nominated or elected from being qualified. Special litigation committees acting upon the dismissal of derivative litigation often consist of directors elected (after the alleged wrongful acts) by directors named as defendants in the action. In other settings, directors who are seeking indemnification, or who are interested in a director's conflicting interest transaction, may have participated in the nomination or election of an individual director who is otherwise a "qualified director."

- Subsection (c) (2) provides, in a similar fashion, that the mere fact that an individual director is or was a director of another corporation—on the board of which a director who is not a "qualified director" also serves or has served—does not automatically prevent qualification to act.

- Subsection (c)(3) confirms a number of decisions, involving dismissal of derivative proceedings, in which the court rejected a disqualification claim predicated on the mere fact that a director had been named as a defendant, was an individual against whom action has been demanded, or had approved the action being challenged. These cases have held that, where a director's approval of the challenged action is at issue, approval does not automatically make the director ineligible to act. See Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984); Lewis v. Graves, 701 F.2d 245 (2d Cir.1983). On the other hand, for example, director approval of a challenged transaction, in combination with other particularized facts showing that the director's ability to act objectively on a proposal to dismiss a derivative proceeding is impaired by a material conflicting personal interest in the transaction, disqualifies a director from acting on the proposal to dismiss the proceeding.

Where status as a qualified director is challenged in a litigation context, the court must assess the likelihood that an interest or relationship has impaired a director's objectivity, without the need for any presumption arising from the presence of one or more of the three specified circumstances. Thus, the effect of subsection (c) of the definition, while significant, is limited. It merely precludes an automatic inference of director disqualification from the circumstances specified in clauses (1), (2) and (3) of subsection (c).

§ 1.44. HOUSEHOLDING

(a) A corporation has delivered written notice or any other report or statement under this Act, the articles of incorporation or the bylaws to all shareholders who share a common address if:

(1) The corporation delivers one copy of the notice, report or statement to the common address;

(2) The corporation addresses the notice, report or statement to those shareholders either as a group or to each of those shareholders individually or to the shareholders in a form to which each of those shareholders has consented; and

(3) Each of those shareholders consents to delivery of a single copy of such notice, report or statement to the shareholders' common address. Any such consent shall be revocable by any of such shareholders who deliver written notice of revocation to the corporation. If such written notice of revocation is delivered, the corporation shall begin providing individual notices, reports or other statements to the revoking shareholder no later than 30 days after delivery of the written notice of revocation.

(b) Any shareholder who fails to object by written notice to the corporation, within 60 days of written notice by the corporation of its intention to send single copies of notices, reports or statements to shareholders who share a common address as permitted by subsection (a), shall be deemed to have consented to receiving such single copy at the common address.

CROSS-REFERENCES

“Electronic transmission” defined, see § 1.40.
Notice, see § 1.41.

OFFICIAL COMMENT

The proxy rules under the Securities Exchange Act of 1934 permit publicly held corporations to meet their obligation to deliver proxy statements and annual reports to shareholders who share a common address by delivery of a single copy of such materials to the common address under certain conditions. See 17 C.F.R. § 240. 14a-3(e). This practice is known as “householding.” This section permits a corporation comparable flexibility to household the written notice of shareholder meetings as well as any other written notices, reports or statements required to be delivered to shareholders under the Act, the corporation’s articles of incorporation or the corporation’s bylaws. Ability to household such notices, reports or statements would not, of course, eliminate the practical necessity of delivering to a common address sufficient copies of any accompanying document requiring individual shareholder signature or other action, such as a proxy card or consent.

In order to meet the conditions of subsection (a), the written notice, report or statement must be delivered to the common address. Address means a street address, a post office box number, an electronic mail address, a facsimile telephone number or another similar destination to which paper or electronic transmission may be sent. The written notice, report or statement must also be addressed to the shareholders who share that address either as a group (e.g., “ABC Corporation Shareholders,” “Jane Doe and Household,” or “the Smith Family”) or to each of the shareholders individually (e.g., “John Doe and Richard Jones”). Such shareholders must consent specifically to being addressed in any other way than as a group or individually. Finally, each shareholder at the common address must have consented to household delivery either affirmatively or implicitly by failure to object to the notice by the corporation permitted in subsection (b). Affirmative consent may be by any reasonable means of written or oral communication to the corporation or its agent. Implicit consent may only be given by means of the notice permitted in subsection (b).

Whether consent is explicit or implicit, it is revocable at any time by a shareholder by written notice delivered to the corporation. If such written notice of revocation is delivered, the corporation shall provide individual notices, reports or other statements to the revoking shareholder beginning no later than 30 days after delivery of the written revocation to the corporation.

In order to be effective, the written notice of intention to household notices, reports or other statements permitted by subsection (b) must explain that affirmative or implied consent may be revoked and the method for revoking.

CHAPTER 2

Incorporation

§ 2.01. INCORPORATORS

One or more persons may act as the incorporator or incorporators of a corporation by delivering articles of incorporation to the secretary of state for filing.

CROSS-REFERENCES

Articles of incorporation, see § 2.02.

"Deliver," see § 1.40.

Effective time and date of filing, see § 1.23.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

Organization of corporation by incorporators, see § 2.05.

"Person" defined, see § 1.40.

OFFICIAL COMMENT

The only functions of incorporators under the Model Act are (1) to sign the articles of incorporation, (2) to deliver them for filing with the secretary of state, and (3) to complete the formation of the corporation to the extent set forth in section 2.05. One or more "persons" may serve as incorporator; "person" is defined in section 1.40 and, together with the term "unincorporated entity," includes both individuals and entities; "entity" is also defined in that section to include corporations, unincorporated associations, limited liability companies, partnerships, trusts, estates, and governments.

The Model Act also simplifies the formalities of execution and filing. The requirement in earlier versions of the Model Act and in many state statutes that articles be acknowledged or verified has been eliminated. Also, the requirement that "duplicate originals" (each being executed as an original document) be submitted has been replaced with the requirement that a signed original and an "exact or conformed" copy be submitted. See the Official Comment to section 1.20.

§ 2.02. ARTICLES OF INCORPORATION

(a) The articles of incorporation must set forth:

(1) a corporate name for the corporation that satisfies the requirements of section 4.01;

(2) the number of shares the corporation is authorized to issue;

(3) the street address of the corporation's initial registered office and the name of its initial registered agent at that office; and

(4) the name and address of each incorporator.

(b) The articles of incorporation may set forth:

(1) the names and addresses of the individuals who are to serve as the initial directors;

(2) provisions not inconsistent with law regarding:

(i) the purpose or purposes for which the corporation is organized;

(ii) managing the business and regulating the affairs of the corporation;

(iii) defining, limiting, and regulating the powers of the corporation, its board of directors, and shareholders;

(iv) a par value for authorized shares or classes of shares;

(v) the imposition of personal liability on shareholders for the debts of the corporation to a specified extent and upon specified conditions;

(3) any provision that under this Act is required or permitted to be set forth in the bylaws;

(4) a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which the director is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33; or (D) an intentional violation of criminal law; and

(5) a provision permitting or making obligatory indemnification of a director for liability (as defined in section 8.50(5)) to any person for any action taken, or any failure to take any action, as a director, except liability for (A) receipt of a financial benefit to which the director is not entitled, (B) an intentional infliction of harm on the corporation or its shareholders, (C) a violation of section 8.33, or (D) an intentional violation of criminal law.

(c) The articles of incorporation need not set forth any of the corporate powers enumerated in this Act.

(d) Provisions of the articles of incorporation may be made dependent upon facts objectively ascertainable outside the articles of incorporation in accordance with section 1.20(k).

CROSS-REFERENCES

Amendment of articles, see ch. 10A.

Bylaws, see §§ 2.06, 2.07, ch. 10B.

Conflict of interest, see ch. 8F.

Duration of corporate existence, see § 3.02.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

Incorporators, see § 2.01.

Indemnification, see ch. 8E.

"Liability" defined, see § 8.50(5).

Liability of shareholders, see § 6.22.

Powers, see § 3.02.

Purposes, see § 3.01.

Restated articles, see § 10.07.

Share classes, see § 6.01.

OFFICIAL COMMENT

1. Introduction

Section 2.02(a) sets forth the minimum mandatory requirements for all articles of incorporation while section 2.02(b) describes optional provisions that may be included. A corporation that is formed solely pursuant to the mandatory requirements will generally have the broadest powers and least restrictions on activities permitted by the Model Act. The Model Act thus permits the creation of a "standard" corporation by a simple and easily prepared one-page document.

No reference is made in section 2.02(a) either to the period of duration of the corporation or to its purposes. A corporation formed under these provisions will automatically have perpetual duration under section 3.02(1) unless a special provision is included providing a shorter period. Similarly, a corporation formed without reference to a purpose clause will automatically have the purpose of engaging in any lawful business under section 3.01(a). The option of providing a narrower purpose clause is also preserved in sections 2.02(b)(2) and 3.01, with the effect described in the Official Comment to section 3.01.

2. Requirements

The only information required in the articles of incorporation to form a "standard" corporation is:

(1) The name, which must meet the requirements of chapter 4 of the Model Act.

(2) The number of shares the corporation is authorized to issue. If a single class of shares is authorized, only the number of shares authorized need be disclosed; if more than one class of shares is authorized, however, both the number of authorized shares of each class and a description of the rights of each class must be included. See the Official Comment to sections 6.01 and 6.02. It is unnecessary to specify par value, expected minimum capitalization, or contemplated issue price.

(3) The street address of the corporation's initial registered office and the name of its initial registered agent. A mailing address consisting only of a post office box is not sufficient.

(4) The name and address of each incorporator.

No reference need be made in these "standard" articles to a variety of other matters that are referred to in earlier versions of the Model Act and the statutes of many states. For example, there is no need to refer to preemptive rights. See section 6.30 and the Official Comment. Generally, no substantive effect should be given to the absence of a specific reference to such matters in section 2.02 since they are referred to in other sections of the Model Act which usually provide an "opt in" privilege that may be elected. See particularly the list of optional provisions set forth in parts 4 and 5 of this Comment.

3. Optional Provisions

Section 2.02(b) describes specific options that may be elected and contains general authorization to include other provisions relevant to the authority of the corporation, its officers and board of directors, or to the management of the corporation's internal affairs. These provisions include:

A. INITIAL DIRECTORS

Initial directors may be either the permanent directors or interim directors to be replaced by the shareholders after the corporation is organized.

B. PURPOSE CLAUSE

Under section 2.02(b)(2)(i), the corporation may elect a limited purpose clause or provide for specific purposes without limiting the broad purposes provided in section 3.01. (Specific purposes may be needed, among other reasons, for qualification in certain domestic and foreign jurisdictions and in order to obtain licenses.)

C. DURATION

Nearly every corporation today is formed with perpetual duration, but a corporation may elect a shorter duration under section 2 .02(b)(2)(iii).

D. PAR VALUE

While par value is no longer a mandatory statutory concept, section 2.02(b)(2)(iv) permits the inclusion of optional "par value" provisions with regard to shares. Special provisions may give effect or meaning to "par value" essentially as a matter of contract between the parties. These provisions, whether appearing in the articles or in other documents, have only the effect any permissible contractual provision has in the absence of a prohibition by statute. Provisions in the articles establishing an optional par value may also be of use to corporations which are to be qualified in foreign jurisdictions in that franchise or other taxes are computed upon the basis of par value.

For a general discussion of the treatment of par value, stated capital, and other historical concepts relating to capitalization, see the Official Comment to section 6.21.

E. SHAREHOLDER LIABILITY

The basic tenet of modern corporation law is that shareholders are not liable for the corporation's debts by reason of their status as shareholders. Section 2 .02(b)(2)(v) nevertheless permits a corporation to impose that liability under specified circumstances if that is desirable. If no provision of this type is included shareholders have no liability for corporate debts except to the extent they become liable by reason of their own conduct or acts. See section 6.22(b).

F. CORPORATE POWERS

Section 2.02(c) makes it unnecessary to set forth any corporate powers in the articles in view of the broad grant of power in section 3.02. This grant of power, however, may be considered overbroad for certain corporations; if so, it may be qualified or narrowed by appropriate provisions in the articles.

G. MISCELLANEOUS

Under section 2.02(b)(2)(ii) and (iii) the articles may include any provision not inconsistent with law for "managing the business and regulating the affairs of the corporation" and "defining, limiting, and regulating the powers of the corporation, its board of directors and shareholders." This language is designed to allow the articles to contain any number of miscellaneous provisions that the drafter thinks sufficiently important to be of public record or subject to amendment only by the processes applicable to amendments of articles of incorporation. Basically, the process of amendment of articles of incorporation requires shareholder approval, while bylaws typically may be amended by the board of directors acting alone, though in some instances the power of directors to amend bylaws is restricted. See sections 10.20-10.21 and the Official Comments to those sections. Provisions relating to the business or affairs of the corporation that may be included in the articles may be subdivided into four general classes:

(1) Provisions that under the Model Act may be elected only by specific inclusion in the articles of incorporation. A list of these provisions is set forth in part 4 of this Comment.

(2) Provisions that under the Model Act may be elected by specific inclusion in either the articles of incorporation or the bylaws, as listed in part 5 of this Comment.

(3) Other provisions not referred to in the Model Act. This includes but is not limited to any provision that the Act requires or permits to be set forth in the bylaws. See section 2.02(b)(3).

(4) Other provisions that are inconsistent with one or more provisions of the Act but are nonetheless permitted by section 7.32 for inclusion in a shareholders' agreement.

H. SELF-DEALING TRANSACTIONS

When subsidiaries or corporate joint ventures are being formed, special consideration should be given to the inclusion of provisions designed to limit or avoid the unexpected application of the doctrines of corporate opportunity and conflict of interest. While this type of clause will not provide total protection, it may be given limited effect, for example, by shifting the burden of proving unfairness or "exonerating" an arrangement from "adverse influences." See *Spiegel v. Beacon Participations Inc.*, 297 Mass. 398, 8 N.E.2d 895 (1937); see generally the Introductory Note and Official Comment to chapter 8F; see also section 8.70 and Official Comment regarding "business opportunities."

I. DIRECTOR LIABILITY

Section 2.02(b)(4) authorizes the inclusion of a provision in the articles of incorporation eliminating or limiting, with certain exceptions, the liability of the directors to the corporation or its shareholders for money damages. This grant of authority to the shareholders is consistent with the more general authorization of section 2.02(b)(2) for the articles to include a wide range of provisions regulating various matters affecting the corporation, including allocating power between the directors and the shareholders. Developments in the mid- and late 1980s highlighted the need to permit reasonable protection of directors from exposure to personal liability, in addition to indemnification, so that directors would not be discouraged from fully and freely carrying out their duties, including responsible entrepreneurial risk-taking. These developments included increased costs and reduced availability of director and officer liability insurance, the decision of the Delaware Supreme Court in *Smith v. Van Gorkom*, 488 A.2d 858 (1985), and the resulting reluctance of qualified individuals to serve as directors.

So long as any such liability-limitation provision does not extend to liability to third parties, shareholders should be permitted—except when important societal values are at stake—to decide how to allocate the economic risk of the directors' conduct between the corporation and the directors. Shareholders of one corporation may view the issue substantially differently than shareholders of another corporation. Accordingly, section 2.02(b)(4) is optional rather than self-executing. In addition, it follows the path of virtually all the states that have adopted charter option statutes and is applicable only to money damages and not to equitable relief. Likewise, nothing in section 2.02(b)(4) in any way affects the right of the shareholders to remove directors, under section 8.08(a), with or without cause.

The language "any action taken, or any failure to take any action, as a director" parallels section 8.30(d). It is recognized that in the case of individuals who are both directors and officers it will often not be clear in which capacity the individual is acting. The phrase "as a director" emphasizes that section 2.02(b)(4) applies to a director's actions or failures to take action in the director's capacity as a director and not in any other capacity, such as officer, employee, or controlling shareholder. However, it is not intended to exclude coverage of conduct by individuals, even though they are officers, when they are acting in their capacity as directors.

Because adoption of a liability-limitation provision is left to the decision of the shareholders, they are given considerable latitude in the extent to which they are permitted to limit directors' liability. Accordingly, the exceptions to the statute are few and narrow. As important as validating the shareholders' right to determine for themselves the extent of the directors' liability is stating the limits of this right in terms promoting a clear understanding of the conduct which is and which is not included in the limitation of liability. Terms such as "duty of loyalty," "good faith," "bad faith," and "recklessness" seem no more precise than (and therefore as potentially expansive as) "gross negligence." All of these formulations are characterizations of conduct rather than definitions of it. Characterizations by nature tend to be more elastic than definitions.

Directors should be afforded reasonable predictability; they are entitled to know whether a contemplated course of action will result in personal liability for money damages. Limits on their exculpation from liability are appropriate but should be expressed in terms that minimize the opportunity for after-the-fact second-guessing.

The language of the exceptions to section 2.02(b)(4) is intended to express the parameters of the shareholders' right to limit the directors' liability in terms that will promote predictability. First, some types of improper conduct are so clearly without any societal benefit that the law should not appear to endorse such conduct, especially in the case of a state-created entity such as a corporation. Second, any liability limitation will be prospective and, therefore, by definition, the shareholders will not be able to know in advance the exact nature or extent of any claims that they may be giving up. Third, the public has an interest in encouraging good corporate governance. While the exceptions to the shareholders' right to limit liability are few and narrow, they validate important standards of conduct. Finally, in many cases, there will be shareholders who do not vote in favor of the liability limitation. For these shareholders, there should be an irreducible core of protection, especially in view of the fact that in some cases the votes of the directors themselves as shareholders may be sufficient to approve adoption of the provision.

Financial Benefit

Permitting limitation of the liability of a director for receipt of a financial benefit to which the director is not entitled would validate conduct in which the director could realize a personal gain. Corporate law has long subjected transactions from which a director could benefit personally to special scrutiny. The exception is limited, however, to the amount of the benefit actually received. Thus, liability for punitive damages could be eliminated. However, punitive damages are not eliminated in either the exception for infliction of harm or for violation of criminal law and, thus, in a particular case (for example, theft), punitive damages may be available. The benefit must be financial rather than in less easily measurable and more conjectural forms, such as business goodwill, personal reputation, or social ingratiation. The phrase "received by a director' is not intended to be a "bright line." As a director's conduct moves toward the edge of what may be exculpated, he should bear the risk of miscalculation. Depending upon the circumstances, a director may be deemed to have received a benefit that the director caused to be directed to another person, for example, a relative, friend, or affiliate.

What constitutes a financial benefit "to which the director is not entitled' is left to judicial development. For example, a director is clearly entitled to reasonable compensation for the performance of services or to an increase in the value of stock or stock options held by him; just as clearly, a director is not entitled to a bribe, a kick-back, or the profits from a corporate opportunity improperly taken by the director.

Intentional Infliction of Harm

There may be situations in which a director intentionally causes harm to the corporation even though the director does not receive any improper benefit. The use of the word "intentional,' rather than a less precise term such as "knowing," is meant to refer to the specific intent to perform, or fail to perform, the acts with actual knowledge that the director's action, or failure to act, will cause harm, rather than a general intent to perform the acts which cause the harm. No public policy should permit the shareholders to eliminate or limit the liability of directors for conduct intended to cause harm to the corporation.

Unlawful Distributions

Section 8.33(a) indicates a strong policy in favor of liability for unlawful distributions approved by directors who have not complied with the standards of conduct of section 8.30. Many states have similar provisions, which originated, along with other legal capital statutes, out of a concern for creditors. Accordingly, the exception prohibits the shareholders from eliminating or limiting the liability of directors for a violation of section 8.33.

Intentional Violation of Criminal Law

Historically, the criminal law has represented society's statement of the conduct that it most emphatically rejects. Accordingly, even though a director committing a crime may intend to benefit the corporation, the shareholders should not be permitted to exculpate the director for any harm caused by the crime, including, for example, fines and legal expenses of the corporation in defending a criminal prosecution. The use of the word "intentional," rather than a less precise term such as "knowing," is meant to refer to the specific intent to perform, or fail to perform, the acts with actual knowledge that the director's action, or failure to act, constitutes a violation of criminal law.

In order to recover for conduct included within any of the exceptions, the plaintiff will continue to be required to establish causation, damages, and other elements imposed by applicable law.

An amendment authorized by section 2.02(b)(4) will become effective in the manner provided by section 1.23 generally for amendments to the articles of incorporation. In addition, in accordance with section 10.09, an amendment under section 2.02(b)(4) will not affect a cause of action existing in favor of the corporation against any directors at the effective time of the amendment.

J. INDEMNIFICATION

Section 2.02(b)(5) permits a corporation to include in its articles of incorporation a provision authorizing permissible or mandatory indemnification of a director in accordance with section 8.51(a)(2). Section 2.02(b)(5) specifically excepts liability arising out of improper financial benefit received by a director, an intentional infliction of harm on the corporation or the shareholders, an unlawful distribution or an intentional violation of criminal law. These excepted liabilities parallel those a corporation is not permitted to limit or eliminate under section 2.02(b)(4). See "Director Liability,' above. Officers are not included in the language of section 2.02(b)(5) because, as provided in section 8.56, mandatory indemnification of officers does not require a provision in the articles of incorporation.

4. Options in Model Act That May Be Elected Only in the Articles of Incorporation

A. OPTIONS WITH RESPECT TO DIRECTORS

(1) Board of directors may be dispensed with entirely in limited circumstances or its functions may be restricted, §§ 7.32, 8.01.

(2) Power to compensate directors may be restricted or eliminated, § 8.11.

(3) Election of directors by cumulative voting may be authorized, § 7.28.

(4) Election of directors by greater than plurality of vote may be authorized, § 7.28.

(5) Directors may be elected by classes of shares, § 8.04.

(6) Director's term may be limited by failure to receive specified vote for election, § 8.05.

(7) Power to remove directors without cause may be restricted or eliminated, § 8.08.

(8) Terms of directors may be staggered so that all directors are not elected in the same year, § 8.06.

(9) Power to fill vacancies may be limited to the shareholders, § 8.10.

(10) Power to indemnify directors, officers, and employees may be limited, §§ 8.50-8.59.

(11) Prohibition on adoption of bylaw provision under § 10.22.

B. OPTIONS WITH RESPECT TO SHAREHOLDERS

(1) Action without a meeting, § 7.04.

(2) Special voting groups of shareholders may be authorized, § 7.25.

(3) Quorum for voting groups of shareholders may be increased or reduced, §§ 7.25, 7.26, and 7.27.

(4) Quorum for voting by voting groups of shareholders may be prescribed, see § 7.26.

(5) Greater than majority vote may be required for action by voting groups of shareholders, § 7.27.

C. OPTIONS WITH RESPECT TO SHARES

(1) Shares may be divided into classes and classes into series, §§ 6.01 and 6.02.

(2) Cumulative voting for directors may be permitted, § 7.28.

(3) Distributions may be restricted, § 6.40.

(4) Share dividends may be restricted, § 6.23.

(5) Voting rights of classes of shares may be limited or denied, § 6.01.

(6) Classes of shares may be given more or less than one vote per share, § 7.21.

(7) Terms of a class may vary among holders of the same class, so long as such variations are expressly set forth in the articles, § 6.01(e).

(8) The board may allocate authorized but unissued shares of a class to another class or series without shareholder approval, § 6.02.

(9) Shares may be redeemed at the option of the corporation or the shareholder, § 6.01.

(10) Reissue of redeemed shares may be prohibited, § 6.31.

(11) Shareholders may be given preemptive rights to acquire unissued shares, § 6.30.

(12) Redemption preferences may be ignored in determining lawfulness of distributions, § 6.40.

5. *Options in Model Act That May Be Elected Either in the Articles of Incorporation or in the Bylaws*

A. OPTIONS WITH RESPECT TO DIRECTORS

(1) Number of directors may be fixed or changed within limits, § 8.03.

(2) Qualifications for directors may be prescribed, § 8.02.

(3) Notice of regular or special meetings of board of directors may be prescribed, § 8.22.

(4) Power of board of directors to act without meeting may be restricted, § 8.21.

(5) Quorum for meeting of board of directors may be increased or decreased (down to ⅓) from majority, § 8.24.

(6) Action at meeting of board of directors may require a greater than majority vote, § 8.24.

(7) Power of directors to participate in meeting without being physically present may be prohibited, § 8.20.

(8) Board of directors may create committees and specify their powers, § 8.25.

(9) Power of board of directors to amend bylaws may be restricted, §§ 10.20 and 10.21.

(10) Term of director receiving more no than yes votes in election limited to 90 days, § 10.22.

B. OPTIONS WITH RESPECT TO SHARES

(1) Shares may be issued without certificates, § 6.26.

(2) Procedure for treating beneficial owner of street name shares as record owner may be prescribed, § 7.23.

(3) Transfer of shares may be restricted, § 6.27.

§ 2.03. INCORPORATION

(a) Unless a delayed effective date is specified, the corporate existence begins when the articles of incorporation are filed.

(b) The secretary of state's filing of the articles of incorporation is conclusive proof that the incorporators satisfied all conditions precedent to incorporation except in a proceeding by the state to cancel or revoke the incorporation or involuntarily dissolve the corporation.

CROSS-REFERENCES

Corporations de facto, see § 2.04.

Dissolution, see ch. 14.

Duration, see § 3.02.

Effective time and date of filing, see § 1.23.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

Secretary of state's filing duty, see § 1.25.

OFFICIAL COMMENT

Section 2.03(a) provides that the existence of a corporation begins when the articles of incorporation are filed, unless a delayed effective date is specified under section 1.23. Chapter 1 contains detailed rules for the filing and effective dates of documents, all of which are applicable to articles of incorporation and other documents. These filing rules simplify the process of creating a corporation in several respects.

1. What to File

Section 1.20 requires that only one signed original and an exact or conformed copy of the articles need be delivered to the secretary of state for filing. This delivery must be accompanied by the applicable filing fee.

2. Nature of Filing

Section 1.25 provides that the secretary of state files the articles by stamping them "filed" and recording the date and time of receipt retaining the signed original articles of incorporation and returning the exact or conformed copy to the incorporators along with a receipt for the fee. The return of this copy and the fee receipt establishes that the articles have been filed in the form of the copy.

3. Certificate of Incorporation Eliminated

Section 1.25 provides that approval by the secretary of state is in the form of return of the copy of the articles with a fee receipt rather than a certificate of incorporation, as was the older practice still followed in many states. See the Official Comment to section 1.25.

4. Precise Time of Incorporation

Section 2.03(a) ties the precise time of incorporation to the date and time stamped on the articles. Section 1.23 provides in turn that this is the date and time the articles are received by the secretary of state; in other words, consistent with the practice of many secretaries of state, processing time is ignored and the date and time of receipt of the articles are the date and time of incorporation. The creators of the corporation may, however, specify that the corporation's existence will begin on a later date than the date of filing, and at a precise time on such a date, to the extent permitted by section 1.23.

5. Conclusiveness of Secretary of State's Action on Question of Individual Liability for Corporate Actions

Under section 2.03(b) the filing of the articles of incorporation as evidenced by return of the stamped copy of the articles with the fee receipt is conclusive proof that all conditions precedent to incorporation have been met, except in proceedings brought by the state. Thus the filing of the articles of incorporation is conclusive as to the existence of limited liability for persons who enter into transactions on behalf of the corporation. If articles of incorporation have not been filed, section 2.04 generally imposes personal liability on all persons who prematurely act as or on behalf of a "corporation" knowing that articles have not been filed. Section 2.04 may protect some of these persons to a limited extent, however; see the Official Comment to that section.

§ 2.04. LIABILITY FOR PREINCORPORATION TRANSACTIONS

All persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this Act, are jointly and severally liable for all liabilities created while so acting.

CROSS-REFERENCES

Incorporation, see § 2.03.

"Person" defined, see § 1.40.

OFFICIAL COMMENT

Earlier versions of the Model Act, and the statutes of many states, have long provided that corporate existence begins only with the acceptance of articles of incorporation by the secretary of state. Many states also have statutes that provide expressly that those who prematurely act as or on behalf of a corporation are personally liable on all transactions entered into or liabilities incurred before incorporation. A review of recent case law indicates, however, that even in states with such statutes courts have continued to rely on common law concepts of de facto corporations, de jure corporations, and corporations by estoppel that provide uncertain protection against liability for preincorporation transactions. These cases caused a review of the underlying policies represented in earlier versions of the Model Act and the adoption of a slightly more flexible or relaxed standard.

Incorporation under modern statutes is so simple and inexpensive that a strong argument may be made that nothing short of filing articles of incorporation should create the privilege of limited liability. A number of situations have arisen, however, in which the protection of limited liability arguably should be recognized even though the simple incorporation process established by modern statutes has not been completed.

(1) The strongest factual pattern for immunizing participants from personal liability occurs in cases in which the participant honestly and reasonably but erroneously believed the articles had been filed. In *Cranson v. International Business Machines Corp.*, 234 Md. 477, 200 A.2d 33 (1964), for example, the defendant had been shown executed articles of incorporation some months earlier before investing in the corporation and becoming an officer and director. The defendant was also told by the corporation's attorney that the articles had been filed, but in fact they had not been filed because of a mix-up in the attorney's office. The defendant was held not liable on the "corporate" obligation.

(2) Another class of cases, which is less compelling but in which the participants sometimes have escaped personal liability, involves the defendant who mails in articles of incorporation and then enters into a transaction in the corporate name; the letter is either delayed or the secretary of state's office refuses to file the articles after receiving them or returns them for correction. E.g., *Cantor v. Sunshine Greenery, Inc.*, 165 N.J. Super. 411, 398 A.2d 571 (1979). Many state filing agencies adopt the practice of treating the date of receipt as the date of issuance of the certificate even though delays and the review process may result in the certificate being backdated. The finding of nonliability in cases of this second type can be considered an extension of this principle by treating the date of original mailing or original filing as the date of incorporation.

(3) A third class of cases in which the participants sometimes have escaped personal liability involves situations where the third person has urged immediate execution of the contract in the corporate name even though knowing that the other party has not taken any steps toward incorporating. E.g., *Quaker Hill, Inc. v. Parr*, 148 Colo. 45, 364 P.2d 1056 (1961).

(4) In another class of cases the defendant has represented that a corporation exists and entered into a contract in the corporate name when the defendant knows that no corporation has been formed, either because no attempt has been made to file articles of incorporation or because he has already received rejected articles of incorporation from the filing agency. In these cases, the third person has dealt solely with the "corporation" and has not relied on the personal assets of the defendant. The imposition of personal liability in this class of case, it has sometimes been argued, gives the plaintiff more than originally bargained for. On the other hand, to recognize limited liability in this situation threatens to undermine the incorporation process, since one then may obtain limited liability by consistently conducting business in the corporate name. Most courts have imposed personal liability in this situation. E.g., *Robertson v. Levy*, 197 A.2d 443 (D.C. App. 1964).

(5) A final class of cases involves inactive investors who provide funds to a promoter with the instruction, "Don't start doing business until you incorporate." After the promoter does start business without incorporating, attempts have been made, sometimes unsuccessfully, to hold the investors liable as partners. E.g., *Frontier Refining Co. v. Kunkels, Inc.*, 407 P.2d 880 (Wyo. 1965). One case held that the language of section 146 of the 1969 Model Act ["persons who assume to act as a corporation are liable for preincorporation transactions"] creates a distinction between active and inactive participants, makes only the former liable as partners, and therefore relieves the latter of personal liability. Nevertheless, "active" participation was defined to include all investors who actively participate in the policy and operational decisions of the organization and is, therefore, a larger group than merely the persons who incurred the obligation in question on behalf of the "corporation." *Timberline Equipment Co. v. Davenport*, 267 Or. 64, 72–76, 514 P.2d 1109, 1113-14 (1973).

After a review of these situations, it seemed appropriate to impose liability only on persons who act as or on behalf of corporations "knowing" that no corporation exists. Analogous protection has long been accorded under the uniform limited partnership acts to limited partners who contribute capital to a partnership in the erroneous belief that a limited partnership certificate has been filed. Uniform Limited Partnership Act § 12 (1916); Revised Uniform Limited Partnership Act § 3.04 (1976). Persons protected under § 3.04 of the latter are persons who "erroneously but in good faith" believe that a limited partnership certificate has been filed. The language of section 2.04 has essentially the same meaning.

While no special provision is made in section 2.04, the section does not foreclose the possibility that persons who urge defendants to execute contracts in the corporate name knowing that no steps to incorporate have been taken may be estopped to impose personal liability on individual defendants. This estoppel may be based on the inequity perceived when persons, unwilling or reluctant to enter into a commitment under their own name, are persuaded to use the name of a nonexistent corporation, and then are sought to be held personally liable under section 2.04 by the party advocating that form of execution. By contrast, persons who knowingly participate in a business under a corporate name are jointly and severally liable on "corporate" obligations under section 2.04 and may not argue that plaintiffs are "estopped" from holding them personally liable because all transactions were conducted on a corporate basis.

§ 2.05. ORGANIZATION OF CORPORATION

(a) After incorporation:

(1) if initial directors are named in the articles of incorporation, the initial directors shall hold an organizational meeting, at the call of a majority of the directors, to complete the organization of the corporation by appointing officers, adopting bylaws, and carrying on any other business brought before the meeting;

(2) if initial directors are not named in the articles, the incorporator or incorporators shall hold an organizational meeting at the call of a majority of the incorporators:

(i) to elect directors and complete the organization of the corporation; or

(ii) to elect a board of directors who shall complete the organization of the corporation.

(b) Action required or permitted by this Act to be taken by incorporators at an organizational meeting may be taken without a meeting if the action taken is evidenced by one or more written consents describing the action taken and signed by each incorporator.

(c) An organizational meeting may be held in or out of this state.

CROSS-REFERENCES

Articles of incorporation, see § 2.02.

Bylaws, see §§ 2.06 & 2.07.

Director action without meeting, see § 8.21.

Incorporators, see § 2.01.

OFFICIAL COMMENT

Following incorporation, the organization of a new corporation must be completed so that it may engage in business. This usually requires adoption of bylaws, the appointment of officers and agents, the raising of equity capital by the issuance of shares to the participants in the venture, and the election of directors.

Earlier versions of the Model Act required initial directors to be named in the articles and provided that they complete the organization of the corporation. Many states followed this pattern, but others provided that the incorporators organize the corporation or meet to elect a board of directors to organize the corporation. The goal of all these provisions was usually to permit the completion of the organization of the corporation with minimum expense and formality, though in many cases it was felt necessary for business decisions to be made at an early stage by the persons with responsibility for business operation.

Experience in states that followed the Model Act pattern revealed that multiple organizational meetings were often necessary, particularly where for reasons of convenience or secrecy both the incorporators and initial directors were “dummies” without any financial interest in the enterprise who were not expected to make any significant business decisions. In this situation, the initial directors formally organized the corporation, including issuing of at least some shares; immediately following this organizational meeting, the new shareholders met to elect a permanent board of directors who were to manage the business. In many instances, the permanent board of directors also had to meet immediately after its selection by the shareholders to consider business questions that must be resolved promptly, such as authorization of employment contracts or the valuation of property or services to be accepted as consideration for shares.

Section 2.05 simplifies the formation process by allowing alternative methods of completing the formation of the corporation.

First, section 2.05(a)(1) contemplates that if the names of the initial directors are set forth in the articles of incorporation, the persons so named will organize the corporation. It is expected that initial directors will be named only if they will be the permanent board of directors and there is no objection to the disclosure of their identity in the articles of incorporation.

Second, section 2.05(a)(2) provides alternative methods for completing the organization of the corporation if initial directors are not named in the articles of incorporation. The incorporators may themselves complete the organization, or they may simply meet to elect a board of directors who are then to complete the organization. It is contemplated that in routine incorporations, the first alternative will be elected, while in more complex situations when prompt business decisions must be made, the second alternative will be chosen and the completion of the organization will be turned over to the board of directors representing the investment interests in the corporation.

Sections 2.05(b) and (c) are limited to meetings of incorporators since sections 8.21 and 8.22 permit the same actions by the board of directors. If a meeting of shareholders is necessary, sections 7.01 and 7.04 give them the same flexibility that is given incorporators under sections 2.05(b) and (c).

§ 2.06. BYLAWS

(a) The incorporators or board of directors of a corporation shall adopt initial bylaws for the corporation.

(b) The bylaws of a corporation may contain any provision for managing the business and regulating the affairs of the corporation that is not inconsistent with law or the articles of incorporation.

CROSS-REFERENCES

Amendment, see §§ 10.20, 10.21, 10.22.

Directors:

action without meeting, see § 8.21.

committees, see § 8.25.

election by shareholders, see §§ 7.04, 7.28, 10.22.

emergency bylaws, see § 2.07.

majority vote at meeting, see § 8.24.

nominee registration of shares, see § 7.23.

notice of meeting, see § 8.22.

number, see § 8.03.

participation in meeting, see § 8.20.

qualifications, see § 8.02.

quorum for meeting, see § 8.24.

supermajority vote at meeting, see § 8.24.

Officers:

appointment, see § 8.40.

functions, see § 8.41.

Organizing corporation, see § 2.05.

Record date, see § 7.07.

Share transfer restrictions, see § 6.27.

Shareholders' meeting notice, see § 7.05.

Shareholders' meetings, see §§ 7.01 & 7.02.

Shares without certificates, see § 6.26.

Subscriptions, see § 6.20.

Supermajority vote at shareholders' meeting, see § 7.27.

OFFICIAL COMMENT

The responsibility for adopting the original bylaws is placed on the person or persons completing the organization of the corporation. Section 2.06(b) restates the accepted scope of bylaw provisions. For a list of Model Act provisions that become effective only if specific reference is made to them in the bylaws, see the Official Comment to section 2.02. Provisions set forth in bylaws may additionally be contained in shareholder or board resolutions unless this Act requires them to be set forth in the bylaws.

The power to amend or repeal bylaws, or adopt new bylaws after the formation of the corporation is completed, is addressed in sections 10.20, 10.21, and 10.22 of the Model Act.

§ 2.07. EMERGENCY BYLAWS

(a) Unless the articles of incorporation provide otherwise, the board of directors of a corporation may adopt bylaws to be effective only in an emergency defined in subsection (d). The emergency bylaws, which are subject to amendment or repeal by the shareholders, may make all provisions necessary for managing the corporation during the emergency, including:

(1) procedures for calling a meeting of the board of directors;

(2) quorum requirements for the meeting; and

(3) designation of additional or substitute directors.

(b) All provisions of the regular bylaws consistent with the emergency bylaws remain effective during the emergency. The emergency bylaws are not effective after the emergency ends.

(c) Corporate action taken in good faith in accordance with the emergency bylaws:

(1) binds the corporation; and

(2) may not be used to impose liability on a corporate director, officer, employee, or agent.

(d) An emergency exists for purposes of this section if a quorum of the corporation's directors cannot readily be assembled because of some catastrophic event.

CROSS-REFERENCES

Amendment of bylaws, see §§ 10.20, 10.21.

Bylaws generally, see § 2.06.

Emergency powers without bylaw provision, see § 3.03.

OFFICIAL COMMENT

Section 2.07 is no longer an optional provision (as was the case with its predecessor in earlier versions of the Model Act) but is unqualifiedly recommended for adoption. The problem it addresses is potentially present in every state and in every corporation and the widespread acceptance of the earlier provision to date by a number of states argues that it be uniformly adopted.

The adoption of emergency bylaws in advance of an emergency not only clarifies lines of command and responsibility but also tends to ensure continuity of responsibility. The board of directors may be authorized by the emergency bylaws, for example, to designate the officers or other persons, in order of seniority and subject to various conditions, who may be deemed to be directors during the emergency.

The definition of "emergency" adopted by subsection (d) is broader than a nuclear disaster or attack on the United States. It includes any catastrophic event, such as an airplane crash or fire that makes it difficult or impossible for a quorum of the corporation's board of directors to be assembled. While there apparently has been no recent illustration of a public corporation facing such a catastrophic event, its possibility should not be ignored. In order to encourage corporations to adopt emergency bylaws, section 2.07(c) broadly validates all corporate actions taken "in good faith" pursuant to them and immunizes all corporate directors, officers, employees, and agents from liability as a result of these actions. The phrase "action taken in good faith in accordance with the emergency bylaws" has been substituted for "willful misconduct," the language of the earlier Model Act provision. This change is designed to conform the standard for immunity here and elsewhere in the Model Act and represents no substantive change.

A corporation that does not adopt emergency bylaws under this section may nevertheless exercise the powers described in section 3.03 in the event of an emergency as defined in section 2.07(d).

CHAPTER 3

Purposes and Powers

§ 3.01. PURPOSES

(a) Every corporation incorporated under this Act has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation.

(b) A corporation engaging in a business that is subject to regulation under another statute of this state may incorporate under this Act only if permitted by, and subject to all limitations of, the other statute.

CROSS-REFERENCES

Foreign corporations, see § 15.05.

Statement of purpose in articles, see § 2.02.

OFFICIAL COMMENT

Section 3.01(a) provides that every corporation automatically has the purpose of engaging in any lawful business unless a narrower purpose is described in the articles of incorporation. The specification of an "any lawful business" clause has become so nearly universal in states that permit the clause that no reason exists for treating it otherwise than as the norm for the "standard" corporation.

The option of a narrower purpose clause is most likely to be elected only in situations where one or more participants in the corporation desire to limit or retain a check on the business operations of the corporation. The articles of incorporation may limit lines of business in which the corporation may engage. It should be recognized, however, that the limited scope of the ultra vires concept in litigation between the corporation and outsiders means that a third person entering into a transaction that violates the restrictions in the purpose clause may be able to enforce the transaction in accordance with its terms if the third person was unaware of the narrow purpose clause when entering into the transaction. See the Official Comment to section 3.04.

Many corporations may also find it desirable to supplement a general purpose clause with an additional statement of business purposes. This may be necessary for licensing or for qualification purposes in some states.

Section 3.01(b) is designed to tie in the limitless lawful purpose corporation permitted by section 3.01(a) with the numerous state statutes that impose regulations or limitations on corporations formed to, or actually engaging in, certain lines of business. These state statutes are of various types.

a. Special incorporation statutes

Some of these statutes, particularly those relating to banking and insurance, establish a separate incorporation process and incorporating agency. These special incorporating states may refer back to or incorporate by reference portions of the general business corporation statute.

b. Miscellaneous regulatory statutes

Other regulatory statutes may permit incorporation under the general business corporation act if the corporation imposes restrictions or limitations in its articles of incorporation; these restrictions may relate to the business in which the corporation may engage, its manner of internal governance, or the persons who may or may not be shareholders and participate in the venture. The language of section 3.01(b) is designed to cover all these multiple variations and is a substitute for the narrower language "except for the purpose of banking or insurance" that appeared in earlier versions of the Model Act and the statutes of many states.

c. Professional corporations

Traditionally, incorporation was not permitted at all for the purpose of practicing the learned professions—e.g., law, medicine, and dentistry—primarily because of the personal skills and confidential relationships between lawyer and client or physician and patient. In the early 1960s, however, a significant movement toward incorporation of professionals surfaced as part of an effort by professionals to obtain employee federal tax benefits. Professionals hoped to form corporations to conduct their practice as employees of the corporation rather than as independent entrepreneurs. Early efforts by professionals to form entities to conduct their practice (despite the lack of state statutory authority to incorporate) met with opposition from the Internal Revenue Service. In 1960 the I.R.S. issued the "Kintner" regulations, which in effect provided that federal tax status would be determined on the basis of the organization's characterization under state law. TREAS. REGS. § 301.7701-2 (1960). In response, a number of states passed legislation specifically authorizing professionals to incorporate. Recognition of the corporate tax status of professional corporations was eventually conceded. REV. RUL. 70-101, 1970-1 C.B. 278. All jurisdictions now have statutes providing for incorporation for the purpose of practicing a profession.

d. Miscellaneous organizations

Other types of corporations, such as nonprofit corporations, cooperatives, and unions, usually may not incorporate under the business corporation act. Many states have enacted special statutes for these classes of entities: a Model Nonprofit Corporation Act was approved in 1952 and has been periodically revised since then.

Section 3.01(b) is designed to preserve all statutory requirements applicable to all of these various classes of specialized and nonbusiness corporations.

§ 3.02. GENERAL POWERS

Unless its articles of incorporation provide otherwise, every corporation has perpetual duration and succession in its corporate name and has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs, including without limitation power:

(1) to sue and be sued, complain and defend in its corporate name;

(2) to have a corporate seal, which may be altered at will, and to use it, or a facsimile of it, by impressing or affixing it or in any other manner reproducing it;

(3) to make and amend bylaws, not inconsistent with its articles of incorporation or with the laws of this state, for managing the business and regulating the affairs of the corporation;

(4) to purchase, receive, lease, or otherwise acquire, and own, hold, improve, use, and otherwise deal with, real or personal property, or any legal or equitable interest in property, wherever located;

(5) to sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of all or any part of its property;

(6) to purchase, receive, subscribe for, or otherwise acquire; own, hold, vote, use, sell, mortgage, lend, pledge, or otherwise dispose of; and deal in and with shares or other interests in, or obligations of, any other entity;

(7) to make contracts and guarantees, incur liabilities, borrow money, issue its notes, bonds, and other obligations (which may be convertible into or include the option to purchase other securities of the corporation), and secure any of its obligations by mortgage or pledge of any of its property, franchises, or income;

(8) to lend money, invest and reinvest its funds, and receive and hold real and personal property as security for repayment;

(9) to be a promoter, partner, member, associate, or manager of any partnership, joint venture, trust, or other entity;

(10) to conduct its business, locate offices, and exercise the powers granted by this Act within or without this state;

(11) to elect directors and appoint officers, employees, and agents of the corporation, define their duties, fix their compensation, and lend them money and credit;

(12) to pay pensions and establish pension plans, pension trusts, profit sharing plans, share bonus plans, share option plans, and benefit or incentive plans for any or all of its current or former directors, officers, employees, and agents;

(13) to make donations for the public welfare or for charitable, scientific, or educational purposes;

(14) to transact any lawful business that will aid governmental policy;

(15) to make payments or donations, or do any other act, not inconsistent with law, that furthers the business and affairs of the corporation.

CROSS-REFERENCES

Bylaws, see §§ 2.06, 2.07, 10.20, 10.22.

Compensation of directors, see § 8.11.

Disposition of assets, see ch. 12.

“Employee” defined, see § 1.40.

“Entity” defined, see § 1.40.

Foreign corporations, see § 15.05.

Indemnification, see ch. 8E.

“State” defined, see § 1.40.

Ultra vires, see § 3.04.

OFFICIAL COMMENT

The law of corporations has always proceeded on the fundamental assumption that corporations are creations with limited power; such an assumption was articulated by the U.S. Supreme Court as early as 1804, *Head & Armory v. Providence Insurance Co.*, 6 U.S. (2 Cranch) 127, 169 (1804), and appears never to have been seriously questioned as a judicial matter.

It is clear that narrow and limited powers clauses are undesirable: they encourage litigation by bringing into question reasonable transactions that further the business and interests of the corporation and to the extent transactions are unauthorized, may defeat valid and reasonable expectations. The history of the Model Act and of many state statutes in this area is largely one ensuring that corporate powers are broad enough to cover all reasonable business transactions.

In developing section 3.02, serious consideration was given to whether there was a continued need for a long list of corporate powers or whether a general provision granting every corporation power to act to the same extent as an individual might be substituted. Because of the long history of these powers, however, it was feared that no matter how broadly phrased a general provision might be, a court might conclude that some power might not exist because no specific reference to it was made in the statute. It was also feared that cautious attorneys might begin to restore power clauses to articles of incorporation out of concern that a general clause of the type in question might not be interpreted literally. Hence, the present language, which is similar to that included in the statutes of California and other states, was adopted. The general clause granting the corporation essentially the same powers as an individual is coupled with a nonexclusive listing of powers, including the traditional power clauses that appear in many state statutes.

The general philosophy of section 3.02 is thus that corporations formed under the Model Act provisions should be automatically authorized to engage in all acts and have all powers that an individual may have. Because broad grants of power of this nature may not be desired in some corporations, section 3.02 generally authorizes articles of incorporation to deny or limit specific powers to a specific corporation if that is felt desirable. This power to exclude specific powers does not reflect a substantive change from earlier versions of the Model Act (which did not contain an express provision to this effect) but simply makes explicit what was always implicit. Illustrative of the powers that may be appropriate for limitation in specific corporations are the powers (discussed below) to make political contributions to the extent permitted by law or to make expenditures to influence elections affecting the corporate business to the extent permitted by law.

The powers listed in section 3.02 were broadened in several significant respects:

(1) All limitations on loans to directors have been eliminated. The wisdom and propriety of these loans should be evaluated on the basis of general fiduciary standards and the benefits to the corporation. See sections 8.30, 8.31, and 8.32. Section 3.02(11) thus rejects the conceptual argument that because certain transactions are subject to abuse, all such transactions should be prohibited.

(2) It is made clear in section 3.02(12) that former as well as present directors, officers, employees, and agents may participate in pension, option, and similar benefit plans.

(3) Section 3.02(15) permits payments, donations, or other acts "that further[] the business and affairs of the corporation." This clause, which is in addition to and independent of the power to make charitable and similar donations under section 3.02(13), permits contributions for purposes that may not be charitable, such as for political purposes or to influence elections. This power exists only to the extent consistent with law other than the Model Act. It is the purpose of this section to authorize all corporate actions that are lawful or not against public policy.

The powers of a corporation under the Model Act exist independently of whether a corporation has a broad or narrow purpose clause. A corporation with a narrow purpose clause nevertheless has the same powers as an individual to do all things necessary or convenient to carry out its business. Many actions are therefore intra vires even though they do not directly affect the limited purpose for which the corporation is formed. For example, a corporation may generally make charitable contributions without regard to the purpose for which the charity will use the funds or may invest money in shares of other corporations without regard to whether the corporate purpose of the other corporation is broader or narrower than the limited purpose clause of the investing corporation. In some instances, however, a limited or narrow purpose clause may be considered to be a restriction on corporate powers as well as a restriction on purposes. Since the same ultra vires rule is applicable to corporations that exceed their purposes or powers (see the Official Comment to section 3.04), it is not necessary to determine whether a narrow purpose clause also limits the powers of the corporation but simply whether the purpose of the transaction in question is consistent with the purpose clause. Of course, these issues cannot arise in corporations with an "any lawful business" purpose clause.

§ 3.03. EMERGENCY POWERS

(a) In anticipation of or during an emergency defined in subsection (d), the board of directors of a corporation may:

(1) modify lines of succession to accommodate the incapacity of any director, officer, employee, or agent; and

(2) relocate the principal office, designate alternative principal offices or regional offices, or authorize the officers to do so.

(b) During an emergency defined in subsection (d), unless emergency bylaws provide otherwise:

(1) notice of a meeting of the board of directors need be given only to those directors whom it is practicable to reach and may be given in any practicable manner, including by publication and radio; and

(2) one or more officers of the corporation present at a meeting of the board of directors may be deemed to be directors for the meeting, in order of rank and within the same rank in order of seniority, as necessary to achieve a quorum.

(c) Corporate action taken in good faith during an emergency under this section to further the ordinary business affairs of the corporation:

(1) binds the corporation; and

(2) may not be used to impose liability on a corporate director, officer, employee, or agent.

(d) An emergency exists for purposes of this section if a quorum of the corporation's directors cannot readily be assembled because of some catastrophic event.

CROSS-REFERENCES

Corporate powers, see § 3.02.

Emergency bylaws, see § 2.07.

"Notice" defined, see § 1.41.

Notice of directors' meeting, see § 8.22.

"Principal office" defined, see § 1.40.

OFFICIAL COMMENT

Section 3.03 should be read in conjunction with section 2.07, which authorizes a corporation to adopt emergency or standby bylaws. Section 3.03 grants every corporation limited powers to act in an emergency even though it has failed to enact emergency bylaws under section 2.07.

An "emergency" for purposes of section 3.03 is defined in subsection (d) as any catastrophic event that makes it difficult or impossible to assemble a quorum of directors. In this situation, section 3.03(b) dispenses with or relaxes notice requirements and permits corporate officers to serve as directors in order to achieve a quorum. The section also authorizes the board of directors, either before or during an emergency, to modify lines of succession and relocate the principal business office of the corporation. These actions may be taken only by the board of directors at a meeting at which a quorum is present after giving effect, if necessary, to section 3.03(b).

These minimal provisions, it is believed, should permit a corporation to continue to function in the face of an emergency even if no emergency bylaws have been adopted under section 2.07.

§ 3.04. ULTRA VIRES

(a) Except as provided in subsection (b), the validity of corporate action may not be challenged on the ground that the corporation lacks or lacked power to act.

(b) A corporation's power to act may be challenged:

(1) in a proceeding by a shareholder against the corporation to enjoin the act;

(2) in a proceeding by the corporation, directly, derivatively, or through a receiver, trustee, or other legal representative, against an incumbent or former director, officer, employee, or agent of the corporation; or

(3) in a proceeding by the attorney general under section 14.30.

(c) In a shareholder's proceeding under subsection (b)(1) to enjoin an unauthorized corporate act, the court may enjoin or set aside the act, if equitable and if all affected persons are parties to the proceeding, and may award damages for loss (other than anticipated profits) suffered by the corporation or another party because of enjoining the unauthorized act.

CROSS-REFERENCES

Corporate powers, see § 3.02.

Corporate purposes, see § 3.01.

Derivative proceedings, see ch. 7D.

Director standards of conduct, see § 8.30.

Dissolution, see ch. 14.

"Employee" defined, see § 1.40.

"Proceeding" defined, see § 1.40.

OFFICIAL COMMENT

The basic purpose of section 3.04—as has been the purpose of all similar statutes during the 20th century—is to eliminate all vestiges of the doctrine of inherent incapacity of corporations. See Campbell, "The Model Business Corporation Act," 11-4 BUS. LAW. 98, 102 (1956). Under this section it is unnecessary for persons dealing with a corporation to inquire into limitations on its purpose or powers that may appear in its articles of incorporation. A person who is unaware of these limitations when dealing with the corporation is not bound by them. The phrase in section 3.04(a) that the "validity of corporate action may not be challenged on the ground that the corporation lacks or lacked power to act" applies equally to the use of the doctrine as a sword or as a shield: a third person may no more avoid an undesired contract with a corporation on the ground the corporation was without authority to make the contract than a corporation may defend a suit on a contract on the ground that the contract is ultra vires.

The language of section 3.04 extends beyond contracts and conveyances of property; "corporate action" of any kind cannot be challenged on the ground of ultra vires. For this reason it makes no difference whether a limitation in articles of incorporation is considered to be a limitation on a purpose or a limitation on a power; both are equally subject to section 3.04. Corporate action also includes inaction or refusal to act. The common law of ultra vires distinguished between executory contracts, partially executed contracts, and fully executed ones; section 3.04 treats all corporate action the same—except to the extent described in section 3.04(b)—and the same rules apply to all contracts no matter at what stage of performance.

Section 3.04, however, does not validate corporate conduct that is made illegal or unlawful by statute or common law decision. This conduct is subject to whatever sanction, criminal or civil, that is provided by the statute or decision. Whether or not illegal corporate conduct is voidable or rescindable depends on the applicable statute or substantive law and is not affected by section 3.04.

Section 3.04 also does not address the validity of essentially intra vires conduct that is not approved by appropriate corporate action. It does not deal, for example, with the enforceability of an executory contract to sell substantially all the assets of a corporation not in the ordinary course of business that was not approved by the shareholders as required by section 12.02. This type of transaction is not beyond the purposes or powers of the corporation; it simply has not been approved by the corporate authorities as required by law. Similarly, section 3.04 does not deal with whether a corporation is bound by the action of a corporate agent if the action requires, but has not received, approval by the board of directors. Whether or not the corporation is bound by this action depends on the law of agency, particularly the scope of apparent authority and whether the third person knew or should have known of the defect in the corporate approval process. These actions may be ultra vires with respect to the agent's authority but they are not ultra vires with respect to the corporation and are not controlled by section 3.04.

Similarly, corporate action is not ultra vires under section 3.04 merely because it constitutes a breach of fiduciary duty. For example, a misuse of corporate assets for personal purposes by an officer or director is a breach of fiduciary duty and may be enjoined. Similarly, in some circumstances a lien on corporate assets and a contract entered into by the corporation may be cancelled or enjoined if they constitute breaches of fiduciary duty and the third person is charged with knowledge that they were improper. These transactions, however, are not ultra vires with respect to the corporation, and cannot be attacked under section 3.04. They may be enjoined because of breach of the fiduciary duty, not because the transaction exceeds the powers or purposes of the corporation.

Section 3.04(b), like the prior Model Act provisions, permits challenges to the corporation's lack of power in three limited classes of cases:

(1) In suits by the attorney general under section 14.30. This provision does not answer the question whether or not a corporation may be dissolved or enjoined by the attorney general for committing an ultra vires act; it simply preserves the power of the state to assert that certain corporate action was ultra vires.

(2) In a suit by the corporation, either directly or through a legal representative, against incumbent or former officers or directors for authorizing or causing the corporation to engage in an ultra vires act. Again, this section does not address whether or not there is liability for causing the corporation to enter into an ultra vires act; it simply preserves the power of the corporation to assert that certain corporate action was ultra vires.

(3) In a suit by a shareholder against the corporation to enjoin an ultra vires act. This suit, however, is subject to the requirements of section 3.04(c). Under this subsection an ultra vires act may be enjoined only if all "affected parties" are parties to the suit. The requirement that the action be "equitable" generally means that only third persons dealing with a corporation while specifically aware that the corporation's action was ultra vires will be enjoined. The general phrase "if equitable" was retained because of the possibility that other circumstances may exist in which it may be equitable to refuse to enforce an ultra vires contract. Further, if enforcement of the contract is enjoined, either the third person or the corporation may in the discretion of the court be awarded damages from the other for loss (excluding anticipated profits).

Section 3.04(c) thus authorizes a court to enjoin or set aside an ultra vires act or grant other relief that may be necessary to protect the interests of all affected persons, including the interests of third persons who deal with the corporation.

CHAPTER 4

Name

§ 4.01. CORPORATE NAME

(a) A corporate name:

(1) must contain the word “corporation,” “incorporated,” “company,” or “limited,” or the abbreviation “corp.,” “inc.,” “co.,” or “ltd.,” or words or abbreviations of like import in another language; and

(2) may not contain language stating or implying that the corporation is organized for a purpose other than that permitted by section 3.01 and its articles of incorporation.

(b) Except as authorized by subsections(c) and (d), a corporate name must be distinguishable upon the records of the secretary of state from:

(1) the corporate name of a corporation incorporated or authorized to transact business in this state;

(2) a corporate name reserved or registered under section 4.02 or 4.03;

(3) the fictitious name adopted by a foreign corporation authorized to transact business in this state because its real name is unavailable; and

(4) the corporate name of a not-for-profit corporation incorporated or authorized to transact business in this state.

(c) A corporation may apply to the secretary of state for authorization to use a name that is not distinguishable upon the secretary of state’s records from one or more of the names described in subsection (b). The secretary of state shall authorize use of the name applied for if:

(1) the other corporation consents to the use in writing and submits an undertaking in form satisfactory to the secretary of state to change its name to a name that is distinguishable upon the records of the secretary of state from the name of the applying corporation; or

(2) the applicant delivers to the secretary of state a certified copy of the final judgment of a court of competent jurisdiction establishing the applicant’s right to use the name applied for in this state.

(d) A corporation may use the name (including the fictitious name) of another domestic or foreign corporation that is used in this state if the other corporation is incorporated or authorized to transact business in this state and the proposed user corporation:

(1) has merged with the other corporation;

(2) has been formed by reorganization of the other corporation; or

(3) (3) has acquired all or substantially all of the assets, including the corporate name, of the other corporation.

(4) This Act does not control the use of fictitious names.

CROSS-REFERENCES

Corporate and fictitious names for foreign corporations, see § 15.06.

"Deliver," see § 1.40.

Effective time and date of filing, see § 1.23.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

Registered name, see § 4.03.

Reserved name, see § 4.02.

Statement of name in articles, see § 2.02.

OFFICIAL COMMENT

All of chapter 4, relating to corporate names, has been reviewed and revised in light of the responsibilities that should reasonably be placed on secretaries of state considering their available resources.

Section 4.01 deals with two basic name requirements: (1) the name must indicate "corporateness," and (2) the name must be distinguishable upon the records of the secretary of state.

1. Indication of Corporateness

Section 4. 01(a) permits the words indicating corporateness to include "corporation," "incorporated," "limited," or "company" or an abbreviation of them. While the words "company" and "limited" are commonly used by partnerships or limited partnerships, and therefore do not uniquely indicate corporateness, their use is widespread and is continued since it creates no discernible harm. The Act also permits the use of words or abbreviations in another language that import corporateness.

2. Names That Are "Distinguishable upon the Records of the Secretary of State"

The revision of the Model Act is based on the fundamental premise that its name provisions should only ensure that each corporation has a sufficiently distinctive name so that it may be distinguished from other corporations upon the records of the secretary of state. The general business corporation statute should not be a partial substitute for a general assumed name, unfair competition, or antifraud statute. As a result, the Model Act does not restrict the power of a corporation to adopt or use an assumed or fictitious name with the same freedom as an individual or impose a requirement that an "official" name not be "deceptively similar" to another corporate name (a requirement of earlier versions of the Model Act). Principles of unfair competition, not the business corporation act, provide the limits on the competitive use of similar names.

The phrase "distinguishable upon the records of the secretary of state" is drawn from section 102(a)(1) of the Delaware General Corporation Law. The principal justifications for requiring a distinguishable official name are (1) to prevent confusion within the secretary of state's office and the tax office and (2) to permit accuracy in naming and serving corporate defendants in litigation. Thus, confusion in an absolute or linguistic sense is the appropriate test under the Model Act, not the competitive relationship between the corporations, which is the test for fraud or unfair competition. The precise scope of "distinguishable upon the records of the secretary of state" is an appropriate subject of regulation by the office of secretary of state in order to ensure uniformity of administration. Corporate names that differ only in the words used to indicate corporateness are generally not distinguishable. Thus, if ABC Corporation is in existence, the names "ABC Inc.," "ABC Co. ," or "ABC Corp." should not be viewed as distinguishable. Similarly, minor variations between names that are unlikely to be noticed, such as the substitution of a "," for a ". " or the substitution of an Arabic numeral for a word, such as "2" for "Two," or the substitution of a lower case letter for a capital, such as "d" for "D," generally should not be viewed as being distinguishable.

The elimination of the "deceptively similar" requirement that appeared in earlier versions of the Model Act is based on the fact that the secretary of state does not generally police the unfair competitive use of names and, indeed, usually has no resources to do so. For example, assume that "ABC Corporation" operates a retail furniture store in Albany, New York, and another group wants to use the same name to engage in a business involving imports of textiles in New York City. An attempt to incorporate a second "ABC Corporation" (or a very close variant such as "ABC Corp." or "ABC Inc.") should be rejected because the names are not distinguishable upon the records of the secretary of state. If the second group uses a distinguishable official name, like "ABD Corporation," it probably may lawfully assume the fictitious name "ABC Corporation" to import goods in New York City if it files the assumed name certificate required by New York law. In these situations, the secretary of state will usually not know in what business or in what geographical area "ABC Corporation" is active or what name ABD Corporation is actually using in its business; the secretary of state simply maintains an alphabetical list of "official" corporate names as they appear from corporate records and decides whether a proposed name is distinguishable from other "official names" by comparing the proposed name with those on the list. This assumes that there is either no assumed name statute or that if there is such a statute it requires only local filing in counties or, as in New York, a central filing which does not become part of the corporate records maintained by the secretary of state's office. These assumptions are generally if not universally correct.

3. Classes of Unavailable Names

Section 4.01(b) lists classes of "official names" that are not available. Names in use and thus unavailable from the standpoint of the secretary of state's uniqueness test for "official names" come from the following sources: (1) official names of profit or not-for-profit domestic corporations, (2) official names of foreign profit or not-for-profit corporations qualified to transact business, (3) reserved names, and (4) registered names. The secretary of state becomes involved with fictitious or assumed names only in the situation where a foreign corporation, planning to transact business in a state, discovers that its name is not available in that state. To qualify it must adopt an assumed or fictitious name as its "official name" in the state, see section 15.06. Such a fictitious or assumed name is thereafter an "official" name and is unavailable to the same extent as any other "official name" in use is unavailable.

4. Consent to Use

Section 4.01(c)(1) authorizes the secretary of state to accept a name that is indistinguishable from the name of another corporation if that corporation files an undertaking in a form satisfactory to the secretary of state that it will thereafter change its name to a name that is distinguishable upon the records of the secretary of state. This privilege may be important in acquisition transactions where a new corporation is to take over the business of an existing corporation without a change in corporate name. The secretary of state may require the undertaking to specify the new name which the corporation will adopt and the time period within which the change will be made. The requirements imposed on the undertaking should be consistent with the limited role of the secretary of state in the administration of section 4.01.

§ 4.02. RESERVED NAME

(a) A person may reserve the exclusive use of a corporate name, including a fictitious name for a foreign corporation whose corporate name is not available, by delivering an application to the secretary of state for filing. The application must set forth the name and address of the applicant and the name proposed to be reserved. If the secretary of state finds that the corporate name applied for is available, the secretary of state shall reserve the name for the applicant's exclusive use for a nonrenewable 120-day period.

(b) The owner of a reserved corporate name may transfer the reservation to another person by delivering to the secretary of state a signed notice of the transfer that states the name and address of the transferee.

CROSS-REFERENCES

Availability of names, § 4.01.

Consent to use corporate name, see § 4.01.

"Deliver," see § 1.40.

Corporate and fictitious names for foreign corporations, see § 15.06.

Effective time and date of filing, see § 1.23.

Filing fees, see § 1. 22.

Filing requirements, see § 1.20.

Foreign corporation, see ch. 15.

"Person" defined, see § 1.40.

Registered name, see § 4.03.

OFFICIAL COMMENT

The "reservation" of a corporate name is basically a device to simplify the formation of a new corporation or the qualification of a foreign corporation. By reserving a name, the persons considering the formation or qualification of the corporation can order stationery, prepare documents, etc., on the assumption that the reserved name will be available. Reference to a specific intent to form a new corporation is not required by the statute, however, since a secretary of state is not equipped and should not be asked to determine whether the requisite intent actually exists. For the same reason, "any person" is permitted to reserve a corporate name without reference to specific classes of persons who might wish to reserve a corporate name for various purposes.

Under section 4.02 of the Model Act, an available corporate name may be reserved:

(1) by persons considering the formation of a new domestic corporation;

(2) by persons considering the formation of a corporation in another state and the immediate qualification of that new corporation in this state; and

(3) by a foreign corporation planning or considering qualification in this state. The name reserved may be the foreign corporation's "official name" (if that name is available) or another name. The foreign corporation may thereafter use the reserved name as the name of a domestic subsidiary or, if its real name is unavailable, as a fictitious "official name" for its qualification under section 15.06.

These illustrations are designed to suggest the scope and flexibility of section 4.02, and not to exhaust the possible uses to which a reserved name may be put.

Consideration was also given to whether reservation of a corporate name should be made renewable. The modern requirements for incorporation of a domestic corporation or the qualification of a foreign corporation are so simple that it is unlikely that more than 120 days could ever be realistically required to form or qualify a corporation. Also, it was believed to be undesirable to allow the reservation procedure to be used for other purposes, such as permanently setting aside a name by successive renewals. Therefore, only a single, one-time reservation is provided for, although after the 120-day period expires the name becomes available again and anyone, including the original reserver, may reserve the name. And nothing prevents the formation of an inactive corporation specifically to hold the desired name if a longer period of reservation is desired than the 120-day period specified by section 4.02.

§ 4.03. REGISTERED NAME

(a) A foreign corporation may register its corporate name, or its corporate name with any addition required by section 15.06, if the name is distinguishable upon the records of the secretary of state from the corporate names that are not available under section 4.01(b).

(b) A foreign corporation registers its corporate name, or its corporate name with any addition required by section 15.06, by delivering to the secretary of state for filing an application:

(1) setting forth its corporate name, or its corporate name with any addition required by section 15.06, the state or country and date of its incorporation, and a brief description of the nature of the business in which it is engaged; and

(2) accompanied by a certificate of existence (or a document of similar import) from the state or country of incorporation.

(c) The name is registered for the applicant's exclusive use upon the effective date of the application.

(d) A foreign corporation whose registration is effective may renew it for successive years by delivering to the secretary of state for filing a renewal application, which complies with the requirements of subsection (b), between October 1 and December 31 of the preceding year. The renewal application when filed renews the registration for the following calendar year.

(e) A foreign corporation whose registration is effective may thereafter qualify as a foreign corporation under the registered name or consent in writing to the use of that name by a corporation thereafter incorporated under this Act or by another foreign corporation thereafter authorized to transact business in this state. The registration terminates when the domestic corporation is incorporated or the foreign corporation qualifies or consents to the qualification of another foreign corporation under the registered name.

CROSS-REFERENCES

Certificate of existence, see §§ 1.28 & 15.03.

Consent to use corporate name, see § 4.01.

Corporate and fictitious name for foreign corporations, see § 15.06.

"Deliver," see § 1.40.

Effective time and date of filing, see § 1.23.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

Reserved name, see § 4.02.

"State" defined, see § 1.40.

OFFICIAL COMMENT

The "registration" of a corporate name is basically a device by which a foreign corporation, not qualified to transact business in the state, can preserve the right to use its unique "real" name if it decides later to qualify in the state. In effect, registration ensures "real" name availability in areas of potential future expansion.

It is believed desirable to limit section 4.03 to this purpose and not allow it to become an indirect device for the preservation of trademarks, trade names, or possible assumed names. For this reason, generally only "real" names of foreign corporations may be registered (with exceptions described below). A broader approach would create issues better resolved under a trademark or similar statute, or by litigation under unfair competition principles, and might impose duties on secretaries of state that they are generally not equipped to handle, or could handle only at increased cost.

Registration of a name other than the "real" name is permitted in only one situation: if the "real" name of a foreign corporation is not available solely because it does not comply with section 15.06, requiring the words "incorporated," "corporation," "company," or "limited," or an abbreviation of one of these words, the corporation may add one of these words or abbreviations and register its "real" name as so modified under section 4.03(a).

Confusion sometimes exists between "reservation" of names under section 4.02 and registration of names under section 4.03. A foreign corporation that is planning to qualify as a foreign corporation and finds that its name is available in the state may either register or reserve the name. Often a foreign corporation will have to decide whether to qualify or to create a domestic subsidiary; this well may be decided after the exclusive right to use the corporate name in the state is obtained either by reservation or by registration. If the corporation registers its name, it will be kept indefinitely; if it reserves, it will be kept for 120 days and then become available again. That is the foreign corporation's choice. If a foreign corporation registers its name and then elects to form a domestic or foreign subsidiary, the written consent procedure of section 4.03(e) allows the secretary of state to ascertain that the domestic subsidiary is related to the foreign corporation and that use of the registered name by that subsidiary is acceptable to the foreign parent.

If a foreign corporation's "real" name is unavailable, a foreign corporation may reserve any name—including one that is assumed or fictitious when compared with the corporation's "real" name—for 120 days, but it may not register this type of name in light of the policy against allowing the name provisions of the Model Act to be used for purposes broader than the "unique name" issue. Nevertheless, a foreign corporation that wishes to be certain that a particular fictitious or assumed name will be available in the future may create an inactive domestic subsidiary with the desired name to preserve its future availability. See also the Official Comment to section 15.06.

Section 4.03(e) provides that the protection of the name provided by this section terminates when the name is used pursuant to this section by the foreign corporation or its domestic or foreign subsidiary.

CHAPTER 5

Office and Agent

§ 5.01. REGISTERED OFFICE AND REGISTERED AGENT

Each corporation must continuously maintain in this state:

(1) a registered office that may be the same as any of its places of business; and

(2) a registered agent, who may be:

(i) an individual who resides in this state and whose business office is identical with the registered office;

(ii) a domestic or foreign corporation or other eligible entity whose business office is identical with the registered office and, in the case of a foreign corporation or foreign eligible entity, is authorized to transact business in the state.

CROSS-REFERENCES

Annual report disclosure, see § 16.21.
Changing registered office or agent, see § 5.02.
Effect of dissolution of corporation, see § 14.05.
"Eligible Entity" defined, see § 140(7B).
Foreign corporations, see § 140(10) and ch. 15.
Involuntary dissolution for failure to appoint and maintain registered agent and office, see § 14.20.
Naming registered agent and office in articles of incorporation, see § 2.02.
"Principal office":
    defined, see § 1.40(17).
    designated in annual report, see § 16.21.
Resignation of registered agent, see § 5.03.
Service on corporation, see § 5.04.

OFFICIAL COMMENT

The requirements that a corporation continuously maintain a registered office and a registered agent at that office are based on the premises that at all times a corporation should have an office where it may be found and a person at that office on whom any notice or process required or permitted by law may be served. This covers not only service of process in connection with litigation but also tax notices and communications from the secretary of state and other governmental offices. The street address of the registered office must appear in the public records maintained by the secretary of state. A mailing address, such as a post office box, is not sufficient since the registered office is the designated location for service of process.

The Model Act assumes that formal communications to the corporation will normally be addressed to the registered agent at the registered office. If the communication itself deals with the registered office or registered agent, however, copies must be sent to the principal office of the corporation. Moreover, the Act authorizes corporations to retain records at, or to provide information to shareholders through, offices other than the registered office. The Model Act consistently recognizes that the registered office may be a "legal" rather than a "business" office.

Many corporations designate their registered office to be a business office of the corporation and a corporate officer at that office to be the registered agent. Since most of the communication to the registered agent at the registered office deals with legal matters, however, corporations often designate their regular legal counsel or the counsel's nominee as their registered agent and the counsel's office as the registered office of the corporation. This practice may also encourage regular communication between the corporation and its legal counsel.

The registered agent need not be an individual. Corporation service businesses often provide, as a commercial service, registered offices and registered agents at the office of the corporation service business.

The voluntary dissolution of the corporation does not of itself terminate the authority of the registered agent to accept service of process or other communications on behalf of the dissolved corporation. See section 14.05.

§ 5.02. CHANGE OF REGISTERED OFFICE OR REGISTERED AGENT

(a) A corporation may change its registered office or registered agent by delivering to the secretary of state for filing a statement of change that sets forth:

(1) the name of the corporation;

(2) the street address of its current registered office;

(3) if the current registered office is to be changed, the street address of the new registered office;

(4) the name of its current registered agent;

(5) if the current registered agent is to be changed, the name of the new registered agent and the new agent's written consent (either on the statement or attached to it) to the appointment; and

(6) that after the change or changes are made, the street addresses of its registered office and the business office of its registered agent will be identical.

(b) If a registered agent changes the street address of his or her business office, the agent may change the street address of the registered office of any corporation for which the agent is the registered agent by notifying the corporation in writing of the change and signing (either manually or in facsimile) and delivering to the secretary of state for filing a statement that complies with the requirements of subsection (a) and recites that the corporation has been notified of the change.

CROSS-REFERENCES

Deletion of initial agent and office from articles of incorporation, see § 10.05.
"Deliver," see § 1.40.
Effect of dissolution of corporation, see § 14.05.

Effective time and date of filing, see § 1.23.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.
Involuntary dissolution for failure to file notice of change of registered agent or office, see § 14.20.
"Notice" defined, see § 1.41.
Resignation of registered agent, see § 5.03.

OFFICIAL COMMENT

Changes of registered office or registered agent are usually routine matters which do not affect the rights of shareholders. The purpose of this section is to permit these changes without a formal amendment of the articles of incorporation, without approval of the shareholders, and, indeed, even without formal approval of the board of directors.

Changes of registered office or registered agent are often of particular concern to corporation service companies which routinely serve as registered agent and routinely provide a registered office for literally thousands of corporations within many states.

Experience with the change of registered agent and registered office provisions in earlier versions of the Model Act and the statutes of many states revealed several minor problems with these largely formal provisions that are addressed in the revised Model Act.

(1) Changes of registered office or registered agent need not be authorized by the board of directors. Many changes (such as the name of a specific registered agent at a registered office) are so routine that they should not require action by the board of directors, particularly in publicly held corporations.

(2) In the case of a change of registered agent, the written consent of the new registered agent is required. This is designed to prevent naming persons as registered agents without their knowledge.

(3) The procedure by which a registered agent may change the street address of the registered office applies to any location within the state and the agent is expressly required to notify the corporation of the change. But a facsimile signature of the agent is acceptable since a corporation service company changing its street address may be required to file a form for each of the thousands of corporations for which it serves as registered agent and to notify each corporation of the change.

Resignation of the registered agent is separately treated in section 5.03.

§ 5.03. RESIGNATION OF REGISTERED AGENT

(a) A registered agent may resign the agent's appointment by signing and delivering to the secretary of state for filing the signed original and two exact or conformed copies of a statement of resignation. The statement may include a statement that the registered office is also discontinued.

(b) After filing the statement the secretary of state shall mail one copy to the registered office (if not discontinued) and the other copy to the corporation at its principal office.

(c) The agency appointment is terminated, and the registered office discontinued if so provided, on the 31st day after the date on which the statement was filed.

CROSS-REFERENCES

Annual report, see § 16.21.
Change of registered agent, see § 5.02.
"Deliver," see § 1.40.
Effect of dissolution of corporation, see § 14.05.
Effective time and date of filing, see § 1.23.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.
"Principal office":
    defined, see § 1.40.
    designated in annual report, see § 16.21.

OFFICIAL COMMENT

The resignation of registered agents in states with statutes similar to earlier versions of the Model Act created special problems. Most of these problems arose in connection with corporation service companies who serve as registered agent for an annual fee. If the fee was not paid, the corporation service company obviously desired to terminate the representation promptly. Often the agent did not have a current business address for the corporation and was uncertain whether the corporation was still actively engaged in business. The earlier Model Act provision required the agent to submit a statement of resignation in duplicate and the secretary of state was directed to mail one copy "forthwith. . . to the corporation at its registered office." This resulted in a circularity in notice: the duplicate was mailed back to the resigned agent who originally filed the copy. The probability that the corporation would receive a copy of the resignation under these circumstances was obviously low.

Section 5.03 resolves the circularity problem by requiring the resigning agent to submit two copies of its statement of resignation, one to be sent to the corporation at its registered office and the other to the corporation "at its principal office." Mailing to this second address appears to be the only option regularly available to "break the circle" of the corporation "receiving" the notice through an agent whose resignation is being communicated.

This section also permits the discontinuance of the registered office as well as the resignation of the agent. Corporation service companies desiring to resign their agency for nonpayment of fees will normally wish to discontinue the registered office as well as the registered agent.

§ 5.04. SERVICE ON CORPORATION

(a) A corporation's registered agent is the corporation's agent for service of process, notice, or demand required or permitted by law to be served on the corporation.

(b) If a corporation has no registered agent, or the agent cannot with reasonable diligence be served, the corporation may be served by registered or certified mail, return receipt requested, addressed to the secretary of the corporation at its principal office. Service is perfected under this subsection at the earliest of:

  (1) the date the corporation receives the mail;

  (2) the date shown on the return receipt, if signed on behalf of the corporation; or

  (3) five days after its deposit in the U.S. Mail, as evidenced by the postmark, if mailed postpaid and correctly addressed.

(c) This section does not prescribe the only means, or necessarily the required means of serving a corporation.

CROSS-REFERENCES

Annual report, see § 16.21.
Foreign corporations, see ch. 15.
"Notice" defined, see § 1.41.
"Principal office":
    defined, see § 1.40.
    designated in annual report, see § 16.21.
Registered office and agent:
    designated in annual report, see § 16.21
    required, see § 5.01.
"Secretary" defined, see § 1.40.

OFFICIAL COMMENT

Somewhat the same circularity problem that arose in connection with the resignation of registered agents (see the Official Comment to section 5.03) also sometimes arose in connection with service of process under statutes based on the former Model Act provision. Under that provision, if service could not be made on the registered agent at its registered office, a duplicate of the process was forwarded to the secretary of state who served it at the registered office (where the agent previously could not be found). It is unlikely that this arrangement resulted in the copy being forwarded routinely to the corporation. Instead of providing for service on the secretary of state if service cannot be perfected on the registered agent, therefore, section 5.04 provides for service by registered or certified mail addressed to the secretary of the corporation at its principal office shown in its most recent annual report.

If service is not perfected on the corporation at its registered office, section 5.04(b) provides that service is deemed perfected at the earliest of:

  (1) the date the corporation receives the mail;

  (2) the date shown on the return receipt if the receipt is signed on behalf of the corporation;

(3) five days after the certified or registered mail is delivered to the post office or deposited in the mail by the person seeking to serve the corporation, if the return receipt was not returned or not signed on behalf of the corporation.

Section 5.04(c) provides that this section does not prescribe the only, or necessarily the required, means of serving a corporation. Service may also be perfected under civil practice statutes, under rules of civil procedure, or under statutes that provide special service requirements applicable to certain types of corporations.

Section 5.04 simplifies the recordkeeping requirements of the secretary of state, who is no longer required to keep records of service of process on domestic corporations.

CHAPTER 6

Shares and Distributions

Subchapter A.
SHARES

§ 6.01. AUTHORIZED SHARES

(a) The articles of incorporation must set forth any classes of shares and series of shares within a class, and the number of shares of each class and series, that the corporation is authorized to issue. If more than one class or series of shares is authorized, the articles of incorporation must prescribe a distinguishing designation for each class or series and must describe, prior to the issuance of shares of a class or series, the terms, including the preferences, rights, and limitations, of that class or series. Except to the extent varied as permitted by this section, all shares of a class or series must have terms, including preferences, rights, and limitations that are identical with those of other shares of the same class or series.

(b) The articles of incorporation must authorize:

(1) one or more classes or series of shares that together have unlimited voting rights, and

(2) one or more classes or series of shares (which may be the same class or classes as those with voting rights) that together are entitled to receive the net assets of the corporation upon dissolution.

(c) The articles of incorporation may authorize one or more classes or series of shares that:

(1) have special, conditional, or limited voting rights, or no right to vote, except to the extent otherwise provided by this Act;

(2) are redeemable or convertible as specified in the articles of incorporation:

(i) at the option of the corporation, the shareholder, or another person or upon the occurrence of a specified event;

(ii) for cash, indebtedness, securities, or other property; and

(iii) at prices and in amounts specified, or determined in accordance with a formula;

(3) entitle the holders to distributions calculated in any manner, including dividends that may be cumulative, noncumulative, or partially cumulative; or

(4) have preference over any other class or series of shares with respect to distributions, including distributions upon the dissolution of the corporation.

(d) Terms of shares may be made dependent upon facts objectively ascertainable outside the articles of incorporation in accordance with section 1.20(k).

(e) Any of the terms of shares may vary among holders of the same class or series so long as such variations are expressly set forth in the articles of incorporation.

(f) The description of the preferences, rights and limitations of classes or series of shares in subsection (c) is not exhaustive.

CROSS-REFERENCES

Note: For samples of descriptions of shares, see part 1 of the Official Comment to this section.

Amendment of articles:

generally, see § 10.05.

terms of series or class, see § 6.02.

Articles of incorporation generally, see § 2.02.

Certificateless shares, see § 6.26.

Certificates for shares, see § 6.25.

Consideration for shares, see § 6.21.

Debt securities, see § 3.02.

Distributions, see § 6.40.

Extrinsic facts, see § 1.20(k).

Fractional shares, see § 6.04.

Nonvoting shareholders' right to notice, see §§ 7.04, 10.03, 11.04, 12.02, 14.02.

Options, see § 6.24.

Outstanding shares, see § 6.03.

Preemptive rights, see § 6.30.

Redemption, see § 6.31.

Series of shares, see § 6.02.

Voting by nonvoting shares, see § 10.04.

Voting by voting groups of shares, see §§ 1.40, 7.25, 7.26.

Voting rights generally, see § 7.21.

OFFICIAL COMMENT

Section 6.01 adopts a new terminology from that traditionally used in corporation statutes to describe classes and series of shares that may be created, but makes only limited substantive changes from earlier versions of the Model Act. Traditional corporation statutes work from a perceived inheritance of concepts of "common shares" and "preferred shares" that at one time may have had considerable meaning but that today often do not involve significant distinctions. It is possible under modern corporation statutes to create classes of "common" shares that have important preferential rights and classes of "preferred" shares that are subordinate in all important economic aspects or that are indistinguishable from common shares in either voting rights or entitlement to participate in the assets of the corporation upon dissolution. The Model Act breaks away from the inherited concepts of "common" and "preferred" shares and develops more general language to reflect the actual flexibility in the creation of classes and series of shares that exists in modern corporate practice.

1. Section 6.01(a)

Section 6.01(a) requires that the articles of incorporation prescribe the classes and series of shares and the number of shares of each class and series that the corporation is authorized to issue. If the articles authorize the issue of only one class of shares, no designation or description of the shares is required, it being understood that these shares have both the power to vote and the power to receive the net assets of the corporation upon dissolution. See section 6.01(b). Shares with both of these characteristics are usually referred to as "common shares" or "common stock," but no specific designation is required by the Model Act. The articles of incorporation may set forth the number of shares authorized and permit the board of directors under section 6.02 to allocate the authorized shares among designated classes or series of shares.

If more than one class or series of shares is authorized, the terms, including the preferences, rights and limitations, of each class or series of shares must be described in the articles of incorporation before any shares of that class or series are issued, or the board of directors may be given authority to establish them under section 6.02. These descriptions constitute the "contract" of the holders of those classes and series of shares with respect to their interest in the corporation and must be set forth in sufficient detail reasonably to define their interest. The terms, including the preferences, rights and limitations, of shares with one or more special or preferential rights which may be authorized are further described in section 6.01(c).

If more than one class or series is authorized (or if only one class or series is originally authorized but at some future time one or more other classes or series of shares are added by amendment), the terms, including the preferences, rights and limitations of each class, classes or series of shares, including the class, classes or series that possess the fundamental characteristics of voting and residual equity financial interests, must be described before shares of those classes or series are issued. If both fundamental characteristics are placed exclusively in a single class of shares, that class may be described simply as "common shares" or by statements such as the "shares have the general distribution and voting rights," the "shares have all the rights of common shares," or the "shares have all rights not granted to the class A shares."

If the articles of incorporation create classes or series of shares that divide these fundamental rights among two or more classes or series of shares, it is necessary that the rights be clearly allocated among the classes and series. Specificity is required only to the extent necessary to differentiate the relative rights of the respective classes and series. For example, where one class or series has a liquidation preference over another, it is necessary to specify only the preferential liquidation right of that class or series; in the absence of a contrary provision in the articles, the remaining class or series would be entitled to receive the net assets remaining after the liquidation preference has been satisfied.

More than one class or series of shares may be designated as "common shares;" however, each must have a "distinguishing designation" under section 6.01(a), e.g., "nonvoting common shares" or "class A common shares," and the rights of the classes and series must be described. For example, if a corporation authorizes two classes of shares with equal rights to share in all distributions and with identical voting rights except that one class is entitled exclusively to elect one director and the second class is entitled exclusively to elect a second director, the two classes may be designated, e.g., as "Class A common" and "Class B common." What is required is language that makes the allocation of these rights clear.

Rather than describing the terms of each class or series of shares in the articles of incorporation, the corporation may delegate to the board of directors under section 6.02 the power to establish the terms of a class of shares (or of series within a class of shares) if no shares of that class or series have previously been issued. Those terms, however, must be set forth in an amendment to the articles of incorporation that is effective before the shares are issued.

2. Section 6.01(b)

Section 6.01(b) requires that every corporation authorize one or more classes or series of shares that have the two fundamental characteristics of unlimited voting rights and the right to receive the net assets of the corporation upon its dissolution. These two fundamental characteristics need not be placed in a single class or series of shares but may be divided as desired. It is nevertheless essential that the corporation always have authorized shares with these two characteristics, and section 6.03 requires that shares having in the aggregate these characteristics always be outstanding.

Section 6.01(b) ensures that there is always in existence one or more classes or series of shares which share in the ultimate residual interest in the corporation and which are entitled to elect a board of directors and make other fundamental decisions with respect to the corporation.

3. Section 6.01(c)

Section 6.01(c) lists the principal features that are customarily incorporated into classes or series of shares. Section 6.01(f) makes clear that this listing is not exhaustive.

A. IN GENERAL

Section 6.01(c) authorizes creation of classes or series of shares with a virtually unlimited range of preferences, rights and limitations. In earlier versions of the Model Act and in the statutes of many states, certain types of rights or privileges were not permitted. Many such statutes, for example, prohibited the creation of a class of voting shares without preferential financial rights that is callable at the discretion of the corporation ("callable common shares"). Another common prohibition was against shares that have the power to be converted at the option of the shareholder into other classes of shares that have preferential financial rights, or into debt securities of the corporation ("upstream" conversion privileges). For the reasons set forth below, these restrictions are not preserved in the Model Act.

B. VOTING OF SHARES

Any class or series of shares may be granted multiple or fractional votes per share without limitation. See section 7.21. Shares of any class or series may also be made nonvoting "except to the extent otherwise provided by this Act." This "except" clause refers to the provisions in the Model Act that permit shares that are designated to be nonvoting to vote as separate voting groups on amendments to articles of incorporation and other organic changes in the corporation that directly affect that class or series (sections 7.26 and 10.04). In addition, shares may be given voting rights that are limited or conditional (e.g., on the passing of a specified number of dividends). Section 6.01(b), however, requires that there always be one or more classes or series of shares that together have unlimited voting rights.

C. REDEMPTION OF SHARES

Section 6.01(c)(2) permits classes or series of shares to be made redeemable on the terms set forth in the articles of incorporation. Under this section, shares may be made "redeemable" at the option of the holder, the corporation, or another person; shares redeemable at the option of the corporation are sometimes called "callable shares," while shares redeemable at the option of the shareholder are sometimes described as involving a "put." The Model Act permits either type of redemption for any class or series of shares and thereby permits the creation of redeemable or callable shares without limitation (subject only to the provisions that the class, classes or series of shares described in section 6.01(b) must always exist and that at least one share of each class or series with those rights must be outstanding under section 6.03).

Earlier versions of the Model Act and the statutes of many states contained a direct or indirect prohibition against callable voting shares or callable common shares. Even where such a prohibition exists, however, the same effect can be obtained by the use of consensual share transfer restrictions (see section 6.27). If it is possible to create what is essentially a callable voting share by agreement, there is no reason why such provisions should not be built directly and publicly into the capital structure of the corporation if that is desired.

The recognition of a redemption that is a "put" exercisable by the holders of the shares (or a third person such as holders of other classes of shares) is also new to the Model Act and is not permitted in many states. However, consensual share transfer restrictions may create a right that is indistinguishable from such a right of redemption, and a right of redemption is expressly recognized by many states in connection with certain specialized types of corporations such as open-end investment companies. As described below, if a right of redemption is recognized, prohibitions in earlier versions of the Model Act and many state statutes against "upstream" conversions serve no purpose.

The prices to be paid upon the redemption of shares under section 6.01(c)(2) and the amounts to be redeemed may be fixed in the articles of incorporation or "determined in accordance with a formula." The formula could be self contained, or, pursuant to the provisions of section 6.01(d), could be determined by reference to extrinsic data or events. This is intended to permit the redemption price and the amounts to be redeemed to be established on the basis of matters external to the corporation, such as the purchase price of other shares, the level of the prime rate, the effective interest rate at which the corporation may obtain short or long-term financing, the consumer price index or a designated currency ratio.

All redemptions of shares are subject to the restrictions on distributions set forth in section 6.40. See section 6.03(b).

D. CONVERTIBILITY OF SHARES

Section 6.01(c)(2) also permits shares of any class or series to be made convertible into shares of any other class or series or into cash, indebtedness, securities, or other property of the corporation or another person.

As described above, earlier versions of the Model Act and the statutes of many states prohibited so-called "upstream" conversions, that is, shares convertible into debt securities or into a class of shares having prior or superior preference rights. This restriction was eliminated from the Model Act since it was recognized that the power to make shares redeemable at the option of the shareholder for cash (see section 6.01(c)(2)(ii)) should logically permit the shares to be redeemable or convertible at the option of the shareholder into other shares with senior preferential rights. Creditors of the corporation and holders of shares with preferential rights are less seriously affected by a conversion of shares into debt or into shares with preferential rights than they would be by the redemption of the shares for money, which is permitted by the Model Act, subject to the limitations of section 6.40. Shares made "redeemable" for debt under section 6.01(c)(2)(ii), achieve the same effect as a right to "convert" shares into debt securities. The authorization by the board of directors of the issuance of shares of one class or series convertible into shares of another class or series constitutes authorization of the issuance of the latter shares.

E. EXTRINSIC FACTS

Subsection 6.01(d) permits the creation of classes of shares or series with terms that are dependent upon facts objectively ascertainable outside the articles of incorporation. See section 1.20 and the related Official Comment for an explanation of the meaning of the phrase "facts objectively ascertainable" and the requirement for the filing of articles of amendment under the circumstances set forth in that section. Terms that depend upon reference to extrinsic facts may include dividend rates that vary according to some external index or event. Because such "variable rate" stock would be intended to respond to current market conditions, it is most often employed with "blank check" stock having terms set by the board of directors immediately before issuance. See the Official Comment to section 6.02. Note that section 6.21 requires the board to determine the adequacy of consideration received or to be received by the corporation before issuing shares. If shares with terms to be determined by reference to extrinsic facts are to be authorized for issuance, the board should take care to establish appropriately defined parameters for such terms in order to discharge its duties under section 6.21.

F. VARIATION AMONG HOLDERS.

Subsection 6.01(e) permits the creation of classes of shares or series with terms that may vary among holders of the same class or series of shares so long as such variations are expressly set forth in the articles of incorporation. An example of the authority to vary terms among holders would be a provision that shares held by a bank or bank holding company in excess of a certain percentage would not have voting rights.

G. NONEXCLUSIVITY.

Section 6.01(f) also recognizes that the description of the preferences, rights and limitations of classes or series of shares in subsection 6.01(c) is not exhaustive.

4. Examples of Classes or Series of Shares Permitted by Section 6.01

Section 6.01 authorizes the creation of new or innovative classes or series of shares without limitation or restriction. The section is basically enabling rather than restrictive since corporations often find it necessary to create new and innovative classes or series of shares for a variety of reasons, and with the disclosure of the terms of the new classes and series in the articles of incorporation that are a matter of public record there is no reason to restrict the power to create these classes and series. Innovative classes or series of shares may be created in connection with raising debt or equity capital. Securities with novel provisions are often created to meet perceived corporate needs in specific circumstances or because of financial problems generated by market conditions for capital. Classes or series of shares may also be created in order to effectuate desired control relationships among the participants in a venture. Classes or series of shares are likely to be used for this purpose in closely held corporations, whether or not statutory close corporation status is elected, but may also be used for this purpose by publicly held corporations.

Examples of such classes and series of shares are the following:

(1) Shares of one class or series may be authorized to elect a specified number of directors while shares of a second class or series may be authorized to elect the same or a different number of directors.

(2) Shares of one class or series may be entitled to vote as a separate voting group on certain transactions, but shares of two or more classes or series may be only entitled to vote together as a single voting group on the election of directors and other matters.

(3) Shares of one class or series may be nonvoting or may be given multiple or fractional votes per share.

(4) Shares of one class or series may be entitled to different dividend rights or rights on dissolution than shares of another class or series.

These examples are intended to be illustrative only and not to exhaust the variations permissible under the Model Act.

A corporation has power to issue debt securities under section 3.02(7). Although 6.01 authorizes the creation of interests that usually will be classed as "equity" rather than "debt," it is permissible to create classes or series of securities under section 6.01 that have some of the characteristics of debt securities. These securities are often referred to as "hybrid securities." Section 6.01 of the Model Act does not limit the development of hybrid securities, and equity securities may be created under the Model Act that embodies any characteristics of debt that may be desired. Unlike some state statutes, however, the Model Act restricts the power to vote to securities classed as "shares" in the articles of incorporation.

§ 6.02. TERMS OF CLASS OR SERIES DETERMINED BY BOARD OF DIRECTORS

(a) If the articles of incorporation so provide, the board of directors is authorized, without shareholder approval, to:

(1) classify any unissued shares into one or more classes or into one or more series within a class,

(2) reclassify any unissued shares of any class into one or more classes or into one or more series within one or more classes, or

(3) reclassify any unissued shares of any series of any class into one or more classes or into one or more series within a class.

(b) If the board of directors acts pursuant to subsection (a), it must determine the terms, including the preferences, rights and limitations, to the same extent permitted under section 6.01, of:

(1) any class of shares before the issuance of any shares of that class, or

(2) any series within a class before the issuance of any shares of that series.

(c) Before issuing any shares of a class or series created under this section, the corporation must deliver to the secretary of state for filing articles of amendment setting forth the terms determined under subsection (a).

CROSS-REFERENCES

Amendment of articles of incorporation, see ch. 10A.

Certificateless shares, see § 6.26.

Certificates for shares, see § 6.25.

"Deliver," see § 1.40.

Director standards of conduct, see § 8.30.

Distributions, see § 6.40.

Effective time and date of filing, see § 1.23.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

Series or class as voting group, see §§ 1.40, 7.25, 7.26, & 10.04.

Terms of shares, see § 6.01(c).

Voting by voting group, see §§ 7.25 & 7.26.

"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 6.02 permits the board of directors, if authority to do so is contained in the articles, to fix the terms of a class or series of shares or of a series of shares within a class to meet corporate needs, including current requirements of the securities markets or the exigencies of negotiations for acquisition of other corporations or properties, without the necessity of holding a shareholders' meeting to amend the articles. This section therefore permits prompt action and gives desirable flexibility. The articles of incorporation may also create "series" of shares within a class (rather than designating that "series" as a separate class).

The board of directors may create new series within a class. The board may also set the terms of a class or series if there are no outstanding shares of that class or series. In some contexts there is no substantive difference between a "class" and a "series within a class." Labels are often a matter of convenience.

Shares that are authorized by the articles to be issued in different classes or series with terms to be set by the board of directors are sometimes referred to as "blank check stock." The power to make the terms of "blank check stock" dependent on facts objectively ascertainable outside the articles and to vary the terms of "blank check stock" among holders of the same class or series extends to all the permitted variables set forth in section 6.01(c).

The granting of authority to create and set the terms for new classes and series of shares permits the board of directors to adjust the capital structure of the corporation without the time and expense of shareholder approval. This power is often used to create classes or series of preferred shares with fixed terms established in light of current market conditions or transactional needs. It is also used in connection with the issuance of so-called variable-rate or auction-rate preferred stock, i.e., stock with a dividend rate that varies according to an extrinsic referent such as the London Interbank Offered Rate, the prime commercial rate established by a bank or even the bids of prospective buyers of the stock as submitted from time to time and accepted by the corporation. This flexibility permits the corporation to respond to evolving market conditions and other time-sensitive developments.

Subsections (a) and (b) make it clear that the board has the same broad flexibility with regard to setting the terms of a class or series under this section as is permitted under 6.01(c).

Subsection (c) requires a simple filing to amend the articles so there will be a public record of the class or series which the corporation intends to issue. The amendment does not require shareholder action. See section 10.05(8).

§ 6.03. ISSUED AND OUTSTANDING SHARES

(a) A corporation may issue the number of shares of each class or series authorized by the articles of incorporation. Shares that are issued are outstanding shares until they are reacquired, redeemed, converted, or cancelled.

(b) The reacquisition, redemption, or conversion of outstanding shares is subject to the limitations of subsection (c) of this section and to section 6.40.

(c) At all times that shares of the corporation are outstanding, one or more shares that together have unlimited voting rights and one or more shares that together are entitled to receive the net assets of the corporation upon dissolution must be outstanding.

CROSS-REFERENCES

Cancellation of shares, see § 6.21.

Certificateless shares, see § 6.26.

Certificates for shares, see § 6.25.

Classes of shares generally, see §§ 6.01 & 6.02.

Consideration for shares, see § 6.21.

Dissolution of corporation, see ch. 14.

Reacquisition of shares, see § 6.31.

Redemption of shares, see §§ 6.01 & 6.31.

Share dividends, see § 6.23.

Voting by nonvoting class of shares, see § 10.04.

Voting by voting groups, see §§ 1.40, 7.25, & 7.26.

"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 6.03 permits the corporation to issue shares up to the number of shares authorized in the articles of incorporation and provides that shares that are issued are outstanding shares for purposes of this Act until they are reacquired, redeemed, converted, or cancelled. The determination of the number of shares to be issued is usually made by the board of directors but may be reserved by the articles of incorporation to the shareholders. The only requirements are that no class of shares be overissued and that one or more shares of a class or classes that together have unlimited voting power and one or more shares of a class or classes that together are entitled to the net assets of the corporation upon dissolution at all times must be outstanding.

Shares of any class that are outstanding may be made subject to share transfer restrictions that may result in contractual obligations by the corporation to reacquire shares. The validity of such share transfer restriction is today not open to serious question. See section 6.27. The corporation may also acquire outstanding shares of any class pursuant to a voluntary transaction between the shareholder and the corporation. All contractual or voluntary reacquisitions are subject to the restrictions set forth in subsection (c) of this section and to section 6.40. The corporation may also reacquire shares pursuant to a right of redemption (or an obligation to redeem) established in the articles of incorporation. See section 6.01(c)(2). All such redemptions of shares are also subject to the restrictions of subsection (c) of this section and to section 6.40. Shares of the class or classes described in section 6.01(b) may be reacquired or redeemed by the corporation in any of the foregoing ways to the same extent as shares of any other class, subject, however, to the overriding requirement of section 6.03(c) that at all times at least shares that meet the requirements of section 6.01(b) be outstanding.

The provisions of the revised Model Act are consistent with the specialized class of corporation known as the open-end investment company, which permits unlimited redemptions of shares at net asset value at the request of shareholders. Sections 6.01 and 6.03 permit the classes of shares with voting and dissolution rights to be made redeemable without limitation. The requirement of section 6.03(c) that at least one share be outstanding is also consistent with an unlimited right of redemption since that section only applies while there are shares of stock outstanding. If an open-end investment company or any other corporation should redeem all of its outstanding shares, it should file articles of dissolution under chapter 14 at or before the time the last share is redeemed.

§ 6.04. FRACTIONAL SHARES

(a) A corporation may:

(1) issue fractions of a share or pay in money the value of fractions of a share;

(2) arrange for disposition of fractional shares by the shareholders;

(3) issue scrip in registered or bearer form entitling the holder to receive a full share upon surrendering enough scrip to equal a full share.

(b) Each certificate representing scrip must be conspicuously labeled “scrip” and must contain the information required by section 6.25(b).

(c) The holder of a fractional share is entitled to exercise the rights of a shareholder, including the right to vote, to receive dividends, and to participate in the assets of the corporation upon liquidation. The holder of scrip is not entitled to any of these rights unless the scrip provides for them.

(d) The board of directors may authorize the issuance of scrip subject to any condition considered desirable, including:

(1) that the scrip will become void if not exchanged for full shares before a specified date; and

(2) that the shares for which the scrip is exchangeable may be sold and the proceeds paid to the scripholders.

CROSS-REFERENCES

Redemption, see §§ 6.01 & 6.31.

Share dividends, see § 6.23.

OFFICIAL COMMENT

Fractional shares may arise from a share dividend that, as applied to a particular holder, does not produce an even multiple of shares; they may also result from fractional stock splits, from reverse splits, and from reclassifications and mergers. Although corporations are authorized to issue fractional shares, which are vested proportionately with the same rights as full shares, the creation of fractional shares often creates administrative difficulties, particularly for voting and dividend purposes.

§ 6.04 authorizes handling fractional shares in various ways, including:

(1) The corporation may issue scrip instead of fractional shares. Scrip confers none of the substantive rights of shareholders, but only authorizes holders to combine scrip certificates in amounts aggregating a full share and then to exchange them for a full share. This aggregation must occur within the time and subject to the conditions set initially by the board of directors and stated in the scrip certificate. Scrip that is not combined and exchanged becomes void. To protect shareholders against forfeiture of their interest, however, it is usually provided that the shares represented by scrip certificates not exchanged by the expiration date are to be sold and the proceeds held, either indefinitely or for a stated period, for the benefit of the scripholders and paid to them on surrender of their scrip certificate.

Scrip has been widely used in lieu of fractional shares. The New York Stock Exchange, while not requiring the use of any particular method for the settlement of fractional share interests, has established a policy relating to the minimum rights and privileges that scrip issued by registered companies must provide. N.Y.S.E. Listed Company Manual section 703.02(B).

(2) The corporation may authorize the immediate sale of all fractional share interests, thereby avoiding the expense and delay of scrip and the inconvenience of recognizing fractional shares. While this procedure denies shareholders the benefit of any subsequent rise in the market, it protects them against any subsequent decline and ensures them of recognition based on market values

> contemporaneous with the transaction. Since these transactions necessarily involve less than one full share for each shareholder, the amount involved in subsequent price changes is usually modest.

One variation of "going private" transactions to eliminate public shareholders in a corporation largely owned by management interests involves a reverse share split at a ratio that reduces all public shareholders' interest to a fractional share, followed by the reduction of the fractional interests to cash under this section. See "Guidelines on Going Private," 37 BUS. LAW. 313 (1981).

Under this section fractional shares may be certificated or uncertificated. There is no difference in treatment of certificated or uncertificated shares for this purpose. See sections 6.25 and 6.26.

Subchapter B.
ISSUANCE OF SHARES

§ 6.20. SUBSCRIPTION FOR SHARES BEFORE INCORPORATION

(a) A subscription for shares entered into before incorporation is irrevocable for six months unless the subscription agreement provides a longer or shorter period or all the subscribers agree to revocation.

(b) The board of directors may determine the payment terms of subscription for shares that were entered into before incorporation, unless the subscription agreement specifies them. A call for payment by the board of directors must be uniform so far as practicable as to all shares of the same class or series, unless the subscription agreement specifies otherwise.

(c) Shares issued pursuant to subscriptions entered into before incorporation are fully paid and nonassessable when the corporation receives the consideration specified in the subscription agreement.

(d) If a subscriber defaults in payment of money or property under a subscription agreement entered into before incorporation, the corporation may collect the amount owed as any other debt. Alternatively, unless the subscription agreement provides otherwise, the corporation may rescind the agreement and may sell the shares if the debt remains unpaid for more than 20 days after the corporation sends written demand for payment to the subscriber.

(e) A subscription agreement entered into after incorporation is a contract between the subscriber and the corporation subject to section 6.21.

CROSS-REFERENCES

Consideration for shares, see § 6.21.

Effective date of notice, see § 1.41.

"Notice" defined, see § 1.41.

OFFICIAL COMMENT

Agreements for the purchase of shares to be issued by a corporation are typically referred to as "subscriptions" or "subscription agreements." Section 6.20 deals exclusively with preincorporation subscriptions, that is, subscriptions entered into before the corporation was formed. Preincorporation subscriptions have often been considered to be revocable offers rather than binding contracts. Since the corporation is not in existence, it cannot be a party to the agreement and the consideration established for the shares is not determined by the board of directors. While preincorporation subscriptions entered into simultaneously by several subscribers may be considered a binding contract between or among the subscribers, not all factual situations lend themselves to contractual analysis. Because of the uncertainty of the legal enforceability of these transactions, section 6.20 provides a simple set of legal rules applicable to the enforcement of preincorporation subscribers by the corporation after its formation. It does not address the extent to which preincorporation subscriptions may constitute a contract between or among subscribers, and other subscribers may enforce whatever contract rights they have without regard to section 6.20.

Section 6.20(a) provides that preincorporation subscriptions are irrevocable for six months unless the subscription agreement provides that they are revocable or that they are irrevocable for some other period. Nevertheless, all the subscribers to shares may agree at any time that a subscriber may withdraw in part from his commitment to subscribe for shares, that a subscriber may revoke his subscription entirely, or that the period of irrevocability may continue for an additional stated period. If the corporation accepts the subscription during the period of irrevocability, the subscription becomes a contract binding on both the subscribers and the corporation. The terms of this contract are set forth in sections 6.20(b) and (d).

Section 6.20(b) provides that after incorporation the board of directors may determine the payment terms of subscriptions but these calls must be uniform so far as practicable as to all shares of the same class or series unless the subscriptions provide otherwise. Section 6.20(d) provides alternative methods of enforcement of preincorporation subscriptions by the corporation. If the consideration for the subscription involves the payment of money or conveyance of property, the corporation may, in the event of nonpayment, collect the amount due as any other debt. Alternatively, unless the subscription agreement provides otherwise, the corporation may rescind the agreement and may resell the shares after 20 days' notice to the subscriber.

Section 6.20(c) provides that shares issued pursuant to preincorporation subscriptions are fully paid and nonassessable when the corporation receives the subscription price. The liability of the subscriber to pay the purchase price is addressed in section 6.22. Section 6.20 does not address the liability of transferees of shares, which may be issued before the subscription price is paid, for the power of the corporation to cancel for nonpayment shares that have been issued before payment of the full subscription price. Issued shares represented by unpaid subscriptions are subject to cancellation for nonpayment to the same extent as shares issued for promissory notes or shares issued before the consideration therefor is paid. See the Official Comment to sections 6.21 and 6.22.

Postincorporation subscriptions are contracts between the corporation and the investor by which the corporation agrees to issue shares for a stated consideration and the investor agrees to purchase the shares for that consideration.

Postincorporation subscriptions are simple contracts subject to the power of the board of directors and they may contain any mutually acceptable provisions subject to section 6.21. Section 6.20(e) states, for completeness, that postincorporation subscriptions are contracts between the corporation and the subscriber, subject to section 6.21.

§ 6.21. ISSUANCE OF SHARES

(a) The powers granted in this section to the board of directors may be reserved to the shareholders by the articles of incorporation.

(b) The board of directors may authorize shares to be issued for consideration consisting of any tangible or intangible property or benefit to the corporation, including cash, promissory notes, services performed, contracts for services to be performed, or other securities of the corporation.

(c) Before the corporation issues shares, the board of directors must determine that the consideration received or to be received for shares to be issued is adequate. That determination by the board of directors is conclusive insofar as the adequacy of consideration for the issuance of shares relates to whether the shares are validly issued, fully paid, and nonassessable.

(d) When the corporation receives the consideration for which the board of directors authorized the issuance of shares, the shares issued therefore are fully paid and nonassessable.

(e) The corporation may place in escrow shares issued for a contract for future services or benefits or a promissory note, or make other arrangements to restrict the transfer of the shares, and may credit distributions in respect of the shares against their purchase price, until the services are performed, the note is paid, or the benefits received. If the services are not performed, the note is not paid, or the benefits are not received, the shares escrowed or restricted and the distributions credited may be cancelled in whole or part.

(f) (1) An issuance of shares or other securities convertible into or rights exercisable for shares, in a transaction or a series of integrated transactions, requires approval of the shareholders, at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast on the matter exists, if:

(i) the shares, other securities, or rights are issued for consideration other than cash or cash equivalents, and

(ii) the voting power of shares that are issued and issuable as a result of the transaction or series of integrated transactions will comprise more than 20% of the voting power of the shares of the corporation that were outstanding immediately before the transaction.

(2) In this subsection:

(i) For purposes of determining the voting power of shares issued and issuable as a result of a transaction or series of integrated transactions, the voting power of shares shall be the greater of (A) the voting power of the shares to be issued, or (B) the voting power of the shares that would be outstanding after giving effect to the conversion of convertible shares and other securities and the exercise of rights to be issued.

(ii) A series of transactions is integrated if consummation of one transaction is made contingent on consummation of one or more of the other transactions.

CROSS-REFERENCES

Certificateless shares, see § 6.26.

Certificates for shares, see § 6.25.

Committees of the board, see § 8.25.

Director standards of conduct, see § 8.30.

Distributions, see § 6.40.

Liability of subscribers and shareholders, see § 6.22.

Par value shares, see § 2.02.

Preincorporation subscriptions for shares, see § 6.20.

Share dividends, see § 6.23.

Share options, see § 6.24.

Share transfer restrictions, see § 6.27.

Voting power, see § 1.40.

OFFICIAL COMMENT

The financial provisions of the Model Act reflect a modernization of the concepts underlying the capital structure and limitations on distributions of corporations. This process of modernization began with amendments in 1980 to the 1969 Model Act that eliminated the concepts of "par value" and "stated capital," and further modernization occurred in connection with the development of the revised Act in 1984. Practitioners and legal scholars have long recognized that the statutory structure embodying "par value" and "legal capital" concepts is not only complex and confusing but also fails to serve the original purpose of protecting creditors and senior security holders from payments to junior security holders. Indeed, to the extent security holders are led to believe that it provides this protection, these provisions may be affirmatively misleading. The Model Act has therefore eliminated these concepts entirely and substituted a simpler and more flexible structure that provides more realistic protection to these interests. Major aspects of this new structure are:

(1) the provisions relating to the issuance of shares set forth in this and the following sections;

(2) the provisions limiting distributions by corporations set forth in section 6.40 and discussed in the Official Comment to that section; and

(3) the elimination of the concept of treasury shares described in the Official Comment to section 6.31.

Section 6.21 incorporates not only the elimination of the concepts of par value and stated capital from the Model Act in 1980 but also eliminates the earlier rule declaring certain kinds of property ineligible as consideration for shares. The caption of the section, "Issuance of Shares by the Board of Directors," reflects the change in emphasis from imposing restrictions on the issuance of shares to establishing general principles for their issuance. The section replaces two sections captioned, respectively, "Consideration for Shares" (section 18) and "Payment for Shares" (section 19) in the 1969 Model Act.

1. Consideration

Since shares need not have a par value, under section 6.21 there is no minimum price at which specific shares must be issued and therefore there can be no "watered stock" liability for issuing shares below an arbitrarily fixed price. The price at which shares are issued is primarily a matter of concern to other shareholders whose interests may be diluted if shares are issued at unreasonably low prices or for overvalued property. This problem of equality of treatment essentially involves honest and fair judgments by directors and cannot be effectively addressed by an arbitrary doctrine establishing a minimum price for shares such as "par value" provided under older statutes.

Section 6.21(b) specifically validates contracts for future services (including promoters' services), promissory notes, or "any tangible or intangible property or benefit to the corporation," as consideration for the present issue of shares. The term "benefit" should be broadly construed to include, for example, a reduction of a liability, a release of a claim, or benefits obtained by a corporation or as a prize in a promotion. In the realities of commercial life, there is sometimes a need for the issuance of shares for contract rights or such intangible property or benefits. And, as a matter of business economics, contracts for future services, promissory notes, and intangible property or benefits often have value that is as real as the value of tangible property or past services, the only types of property that many older statutes permit as consideration for shares. Thus, only business judgment should determine what kind of property should be obtained for shares, and a determination by the directors meeting the requirements of section 8.30 to accept a specific kind of valuable property for shares should be accepted and not circumscribed by artificial or arbitrary rules.

2. Board Determination of Adequacy

The issuance of some shares for cash and other shares for promissory notes, contracts for past or future services, or for tangible or intangible property or benefits, like the issuance of shares for an inadequate consideration, opens the possibility of dilution of the interests of other shareholders. For example, persons acquiring shares for cash may be unfairly treated if optimistic values are placed on past or future services or intangible benefits being provided by other persons. The problem is particularly acute if the persons providing services, promissory notes, or property or benefits of debatable value are themselves connected with the promoters of the corporation or with its directors. Protection of shareholders against abuse of the power granted to the board of directors to determine that shares should be issued for intangible property or benefits is provided by the requirements of section 8.30 applicable to a determination that the consideration received for shares is adequate.

Accounting principles are not specified in the Model Act, and the board of directors is not required by the statute to determine the "value" of noncash consideration received by the corporation (as was the case in earlier versions of the Model Act). In many instances, property or benefit received by the corporation will be of uncertain value; if the board of directors determines that the issuance of shares for the property or benefit is an appropriate transaction that protects the shareholders from dilution that is sufficient under section 6.21. The board of directors does not have to make an explicit "adequacy" determination by formal resolution; that determination may be inferred from a determination to authorize the issuance of shares for a specified consideration.

Section 6.21 also does not require that the board of directors determine the value of the consideration to be entered on the books of the corporation, though the board of directors may do so if it wishes. Of course, a specific value must be placed on the consideration received for the shares for bookkeeping purposes, but bookkeeping details are not the statutory responsibility of the board of directors. The statute also does not require the board of directors to determine the corresponding entry on the right-hand side of the balance sheet under owner's equity to be designated as "stated capital" or be allocated among "stated capital" and other surplus accounts. The corporation, however, may determine that the shareholders' equity accounts should be divided into these traditional categories if it wishes.

The second sentence of section 6.21(c) describes the effect of the determination by the board of directors that consideration is adequate for the issuance of shares. That determination, without more, is conclusive to the extent that adequacy is relevant to the question whether the shares are validly issued, fully paid, and nonassessable. Section 6.21(d) provides that shares are fully paid and nonassessable when the corporation receives the consideration for which the board of directors authorized their issuance. Whether shares are validly issued may depend on compliance with corporate procedural requirements, such as issuance within the amount authorized in the articles of incorporation or holding a directors' meeting upon proper notice and with a quorum present. The Model Act does not address the remedies that may be available for issuances that are subject to challenge. This somewhat more elaborate clause replaces the provision in earlier versions of the Model Act and many state statutes that the determination by the board of directors of consideration for the issuance of shares was "conclusive in the absence of fraud in the transaction."

Shares issued pursuant to preincorporation subscriptions are governed by section 6.20 and not this section.

The Model Act does not address the question whether validly issued shares may thereafter be cancelled on the grounds of fraud or bad faith if the shares are in the hands of the original shareholder or other persons who were aware of the circumstances under which they were issued when they acquired the shares. It also leaves to the Uniform Commercial Code other questions relating to the rights of persons other than the person acquiring the shares from the corporation. See the Official Comment to section 6.22.

Section 6.21(e) permits shares issued for promissory notes or for contracts for future services or benefits to be placed in escrow, or their transfer otherwise restricted until the notes are paid, the services are performed, or the benefits are received. In addition, any distributions on such shares may be credited against payment, or other agreed performance, of the consideration for the shares. Section 6.21(e) then identifies certain remedies available to a corporation where there is a partial or complete failure of performance by the shareholder. If the corporation has restricted the transfer of the shares or placed them in escrow, it may cancel the shares and any credited distributions, in whole or in part, in the event of a failure of performance. This remedy is in the nature of a partial or complete rescission, and therefore rescission principles would be applicable.

Section 6.21 addresses only the corporation's cancellation remedy. It does not address whether other remedies may be available to the corporation, including a right to a deficiency against the nonperforming shareholder, or whether the shareholder may have any rights where the value of the shares subject to cancellation exceeds the value of the obligation remaining unperformed.

If the shares are issued without being restricted as provided in this subsection, they are validly issued insofar as the adequacy of consideration is concerned. See section 6.22 and its Official Comment.

Section 6.21(a) provides that the powers granted to the board of directors by this section may be reserved to the shareholders by the articles of incorporation. No negative inference should be drawn from section 6.21(a) with respect to the efficacy of similar provisions under other sections of the Model Act.

3. Shareholder Approval Requirement for Certain Issuances

Section 6.21(f) provides that an issuance of shares or other securities convertible into or rights exercisable for shares, in a transaction or a series of integrated transactions, for consideration other than cash or cash equivalents, requires shareholder approval if either the voting power of the shares to be issued, or the voting power of the shares into which those shares and other securities are convertible and for which any rights to be issued are exercisable, will comprise more than 20% of the voting power outstanding immediately before the issuance. Section 6.21(f) is generally patterned on New York Stock Exchange Listed Company Manual Rule 312.03, American Stock Exchange Company Guide Rule 712(b), and NASDAQ Stock Market Rule 4310(c)(25)(H)(i). The calculation of the 20% compares the maximum number of votes entitled to be cast by the shares to be issued or that could be outstanding after giving effect to the conversion of convertible securities and the exercise of rights being issued, with the actual number of votes entitled to be cast by outstanding shares before the transaction. The test tends to be conservative: The calculation of one part of the equation, voting power outstanding immediately before the transaction, is based on actual voting power of the shares then outstanding, without giving effect to the possible conversion of existing convertible shares and securities and the exercise of existing rights. In contrast, the calculation of the other part of the equation—voting power that is or may be outstanding as a result of the issuance—takes into account the possible future conversion of shares and securities and the exercise of rights to be issued as part of the transaction.

In making the 20% determination under this subsection, shares that are issuable in a business combination of any kind, including a merger, share exchange, acquisition of assets, or otherwise, on a contingent basis are counted as shares or securities to be issued as a result of the transaction. On the other hand, shares that are issuable under antidilution clauses, such as those designed to take account of future share splits or share dividends, are not counted as shares or securities to be issued as a result of the transaction, because they are issuable only as a result of a later corporate action authorizing the split or dividend. If a transaction involves an earn-out provision, under which the total amount of shares or securities to be issued will depend on future earnings or other performance measures, the maximum amount of shares or securities that can be issued under the earn-out shall be included in the determination.

If the number of shares to be issued or issuable is not fixed, but is subject to a formula, the application of the test in section 6.21(f)(2)(i) requires a calculation of the maximum amount that could be issued under the formula, whether stated as a range or otherwise, in the governing agreement. Even if ultimate issuance of the maximum amount is unlikely, a vote will be required if the maximum amount would result in an issuance of more than 20% of the voting power of shares outstanding immediately before the transaction.

Shares that have or would have only contingent voting rights when issued or issuable are not shares that carry voting power for purposes of the calculation under section 6.21(f).

The vote required to approve issuances that fall within section 6.21(f) is the basic voting rule under the Act, set forth in section 7.25, that more shares must be voted in favor of the issuance than are voted against. This is the same voting rule that applies under chapter 10 for amendments of the articles of incorporation, under chapter 11 for mergers and share exchanges, under chapter 12 for a disposition of assets that requires shareholder approval, and under chapter 14 for voluntary dissolution. The quorum rule under section 6.21(f) is also the same as the quorum rule under chapters 10, 11, 12, and 14: there must be present at the meeting at least a majority of the votes entitled to be cast on the matter.

Section 6.21(f) does not apply to an issuance for cash or cash equivalents, whether or not in connection with a public offering. "Cash equivalents," within the meaning of section 6.21(f), are short-term investments that are both readily convertible to known amounts of cash and present insignificant risk of changes in interest rates. Generally, only investments with original maturities of three months or less or investments that are highly liquid and can be cashed in at any time on short notice could qualify under these definitions. Examples of cash equivalents are types of Treasury Bills, investment grade commercial paper, and money-market funds. Shares that are issued partly for cash or cash equivalents and partly for other consideration are "issued for consideration other than cash or cash equivalents" within the meaning of section 6.21(f).

The term "rights" in section 6.21(f) includes warrants, options, and rights of exchange, whether at the option of the holder, the corporation, or another person. The term "voting power" is defined in section 1.40(27) as the current power to vote in the election of directors. See also the Comment to that subsection. Transactions are integrated within the meaning of section 6.21(f) where consummation of one transaction is made contingent on consummation of one or more of the other transactions. If this test is not satisfied, transactions are not integrated for purposes of section 6.21(f) merely because they are proximate in time or because the kind of consideration for which the corporation issues shares is similar in each transaction.

Section 6.21(f) only applies to issuances for consideration. Accordingly, like the Stock Exchange and NASDAQ rules on which section 6.21(f) is based, section 6.21(f) does not require shareholder approval for share dividends (which includes “splits”) or for shareholder rights plans. See section 6.23 and the official Comment thereto.

Illustrations of the application of section 6.21(f) follow:

1. C corporation, which has two million shares of Class A voting common stock outstanding (carrying one vote per share), proposes to issue 600,000 shares of authorized but unissued shares of Class B nonvoting common stock in exchange for a business owned by D Corporation. The proposed issuance does not require shareholder approval under section 6.21(f), because the Class B shares do not carry voting power.

2. The facts being otherwise as stated in Illustration 1, C proposes to issue 600,000 additional shares of its Class A voting common stock. The proposed issuance requires shareholder approval under section 6.21(f), because the voting power carried by the shares to be issued will comprise more than 20% of the voting power of C’s shares outstanding immediately before the issuance.

3. The facts being otherwise as stated in Illustration 1, C proposes to issue 400,000 shares of authorized but unissued voting preferred, each share of which carries one vote and is convertible into 1.5 shares of Class A voting common. The proposed issuance requires shareholder approval under section 6.21(f). Although the voting power of the preferred shares to be issued will not comprise more than 20% of the voting power of C’s shares outstanding immediately before the issuance, the voting power of the shares issuable upon conversion of the preferred will carry more than 20% of such voting power.

4. The facts being otherwise as stated in Illustration 1, C proposes to issue 200,000 shares of its Class A voting common stock, and 100,000 shares of authorized but unissued nonvoting preferred stock, each share of which is convertible into 2.5 shares of C’s Class A voting common stock. The proposed issuance requires shareholder approval under section 6.21(f), because the voting power of the Class A shares to be issued, after giving effect to the common stock that is issuable upon conversion of the preferred, would comprise more than 20% of the voting power of C’s outstanding shares immediately before the issuance.

5. The facts being otherwise as stated in Illustration 4, each share of the preferred stock is convertible into 1.2 shares of the Class A voting common stock. The proposed issuance does not require shareholder approval under section 6.21(f), because neither the voting power of the shares to be issued at the outset (200,000) nor the voting power of the shares that would be outstanding after giving effect to the common issuable upon conversion of the preferred (a total

of 320,000) constitutes more than 20% of the voting power of C's outstanding shares immediately before the issuance.

6. The facts being otherwise as stated in Illustration 1, C proposes to acquire businesses from Corporations G, H, and I, for 200,000, 300,000, and 400,000 shares of Class A voting common stock, respectively, within a short period of time. None of the transactions is conditioned on the negotiation or completion of the other transactions. The proposed issuance of voting shares does not require shareholder approval, because the three transactions are not integrated within the meaning of section 6.21(f), and none of the transactions individually involves the issuance of more than 20% of the voting power of C's outstanding shares immediately before each issuance.

§ 6.22. LIABILITY OF SHAREHOLDERS

(a) A purchaser from a corporation of its own shares is not liable to the corporation or its creditors with respect to the shares except to pay the consideration for which the shares were authorized to be issued (section 6.21) or specified in the subscription agreement (section 6.20).

(b) Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct.

CROSS-REFERENCES

Articles of incorporation, see § 2.02.

Consideration for shares, see § 6.21.

Share transfer restrictions, see § 6.27.

Subscriptions for shares, § 6.20.

OFFICIAL COMMENT

With the elimination of the concepts of par value and watered stock in 1980, the sole obligation of a purchaser of shares from the corporation, as set forth in section 6.22(a), is to pay the consideration established by the board of directors (or the consideration specified in the subscription, in the case of preincorporation subscriptions). The consideration for the shares may consist of promissory notes, contracts for future services, or tangible or intangible property or benefits, and, if the board of directors so decides, the delivery of the notes, contracts, or accrual of the benefits constitute full payment for the shares. See the Official Comment to section 6.21. Upon the transfer to the corporation of the consideration so determined or specified, the shareholder has no further responsibility to the corporation or its creditors "with respect to the shares," though the shareholder may have continuing obligations under a contract or promissory note entered into in connection with the acquisition of shares.

Section 6.22(a) deals only with the responsibility for payment by the purchaser of shares from the corporation. The revised Model Act leaves to the Uniform Commercial Code questions with respect to the rights of subsequent purchasers of shares with the power of the corporation to cancel shares if the consideration is not paid when due. See sections 8-202 and 8-301 of the Uniform Commercial Code.

Section 6.22(b) sets forth the basic rule of nonliability of shareholders for corporate acts or debts that underlies modern corporation law. Unless such liability is provided for in the articles of incorporation (see section 2.02(b)(2)(v)), shareholders are not liable for corporate obligations, though the last clause recognizes that such liability may be assumed voluntarily or by other conduct.

§ 6.23. SHARE DIVIDENDS

(a) Unless the articles of incorporation provide otherwise, shares may be issued pro rata and without consideration to the corporation's shareholders or to the shareholders of one or more classes or series. An issuance of shares under this subsection is a share dividend.

(b) Shares of one class or series may not be issued as a share dividend in respect of shares of another class or series unless (1) the articles of incorporation so authorize, (2) a majority of the votes entitled to be cast by the class or series to be issued approve the issue, or (3) there are no outstanding shares of the class or series to be issued.

(c) If the board of directors does not fix the record date for determining shareholders entitled to a share dividend, it is the date the board of directors authorizes the share dividend.

CROSS-REFERENCES

Action by shareholders, see §§ 7.0 1–7.04.

Classes of shares, see §§ 6.01 & 6.02.

Consideration for shares, § 6.21.

Distributions generally, see § 6.40.

Fractional shares, see § 6.04.

Record date, see § 7.07.

Series of shares, see § 6.02.

OFFICIAL COMMENT

A share dividend is solely a paper transaction: no assets are received by the corporation for the shares and any "dividend" paid in shares does not involve the distribution of property by the corporation to its shareholders. Section 6.23 therefore recognizes that such a transaction involves the issuance of shares "without consideration," and section 1.40(6) excludes it from the definition of a "distribution." Such transactions were treated in a fictional way under the old "par value" and "stated capital" statutes, which treated a share dividend as involving transfers from a surplus account to stated capital and assumed that par value shares could be issued without receiving any consideration by reason of that transfer of surplus.

The par value statutory treatment of share dividend transactions distinguished a share "split" from a dividend. In a share "split" the par value of the former shares was divided among the new shares and there was no transfer of surplus into the stated capital account as in the case of a share "dividend." Since the Model Act has eliminated the concept of par value, the distinction between a "split" and a "dividend" has not been retained and both types of transactions are referred to simply as "share dividends." A distinction between "share dividends" and "share splits," however, continues to exist in other contexts—for example, in connection with transactions by publicly held corporations, see N.Y.S.E. Listed Company Manual section 703.02(a), or corporations that have optionally retained par value for their shares. The change made in the Model Act is not intended to affect the manner in which transactions by these corporations are handled or described but simply reflects the elimination of artificial legal distinctions based on the par value statutes.

A "reverse stock split" is not a share dividend under this section of the Model Act. A reverse split involves an amendment to the articles of incorporation reducing the number of authorized shares, not the issuance of additional shares.

Share dividends may create problems when a corporation has more than a single class of shares. The requirement that a share dividend be "pro rata" only applies to shares of the same class or series; if there are two or more classes entitled to receive a share dividend in different proportions, the dividend will have to be allocated appropriately.

The distribution of shares of one class to holders of another class may dilute the equity of the holders of the first class. Therefore, subsection (b) permits the distribution of shares of one class to the holders of another class only if one or more of the following conditions are met: (1) the articles of incorporation expressly authorize the transaction, (2) the holders of the class being distributed consent to the distribution, or (3) there are no holders of the class being distributed.

§ 6.24. SHARE OPTIONS

(a) A corporation may issue rights, options, or warrants for the purchase of shares or other securities of the corporation. The board of directors shall determine (i) the terms upon which the rights, options, or warrants are issued and (ii) the terms, including the consideration for which the shares or other securities are to be issued. The authorization by the board of directors for the corporation to issue such rights, options, or warrants constitutes authorization of the issuance of the shares or other securities for which the rights, options or warrants are exercisable.

(b) The terms and conditions of such rights, options or warrants, including those outstanding on the effective date of this section, may include, without limitation, restrictions or conditions that:

(1) preclude or limit the exercise, transfer or receipt of such rights, options or warrants by any person or persons owning or offering to acquire a specified number or percentage of the outstanding shares or other securities of the corporation or by any transferee or transferees of any such person or persons, or

(2) invalidate or void such rights, options, or warrants held by any such person or persons or any such transferee or transferees.

CROSS-REFERENCES

Committees of the board, see § 8.25.

Compensation, see § 3.02.

Consideration for shares, see § 6.21.

Director standards of conduct, see § 8.30.

Distributions, see § 6.40.

OFFICIAL COMMENT

A specific provision authorizing the creation of rights, options and warrants appears in many state business corporation statutes. Even though corporations doubtless have the inherent power to issue these instruments, specific authorization is desirable because of the economic importance of rights, options and warrants, and because it is desirable to confirm the broad discretion of the board of directors in determining the consideration to be received by the corporation for their issuance. The creation of incentive compensation plans for directors, officers, agents, and employees is basically a matter of business judgment. This is equally true for incentive plans that involve the issuance of rights, options or warrants and for those that involve the payment of cash. In appropriate cases incentive plans may provide for exercise prices that are below the current market prices of the underlying shares or other securities.

Section 6.24(a) does not require shareholder approval of rights, options or warrants. Of course, prior shareholder approval may be sought as a discretionary matter, or required in order to comply with the rules of national securities markets (see N.Y.S.E. Listed Company Manual section 309.00), or to acquire the federal income tax benefits conditioned upon shareholder approval of such plans (see section 422(b)(1) of the Internal Revenue Code of 1986, as amended).

Under section 6.24(a), the board of directors may designate the interests issued as options, warrants, rights, or by some other name. These interests may be evidenced by certificates, contracts, letter agreements, or in other forms that are appropriate under the circumstances. Rights, options, or warrants may be issued together with or independently of the corporation's issuance and sale of its shares or other securities.

Some publicly held corporations have delegated administration of programs involving incentive compensation in the form of share rights or options to compensation committees composed of non-management directors, subject to the general oversight of the board of directors.

Section 6.24(b) is intended to clarify that the issuance of rights, options, or warrants as part of a shareholder rights plan is permitted. A number of courts have addressed whether shareholder rights plans are permitted under statutes similar to prior sections 6.01, 6.02, and 6.24. These courts have not agreed on whether provisions similar in language in sections 6.01, 6.02, and 6.24 permit such plans to distinguish between holders of the same class of shares based on the identity of the holder of the shares. However, in each of the states in which a court has interpreted a statute of that state as prohibiting such shareholder rights plans, the legislature has subsequently adopted legislation validating such plans. Section 6.24(b) clarifies that such plans are permitted.

The permissible scope of shareholder rights plans may, however, be limited by the courts. For example, courts have been sensitive to plans containing provisions which the courts perceive as infringing upon the power of the board of directors.

§ 6.25. FORM AND CONTENT OF CERTIFICATES

(a) Shares may but need not be represented by certificates. Unless this Act or another statute expressly provides otherwise, the rights and obligations of shareholders are identical whether or not their shares are represented by certificates.

(b) At a minimum each share certificate must state on its face:

(1) the name of the issuing corporation and that it is organized under the law of this state;

(2) the name of the person to whom issued; and

(3) the number and class of shares and the designation of the series, if any, the certificate represents.

(c) If the issuing corporation is authorized to issue different classes of shares or different series within a class, the designations, relative rights, preferences, and limitations applicable to each class and the variations in rights, preferences, and limitations determined for each series (and the authority of the board of directors to determine variations for future series) must be summarized on the front or back of each certificate. Alternatively, each certificate may state conspicuously on its front or back that the corporation will furnish the shareholder this information on request in writing and without charge.

(d) Each share certificate (1) must be signed (either manually or in facsimile) by two officers designated in the bylaws or by the board of directors and (2) may bear the corporate seal or its facsimile.

(e) If the person who signed (either manually or in facsimile) a share certificate no longer holds office when the certificate is issued, the certificate is nevertheless valid.

CROSS-REFERENCES

Certificateless shares, see § 6.26.

Classes of shares, see §§ 6.01 & 6.02.

"Conspicuously" defined, see § 1.40.

Descriptions of classes, see § 6.01.

Officers, see § 8.40.

Series of shares, see § 6.02.

Share transfer restrictions, see § 6.27.

OFFICIAL COMMENT

This section sets forth the minimum requirements for share certificates. A corporation whose shares are not publicly traded will normally issue certificates that meet these minimum requirements and little more. Securities that are publicly traded, on the other hand, must contain reasonable safeguards against fraudulent duplication; for this reason, regulations by exchanges contain technical requirements relating to design, workmanship, engraving, and printing. Also, exchange requirements may require signatures of a transfer agent and registrar as well as designated corporate officers. All these requirements are in addition to the minimum requirements of the Model Act.

Certificateless shares are permitted under section 6.25(a) upon compliance with section 6.26. Section 6.25(a) makes it clear that there are no differences in the rights and obligations of shareholders, whether or not their shares are represented by certificates, other than mechanical differences, such as the means by which instructions for transfer are communicated to the issuer, necessitated by the use or nonuse of certificates. If share transfer restrictions are imposed, conspicuous references must appear on the certificate if they are to be binding on third persons without knowledge of the restrictions. See section 6.27.

Under section 6.25 all signatures on a share certificate may be facsimiles. This change gives recognition to the fact that a purchaser of publicly traded shares will hardly ever be in a position to determine whether a manual signature on a stock certificate is in fact the authorized signature of an officer or the transfer agent or registrar. From the standpoint of the issuing corporation of publicly traded securities, if a share certificate requiring a manual signature is stolen and the signature thereafter forged, the corporation may defend on lack of genuineness under section 8-202(3) of the Uniform Commercial Code. But this defense is not effective against a bona fide purchaser when the forged signature has been placed on the certificate by an employee of the issuer or registrar or transfer agent entrusted with handling the certificates (U.C.C. section 8-205). It is likely that a corporation would therefore follow the same security precautions for blank certificates requiring manual signatures as for those not requiring them. At the same time, the time and expense required for manual signatures has been eliminated.

§ 6.26. SHARES WITHOUT CERTIFICATES

(a) Unless the articles of incorporation or bylaws provide otherwise, the board of directors of a corporation may authorize the issue of some or all of the shares of any or all of its classes or series without certificates. The authorization does not affect shares already represented by certificates until they are surrendered to the corporation.

(b) Within a reasonable time after the issue or transfer of shares without certificates, the corporation shall send the shareholder a written statement of the information required on certificates by section 6.25(b) and (c), and, if applicable, section 6.27.

CROSS-REFERENCES

Certificates for shares, see § 6.25.

Information on share certificates, see § 6.25.

Share transfer restrictions, see § 6.27.

OFFICIAL COMMENT

Section 6.26(a) authorizes the creation of uncertificated shares either by original issue or in substitution for shares previously represented by certificates. This subsection gives the board of directors the widest discretion so that a particular class and series of shares might be entirely represented by certificates, entirely uncertificated, or represented partly by each. The second sentence ensures that a corporation may not treat as uncertificated, and accordingly transferable on its books without due presentation of a certificate, any shares for which a certificate is outstanding.

The statement required by section 6.26(b) ensures that holders of uncertificated shares will receive from the corporation the same information that the holders of certificates receive when certificates are issued. There is no requirement that this information be delivered to purchasers of uncertificated shares before purchase.

Detailed rules with respect to the issuance, transfer, and registration of both certificated and uncertificated shares appear in article 8 of the Uniform Commercial Code. In general terms there are no differences between certificated and uncertificated securities except in matters such as their manner of transfer. See the Official Comment to section 6.25.

§ 6.27. RESTRICTION ON TRANSFER OF SHARES AND OTHER SECURITIES

(a) The articles of incorporation, bylaws, an agreement among shareholders, or an agreement between shareholders and the corporation may impose restrictions on the transfer or registration of transfer of shares of the corporation. A restriction does not affect shares issued before the restriction was adopted unless the holders of the shares are parties to the restriction agreement or voted in favor of the restriction.

(b) A restriction on the transfer or registration of transfer of shares is valid and enforceable against the holder or a transferee of the holder if the restriction is authorized by this section and its existence is noted conspicuously on the front or back of the certificate or is contained in the information statement required by section 6.26(b). Unless so noted or contained, a restriction is not enforceable against a person without knowledge of the restriction.

(c) A restriction on the transfer or registration of transfer of shares is authorized:

(1) to maintain the corporation's status when it is dependent on the number or identity of its shareholders;

(2) to preserve exemptions under federal or state securities law;

(3) for any other reasonable purpose.

(d) A restriction on the transfer or registration of transfer of shares may:

(1) obligate the shareholder first to offer the corporation or other persons (separately, consecutively, or simultaneously) an opportunity to acquire the restricted shares;

(2) obligate the corporation or other persons (separately, consecutively, or simultaneously) to acquire the restricted shares;

(3) require the corporation, the holders of any class of its shares, or another person to approve the transfer of the restricted shares, if the requirement is not manifestly unreasonable;

(4) prohibit the transfer of the restricted shares to designated persons or classes of persons, if the prohibition is not manifestly unreasonable.

(e) For purposes of this section, "shares" includes a security convertible into or carrying a right to subscribe for or acquire shares.

CROSS-REFERENCES

Certificates for shares, see § 6.25.

Classes of shares, see §§ 6.01 & 6.02.

Consideration for shares, see § 6.21.

"Conspicuously" defined, see § 1.40.

Debt securities, see § 3.02.

Information statement, see §§ 6.25 & 6.26.

OFFICIAL COMMENT

Share transfer restrictions are widely used by both publicly held and closely held corporations for a variety of appropriate purposes. Although most courts have upheld reasonable share transfer restrictions, a few have rigidly followed the common law rule that they constituted restraints on alienation and should be strictly construed. As a result, some cases have invalidated restrictions outright, or construed them narrowly to prevent covering specific transfers. By prescribing reasonable rules to govern the use of transfer restrictions, section 6.27 should guide practitioners in their use and encourage a more uniform and favorable judicial reception.

Examples of the uses of share transfer restrictions include:

(1) a close corporation may impose share transfer restrictions to qualify for the close corporation election under the Model Statutory Close Corporation Supplement;

(2) a corporation with relatively few shareholders may impose share transfer restrictions to ensure that current shareholders will be able to control who may participate in the corporation's business;

(3) a corporation with relatively few shareholders may impose share transfer restrictions to ensure that shareholders who wish to retire will be able to liquidate their investment without disrupting corporate affairs;

(4) a corporation with few shareholders may impose share transfer restrictions in an effort to ensure that estates of deceased shareholders will be able to liquidate the closely held shares and that the Internal Revenue Service will accept the liquidated value of the shares as their value for estate tax purposes;

(5) a professional corporation may impose share transfer restrictions to ensure that its treatment of retiring or deceased shareholders is consistent with the canons of ethics applicable to the profession in question;

(6) a corporation may impose share transfer restrictions to ensure that its election of subchapter S treatment under the Internal Revenue Code will not be unexpectedly terminated; and

(7) a publicly held or closely held corporation issuing securities pursuant to an exemption from federal or state securities act registration may impose share transfer restrictions to ensure that subsequent transfers of shares will not result in the loss of the exemption being relied upon.

This listing, while not exhaustive, illustrates the flexibility of share transfer restrictions, their widespread use, and the importance of having a statute dealing with them.

Section 6.27(a) generally authorizes the imposition of transfer restrictions on "shares," although the caption of the section refers to "shares and other securities." Section 6.27(e) defines "shares" for purposes of section 6.27 to include securities "convertible into or carrying a right to subscribe for or acquire shares;" the phrase "other securities" in the title thus describes the broader scope of this section resulting from the definition in section 6.27(e).

Share transfer restrictions are usually created by provisions in the bylaws or articles of incorporation but may also be created by contract between the corporation and some or all the shareholders or between or among the shareholders themselves. However, if shares are originally issued free of restriction, they may not thereafter be subjected to a transfer restriction without the consent of the holder, evidenced by a vote in favor of the amendment to the articles or bylaws creating the restriction, or by being a party to the contract creating the restriction.

The terms of a restriction on transfer do not need to be set forth in full or summarized in detail on a certificate or information statement required by section 6.26(b) for uncertificated securities. Rather, section 6.27(b) provides that in the case of a certificated security, the existence of the restriction must be conspicuously set forth on the front or back of the certificate; in the case of an uncertificated security, the existence of the restriction must be noted in the information statement. There is no requirement that the notation on an information statement be conspicuous.

If a transferee knows of the restriction he is bound by it even though the restriction is not noted on the certificate or information statement.

Section 6.27(c) describes the purposes for which restrictions may be imposed while section 6.27(d) describes the types of restrictions that may be imposed.

Section 6.27(c) enumerates certain purposes for which share transfer restrictions may be imposed, but does not limit the purposes since section 6.27(c)(3) permits restrictions "for any other reasonable purpose." Examples of the "status" referred to in section 6.27(c)(1) are the subchapter S election under the Internal Revenue Code, and entitlement to a program or eligibility for a privilege administered by governmental agencies or national securities exchanges. Specific references in section 6.27 to subchapter S and other statutes were not made because of the possibility that the Internal Revenue Code or other statute may be amended or recodified after the adoption of the Model Act.

Section 6.27(c)(2) permits restrictions on transfers of shares to ensure availability of exemptions under state or federal securities acts. Share transfer restrictions for other purposes are permitted by section 6.23(c)(3) so long as the purpose is reasonable. It is unnecessary to inquire into the reasonableness of the purposes specifically enumerated in sections 6.27(c)(1) and (2).

The types of restrictions referred to in section 6.27(d)(1) (option agreements) and (2) (buy-sell agreements) are imposed as a matter of contractual negotiation and do not prohibit the outright transfer of shares. Rather, they designate to whom shares or other securities must be offered at a price established in the agreement or by a formula or method agreed to in advance. By contrast, the restrictions described in sections 6.27(d)(3) and (4) may permanently limit the market for shares by disqualifying all or some potential purchasers. As a result the restrictions imposed by these two provisions must not be "manifestly unreasonable."

§ 6.28. EXPENSE OF ISSUE

A corporation may pay the expenses of selling or underwriting its shares, and of organizing or reorganizing the corporation, from the consideration received for shares.

CROSS-REFERENCES

Consideration for shares, see section 6.21.

Fully paid shares, see section 6.21.

Liability for share consideration, see section 6.22.

OFFICIAL COMMENT

The original purpose of this section was to deal with the problems created by the concepts of "par value" and "stated capital;" it permitted the corporation to expend its capital for "the reasonable charges and expenses of" organization without fear of making the shares not fully paid or assessable because the assets were reduced below the aggregate par value of the issued shares.

Under the modern capitalization principles set forth in the Model Act (see the Official Comment to section 6.21), there is no basis for the fear that shares issued properly under section 6.21 can be made assessable because of the subsequent use of the proceeds. While section 6.28 thus may be technically unnecessary, it was believed to be desirable to retain in the Model Act a general authorization to the corporation to pay its expenses of formation and raising capital out of its original capitalization. The reference to "reasonable" charges and expenses was deleted on the theory that the test for these expenses should be no different from the test for expenses of any other type.

The concluding language in the original Model Act, "without rendering the shares not fully paid or assessable," was also deleted as unnecessary and confusing in the context of the revisions to the financial provisions of the Model Act.

This section has been rarely cited or referred to in court decisions even though it appears in a large number of state statutes.

Subchapter C.
SUBSEQUENT ACQUISITION OF SHARES BY SHAREHOLDERS AND CORPORATION

§ 6.30. SHAREHOLDERS' PREEMPTIVE RIGHTS

(a) The shareholders of a corporation do not have a preemptive right to acquire the corporation's unissued shares except to the extent the articles of incorporation so provide.

(b) A statement included in the articles of incorporation that "the corporation elects to have preemptive rights" (or words of similar import) means that the following principles apply except to the extent the articles of incorporation expressly provide otherwise:

(1) The shareholders of the corporation have a preemptive right, granted on uniform terms and conditions prescribed by the board of directors to provide a fair and reasonable opportunity to exercise the right, to acquire proportional amounts of the corporation's unisssued shares upon the decision of the board of directors to issue them.

(2) A shareholder may waive his preemptive right. A waiver evidenced by a writing is irrevocable even though it is not supported by consideration.

(3) There is no preemptive right with respect to:

(i) shares issued as compensation to directors, officers, agents, or employees of the corporation, its subsidiaries or affiliates:

(ii) shares issued to satisfy conversion or option rights created to provide compensation to directors, officers, agents, or employees of the corporation, its subsidiaries or affiliates;

(iii) shares authorized in articles of incorporation that are issued within six months from the effective date of incorporation;

(iv) shares sold otherwise than for money.

(4) Holders of shares of any class without general voting rights but with preferential rights to distributions or assets have no preemptive rights with respect to shares of any class.

(5) Holders of shares of any class with general voting rights but without preferential rights to distributions or assets have no preemptive rights with respect to shares of any class with preferential rights to distributions or assets unless the shares with preferential rights are convertible into or carry a right to subscribe for or acquire shares without preferential rights.

(6) Shares subject to preemptive rights that are not acquired by shareholders may be issued to any person for a period of one year after being offered to shareholders at a consideration set by the board of directors that is not lower than the consideration set for the exercise of preemptive rights. An offer at a lower consideration or after the expiration of one year is subject to the shareholders' preemptive rights.

(c) For purposes of this section, "shares" includes a security convertible into or carrying a right to subscribe for or acquire shares.

CROSS-REFERENCES

Articles of incorporation, see § 2.02.

Consideration for shares, see § 6.21.

Debt securities, see § 3.02.

Director standards of conduct, see § 8.30.

Distributions, see §§ 1.40 & 6.40.

Fractional shares, see § 6.04.

Share classes and series, see §§ 6.01 & 6.02.

Share options, see § 6.24.

OFFICIAL COMMENT

Section 6.30(a) adopts an "opt in" provision for preemptive rights: unless an affirmative reference to these rights appears in the articles of incorporation, no preemptive rights exist. Whether or not preemptive rights are elected, however, the directors' fiduciary duties extend to the issuance of shares. Issuance of shares at favorable prices to directors (but excluding other shareholders) or the issuance of shares on a nonproportional basis for the purpose of affecting control rather than raising capital may violate that duty. These duties, it is believed, form a more rational structure of regulation than the technical principles of traditional preemptive rights.

Section 6.30(b) provides a standard model for preemptive rights if the corporation desires to exercise the "opt in" alternative of section 6.30(a). The simple phrase, "the corporation elects to have preemptive rights," or words of similar import, results in the rest of subsection (b) becoming applicable to the corporation. But a corporation may qualify or limit any of the rules set forth in subsection (b) by express provisions in the articles of incorporation if the rules are felt to be undesirable or inappropriate for the specific corporation. The purposes of this standard model for preemptive rights are (1) to simplify drafting articles of incorporation and (2) to provide a simple checklist of business considerations for the benefit of attorneys who are considering the inclusion of preemptive rights in articles of incorporation.

The provisions of sections 6.30(b) establish rules for most of the problems involving preemptive rights. Thus subsection (b)(1) defines the general scope of the preemptive right giving appropriate recognition to the discretion of the board of directors in establishing the terms and conditions for exercise of that right. Subsection (b)(2) creates rules with respect to the waiver of these rights. Subsection (b)(3) lists the principal exceptions to preemptive rights, including a six-month period during which initial capital can be raised by a newly formed corporation without regard to the preemptive rights of persons who have previously acquired shares. Subsections (b)(4) and (b)(5) provide rules for the often-difficult problems created when preemptive rights are recognized in corporations with more than a single class of shares. These problems are discussed further below. Subsection (b)(6) defines the status of preemptive rights after a shareholder has elected not to exercise a proffered preemptive right: for a period of one year thereafter the corporation may dispose of the shares at the same or a higher price. A corporation deciding to offer shares at a lower price must reoffer the shares preemptively to the shareholders before selling them to third persons.

As indicated above, any portion of section 6.30(b) that is felt not to be appropriate for a specific corporation may be amended or deleted by appropriate provision in the articles of incorporation.

The model provision dealing with preemptive rights in section 6.30(b) is primarily designed to protect voting power within the corporation from dilution. For this reason, section 6.30(c) contains a special definition of "shares" to ensure that the preemptive rights of shareholders, if these rights are granted, apply to all securities that are convertible into or carry a right to acquire voting shares.

On the other hand, preemptive rights also may serve in part the function of protecting the equity participation of shareholders. This combination of functions creates no problem in a corporation that has authorized only a single class of shares but may occasionally create problems in corporations with more complex capital structures. In many multiple-class corporate financial structures, the issuance of additional shares of one class does not adversely affect other classes. For example, the issuance of additional general voting shares without preferential rights normally does not affect either the limited voting power or equity participation of holders of shares with preferential rights; holders of shares with preferential equity participation rights but without general voting rights should therefore have no preemptive rights with respect to general voting shares without preferential rights. See subsections (b)(4) and (b)(5). Classes of shares that may give rise to possible conflict between the protection of voting interests and equity participation when the board of directors desires to issue additional shares include classes of nonvoting shares without preferential rights and classes of shares with both preferential rights to distributions and general voting rights. Attorneys who draft articles of incorporation with classes of shares that may give rise to these conflicts should consider the precise application of section 6.30(b) with respect to preemptive rights for these classes and define more carefully the scope of the preemptive rights desired.

§ 6.31. CORPORATION'S ACQUISITION OF ITS OWN SHARES

(a) A corporation may acquire its own shares, and shares so acquired constitute authorized but unissued shares.

(b) If the articles of incorporation prohibit the reissue of the acquired shares, the number of authorized shares is reduced by the number of shares acquired.

CROSS-REFERENCES

Acquisition as “distribution, see § 1.40.

Amendment of articles of incorporation by board, see § 10.05(6).

Annual report, see § 16.21.

“Deliver,' see § 1.40.

Director standards of conduct, see § 8.30.

Distributions generally, see § 6.40.

Effective time and date of amendment, see § 1.23.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

Issuance of shares, see § 6.21.

Liability for unlawful distributions, see § 8.33.

OFFICIAL COMMENT

Section 6.31 applies only to shares that a corporation acquires for its own account. Shares that a corporation acquires in a fiduciary capacity for the account of others are not considered to be acquired by the corporation for purposes of this section.

Shares that are reacquired by the corporation become authorized but unissued shares under section 6.31(a) unless the articles prohibit reissue, in which event the shares are canceled and the number of authorized shares is reduced as required by section 6.31(b).

If the number of authorized shares of a class is reduced as a result of the operation of section 6.31(b), the board should amend the articles of incorporation under section 10.05(6) to reflect that reduction. If there are no remaining authorized shares in a class as a result of the operation of section 6.31, the board should amend the articles of incorporation under section 10.05(7) to delete the class from the classes of shares authorized by articles of incorporation.

Subchapter D.
DISTRIBUTIONS

§ 6.40. DISTRIBUTIONS TO SHAREHOLDERS

(a) A board of directors may authorize and the corporation may make distributions to its shareholders subject to restriction by the articles of incorporation and the limitation in subsection (c).

(b) If the board of directors does not fix the record date for determining shareholders entitled to a distribution (other than one involving a purchase, redemption, or other acquisition of the corporation's shares), it is the date the board of directors authorizes the distribution.

(c) No distribution may be made if, after giving it effect:

(1) the corporation would not be able to pay its debts as they become due in the usual course of business; or

(2) the corporation's total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

(d) The board of directors may base a determination that a distribution is not prohibited under subsection (c) either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.

(e) Except as provided in subsection (g), the effect of a distribution under subsection (c) is measured:

(1) in the case of distribution by purchase, redemption, or other acquisition of the corporation's shares, as of the earlier of (i) the date money or other property is transferred or debt incurred by the corporation or (ii) the date the shareholder ceases to be a shareholder with respect to the acquired shares;

(2) in the case of any other distribution of indebtedness, as of the date the indebtedness is distributed; and

(3) in all other cases, as of (i) the date the distribution is authorized if the payment occurs within 120 days after the date of authorization or (ii) the date the payment is made if it occurs more than 120 days after the date of authorization.

(f) A corporation's indebtedness to a shareholder incurred by reason of a distribution made in accordance with this section is at parity with the corporation's indebtedness to its general, unsecured creditors except to the extent subordinated by agreement.

(g) Indebtedness of a corporation, including indebtedness issued as a distribution, is not considered a liability for purposes of determinations under subsection (c) if its terms provide that payment of principal and interest are made only if and to the extent that payment of a distribution to shareholders could then be made under this section. If the indebtedness is issued as a distribution, each payment of principal or interest is treated as a distribution, the effect of which is measured on the date the payment is actually made.

(h) This section shall not apply to distributions in liquidation under chapter 14.

CROSS-REFERENCES

Director standards of conduct, see § 8.30.

"Distribution" defined, see § 1.40.

Liability for unlawful distributions, see § 8.33.

Record date, see § 7.07.

Redemption, see § 6.01 & 6.31.

Share dividends, see § 6.23.

OFFICIAL COMMENT

The reformulation of the statutory standards governing distributions is another important change made by the 1980 revisions to the financial provisions of the Model Act. It has long been recognized that the traditional "par value" and "stated capital" statutes do not provide significant protection against distributions of capital to shareholders. While most of these statutes contained elaborate provisions establishing "stated capital," "capital surplus," and "earned surplus" (and often other types of surplus as well), the net effect of most statutes was to permit the distribution to shareholders of most or all of the corporation's net assets—its capital along with its earnings—if the shareholders wished this to be done. However, statutes also generally imposed an equity insolvency test on distributions that prohibited distributions of assets if the corporation was insolvent or if the distribution had the effect of making the corporation insolvent or unable to meet its obligations as they were projected to arise.

The financial provisions of the revised Model Act, which are based on the 1980 amendments, sweep away all the distinctions among the various types of surplus but retain restrictions on distributions built around both the traditional equity insolvency and balance sheet tests of earlier statutes.

1. The Scope of Section 6.40

Section 1.40 defines "distribution" to include virtually all transfers of money, indebtedness of the corporation or other property to a shareholder in respect of the corporation's shares. It thus includes cash or property dividends, payments by a corporation to purchase its own shares, distributions of promissory notes or indebtedness, and distributions in partial or complete liquidation or voluntary or involuntary dissolution. Section 1.40 excludes from the definition of "distribution" transactions by the corporation in which only its own shares are distributed to its shareholders. These transactions are called "share dividends" in the revised Model Act. See section 6.23.

Section 6.40 imposes a single, uniform test on all distributions. Many of the old "par value" and "stated capital" statutes provided tests that varied with the type of distribution under consideration or did not cover certain types of distributions at all.

2. Equity Insolvency Test

As noted above, older statutes prohibited payments of dividends if the corporation was, or as a result of the payment would be, insolvent in the equity sense. This test is retained, appearing in section 6.40(c)(1).

In most cases involving a corporation operating as a going concern in the normal course, information generally available will make it quite apparent that no particular inquiry concerning the equity insolvency test is needed. While neither a balance sheet nor an income statement can be conclusive as to this test, the existence of significant shareholders' equity and normal operating conditions are of themselves a strong indication that no issue should arise under that test. Indeed, in the case of a corporation having regularly audited financial statements, the absence of any qualification in the most recent auditor's opinion as to the corporation's status as a "going concern," coupled with a lack of subsequent adverse events, would normally be decisive.

It is only when circumstances indicate that the corporation is encountering difficulties or is in an uncertain position concerning its liquidity and operations that the board of directors or, more commonly, the officers or others upon whom they may place reliance under section 8.30(b), may need to address the issue. Because of the overall judgment required in evaluating the equity insolvency test, no one or more "bright line" tests can be employed. However, in determining whether the equity insolvency test has been met, certain judgments or assumptions as to the future course of the corporation's business are customarily justified, absent clear evidence to the contrary. These include the likelihood that (a) based on existing and contemplated demand for the corporation's products or services, it will be able to generate funds over a period of time sufficient to satisfy its existing and reasonably anticipated obligations as they mature, and (b) indebtedness which matures in the near-term will be refinanced where, on the basis of the corporation's financial condition and future prospects and the general availability of credit to businesses similarly situated, it is reasonable to assume that such refinancing may be accomplished. To the extent that the corporation may be subject to asserted or unasserted contingent liabilities, reasonable judgments as to the likelihood, amount, and time of any recovery against the corporation, after giving consideration to the extent to which the corporation is insured or otherwise protected against loss, may be utilized. There may be occasions when it would be useful to consider a cash flow analysis, based on a business forecast and budget, covering a sufficient period of time to permit a conclusion that known obligations of the corporation can reasonably be expected to be satisfied over the period of time that they will mature.

In exercising their judgment, the directors are entitled to rely, under section 8.30(b) as noted above, on information, opinions, reports, and statements prepared by others. Ordinarily, they should not be expected to become involved in the details of the various analyses or market or economic projections that may be relevant. Judgments must of necessity be made on the basis of information in the hands of the directors when a distribution is authorized. They should not, of course, be held responsible as a matter of hindsight for unforeseen developments. This is particularly true with respect to assumptions as to the ability of the corporation's business to repay long-term obligations which do not mature for several years, since the primary focus of the directors' decision to make a distribution should normally be on the corporation's prospects and obligations in the shorter term, unless special factors concerning the corporation's prospects require the taking of a longer term perspective.

3. Relationship to the Federal Bankruptcy Act and Other Fraudulent Conveyance Statutes

The revised Model Act establishes the validity of distributions from the corporate law standpoint under section 6.40 and determines the potential liability of directors for improper distributions under sections 8.30 and 8.33. The Federal Bankruptcy Act and state fraudulent conveyance statutes, on the other hand, are designed to enable the trustee or other representative to recapture for the benefit of creditors funds distributed to others in some circumstances. In light of these diverse purposes, it was not thought necessary to make the tests of section 6.40 identical to the tests for insolvency under these various statutes.

4. Balance Sheet Test

Section 6.40(c)(2) requires that, after giving effect to any distribution, the corporation's assets equal or exceed its liabilities plus (with some exceptions) the dissolution preferences of senior equity securities. Section 6.40(d) authorizes asset and liability determinations to be made for this purpose on the basis of either (1) financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or (2) a fair valuation or other method that is reasonable in the circumstances. The determination of a corporation's assets and liabilities and the choice of the permissible basis on which to do so are left to the judgment of its board of directors. In making a judgment under section 6.40(d), the board may rely under section 8.30(b) upon opinions, reports, or statements, including financial statements and other financial data prepared or presented by public accountants or others.

Section 6.40 does not utilize particular accounting terminology of a technical nature or specify particular accounting concepts. In making determinations under this section, the board of directors may make judgments about accounting matters, giving full effect to its right to rely upon professional or expert opinion.

In a corporation with subsidiaries, the board of directors may rely on unconsolidated statements prepared on the basis of the equity method of accounting (see American Institute of Certified Public Accountants, APB Opinion No. 18 (1971)) as to the corporation's investee corporations, including corporate joint ventures and subsidiaries, although other evidence would be relevant in the total determination.

A. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

The board of directors should in all circumstances be entitled to rely upon reasonably current financial statements prepared on the basis of generally accepted accounting principles in determining whether or not the balance sheet test of section 6.40(c)(2) has been met, unless the board is then aware that it would be unreasonable to rely on the financial statements because of newly-discovered or subsequently arising facts or circumstances. But section 6.40 does not mandate the use of generally accepted accounting principles; it only requires the use of accounting practices and principles that are reasonable in the circumstances. While publicly-owned corporations subject to registration under the Securities Exchange Act of 1934 must, and many other corporations in fact do, utilize financial statements prepared on the basis of generally accepted accounting principles, a great number of smaller or closely held corporations do not. Some of these corporations maintain records solely on a tax accounting basis and their financial statements are of necessity prepared on that basis. Others prepare financial statements that substantially reflect generally accepted accounting principles but may depart from them in some respects (e.g., footnote disclosure). These facts of corporate life indicate that a statutory standard of reasonableness, rather than stipulating generally accepted accounting principles as the normative standard, is appropriate in order to achieve a reasonable degree of flexibility and to accommodate the needs of the many different types of business corporations which might be subject to these provisions, including in particular closely held corporations. Accordingly, the revised Model Act contemplates that generally accepted accounting principles are always "reasonable in the circumstances" and that other accounting principles may be perfectly acceptable, under a general standard of reasonableness, even if they do not involve the "fair value" or "current value" concepts that are also contemplated by section 6.40(d).

B. OTHER PRINCIPLES

Section 6.40(d) specifically permits determinations to be made under section 6.40(c)(2) on the basis of a fair valuation or other method that is reasonable in the circumstances. Thus the statute authorizes departures from historical cost accounting and sanctions the use of appraisal and current value methods to determine the amount available for distribution. No particular method of valuation is prescribed in the statute, since different methods may have validity depending upon the circumstances, including the type of enterprise and the purpose for which the determination is made. For example, it is inappropriate in most cases to apply a "quick-sale liquidation" method to value an enterprise, particularly with respect to the payment of normal dividends. On the other hand, a "quick-sale liquidation" valuation method might be appropriate in certain circumstances for an enterprise in the course of reducing its asset or business base by a material degree. In most cases, a fair valuation method or a going concern basis would be appropriate if it is believed that the enterprise will continue as a going concern.

Ordinarily a corporation should not selectively revalue assets. It should consider the value of all of its material assets, whether or not reflected in the financial statements (e.g., a valuable executory contract). Likewise, all of a corporation's material obligations should be considered and revalued to the extent appropriate and possible. In any event, section 6.40(d) calls for the application under section 6.40(c)(2) of a method of determining the aggregate amount of assets and liabilities that is reasonable in the circumstances.

Section 6.40(d) also refers to some “other method that is reasonable in the circumstances.” This phrase is intended to comprehend within section 6.40(c)(2) the wide variety of possibilities that might not be considered to fall under a “fair valuation” or “current value” method but might be reasonable in the circumstances of a particular case.

5. Preferential Dissolution Rights and the Balance Sheet Test

Section 6.40(c)(2) provides that a distribution may not be made unless the total assets of the corporation exceed its liabilities plus the amount that would be needed to satisfy any shareholder’s superior preferential rights upon dissolution if the corporation were to be dissolved at the time of the distribution. This requirement in effect treats preferential dissolution rights of shares for distribution purposes as if they were liabilities for the sole purpose of determining the amount available for distributions, and carries forward analogous treatment of shares having preferential dissolution rights from earlier versions of the Model Act. In making the calculation of the amount that must be added to the liabilities of the corporation to reflect the preferential dissolution rights, the assumption should be made that the preferential dissolution rights are to be established pursuant to the articles of incorporation, as of the date of the distribution or proposed distribution. The amount so determined must include arrearages in preferential dividends if the articles of incorporation require that they be paid upon the dissolution of the corporation. In the case of shares having both a preferential right upon dissolution and other nonpreferential rights, only the preferential right should be taken into account. The treatment of preferential dissolution rights of classes of shares set forth in section 6.40(c)(2) is applicable only to the balance sheet test and is not applicable to the equity insolvency test of section 6.40(c)(1). The treatment of preferential rights mandated by this section may always be eliminated by an appropriate provision in the articles of incorporation.

6. Time of Measurement

Section 6.40(e)(3) provides that the time for measuring the effect of a distribution for compliance with the equity insolvency and balance sheet tests for all distributions not involving the reacquisition of shares or the distribution of indebtedness is the date of authorization, if the payment occurs within 120 days following the authorization; if the payment occurs more than 120 days after the authorization, however, the date of payment must be used. If the corporation elects to make a distribution in the form of its own indebtedness, under section 6.40(e)(2) the validity of that distribution must be measured as of the time of distribution, unless the indebtedness qualifies under section 6.40(g).

Section 6.40(e)(1) provides a different rule for the time of measurement when the distribution involves a reacquisition of shares. See below, Application to Reacquisition of Shares—Time of measurement.

7. Record Date

Section 6.40(b) fixes the record date (if the board of directors does not otherwise fix it) for distributions other than those involving a reacquisition of shares as the date the board of directors authorizes the distribution. No record date is necessary for a reacquisition of shares from one or more specific shareholders. The board of directors has discretion to set a record date for a reacquisition if it is to be pro rata and to be offered to all shareholders as of a specified date.

8. Application to Reacquisition of Shares

The application of the equity insolvency and balance sheet tests to distributions that involve the purchase, redemption, or other acquisition of the corporation's shares creates unique problems; section 6.40 provides a specific rule for the resolution of these problems as described below.

A. TIME OF MEASUREMENT

Section 6.40(e)(1) provides that the time for measuring the effect of a distribution under section 6.40(c), if shares of the corporation are reacquired, is the earlier of (i) the payment date, or (ii) the date the shareholder ceased to be a shareholder with respect to the shares, except as provided in section 6.40(g).

B. WHEN TESTS ARE APPLIED TO REDEMPTION-RELATED DEBT

In an acquisition of its shares, a corporation may transfer property or incur debt to the former holder of the shares. The case law on the status of this debt is conflicting. However, share repurchase agreements involving payment for shares over a period of time are of special importance in closely held corporate enterprises. Section 6.40(e) provides a clear rule for this situation: the legality of the distribution must be measured at the time of the issuance or incurrence of the debt, not at a later date when the debt is actually paid, except as provided in section 6.40(g). Of course, this does not preclude a later challenge of a payment on account of redemption-related debt by a bankruptcy trustee on the ground that it constitutes a preferential payment to a creditor.

C. PRIORITY OF DEBT DISTRIBUTED DIRECTLY OR INCURRED IN CONNECTION WITH A REACQUISITION OF SHARES

Section 6.40(f) provides that indebtedness created to acquire the corporation's shares or issued as a distribution is on a parity with the indebtedness of the corporation to its general, unsecured creditors, except to the extent subordinated by agreement. General creditors are better off in these situations than they would have been if cash or other property had been paid out for the shares or distributed (which is proper under the statute), and no worse off than if cash had been paid or distributed and then lent back to the corporation, making the shareholders (or former shareholders) creditors. The parity created by section 6.40(f) is logically consistent with the rule established by section 6.40(e) that these transactions should be judged at the time of the issuance of the debt.

D. TREATMENT OF CERTAIN INDEBTEDNESS

Section 6.40(g) provides that indebtedness need not be taken into account as a liability in determining whether the tests of section 6.40(c) have been met if the terms of the indebtedness provide that payments of principal or interest can be made only if and to the extent that payment of a distribution could then be made under section 6.40. This has the effect of making the holder of the indebtedness junior to all other creditors but senior to the holders of all classes of shares, not only during the time the corporation is operating but also upon dissolution and liquidation. It should be noted that the creation of such indebtedness, and the related limitations on payments of principal and interest, may create tax problems or raise other legal questions.

Although section 6.40(g) is applicable to all indebtedness meeting its tests, regardless of the circumstances of its issuance, it is anticipated that it will be applicable most frequently to permit the reacquisition of shares of the corporation at a time when the deferred purchase price exceeds the net worth of the corporation. This type of reacquisition will often be necessary in the case of businesses in early stages of development or service businesses whose value derives principally from existing or prospective net income or cash flow rather than from net asset value. In such situations, it is anticipated that net worth will grow over time from operations so that when payments in respect of the indebtedness are to be made the two insolvency tests will be satisfied. In the meantime, the fact that the indebtedness is outstanding will not prevent distributions that could be made under subsection (c) if the indebtedness were not counted in making the determination.

9. Distributions in Liquidation

Subsection (h) provides that distributions in liquidation under chapter 14 are not subject to the distribution limitations of section 6.40. Chapter 14 provides specifically for payment of creditor claims and distributions to shareholders in liquidation upon dissolution of the corporation. See section 14.09.

CHAPTER 7

Shareholders

Subchapter A.
MEETINGS

Subchapter B.
VOTING

Subchapter C.
VOTING TRUSTS AND AGREEMENTS

Subchapter D.
DERIVATIVE PROCEEDINGS

Subchapter E.
PROCEEDING TO APPOINT A CUSTODIAN OR RECEIVER

§ 7.48. Shareholder action to appoint Custodian or Receiver

Subchapter A.
MEETINGS

§ 7.01. ANNUAL MEETING

(a) Unless directors are elected by written consent in lieu of an annual meeting as permitted by section 7.04, a corporation shall hold a meeting of shareholders annually at a time stated in or fixed in accordance with the bylaws; provided, however, that if a corporation's articles of incorporation authorize shareholders to cumulate their votes when electing directors pursuant to section 7.28, directors may not be elected by less than unanimous consent.

(b) Annual shareholders' meetings may be held in or out of this state at the place stated in or fixed in accordance with the bylaws. If no place is stated in or fixed in accordance with the bylaws, annual meetings shall be held at the corporation's principal office.

(c) The failure to hold an annual meeting at the time stated in or fixed in accordance with a corporation's bylaws does not affect the validity of any corporate action.

CROSS-REFERENCES

Action without meeting, see § 7.04.
Bylaws, see § 2.06, ch.10B.
Close corporations, see Model Statutory Close Corporation Supplement.
Court-ordered meeting, see § 7.03.
Director holdover terms, see § 8.05.
Notice of meeting, see § 7.05.
"Principal office":
  defined, see § 1.40.
  designated in annual report, see § 16.21.
Proxies, see § 7.22.
Quorum and voting requirements, see §§ 7.25–7.27.
Shareholders' list at meeting, see § 7.20.
Special meeting, see § 7.02.
Voting entitlement generally, see § 7.21.
"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 7.01(a) requires every corporation to hold an annual meeting of shareholders entitled to participate in the election of directors unless directors are elected by written consent as provided for in section 7.04. The principal action to be taken at the annual meeting is the election of directors pursuant to section 8.03, but the purposes of the annual meeting are not limited and all matters appropriate for shareholder action may be considered at that meeting. An annual meeting is also an appropriate forum for a shareholder to raise any relevant question about the corporation's operations.

The requirement of section 7.01(a) that an annual meeting be held is phrased in mandatory terms to ensure that every shareholder entitled to participate in an annual meeting has the unqualified rights to (1) demand that an annual meeting be held and (2) compel the holding of the meeting under section 7.03 if the corporation does not promptly hold the meeting and if the shareholders have not elected directors by written consent.

Many corporations, such as nonpublic subsidiaries and closely held corporations, do not regularly hold annual meetings and, if no shareholder objects or action has been taken by written consent, that practice creates no problem under section 7.01, since section 7.01(c) provides that failure to hold an annual meeting does not affect the validity of any corporate action. The shareholders may act by consent under section 7.04. Directors, once duly elected, remain in office until their successors are elected or they resign or are removed. See section 8.05. Where the articles of incorporation permit the election of directors by less than unanimous written consent, however, such action could result in the replacement of directors, through the election of new directors, even if the vote in favor of such election were less than the vote necessary to satisfy a provision in the corporation's articles of incorporation or bylaws requiring a higher vote to remove directors.

Where a corporation's articles of incorporation permit cumulative voting in the election of directors, directors may not be elected by less than unanimous written consent.

The time and place of the annual meeting may be "stated in or fixed in accordance with the bylaws." If the bylaws do not themselves fix a time and place for the annual meeting, authority to fix them may be delegated to the board of directors or to a specified corporate officer. This section thus gives corporations the flexibility to hold annual meetings in varying places at varying times as convenience may dictate.

The annual meeting may be held either inside or outside the state or in a foreign country, but if the bylaws do not fix, or state the method of fixing, the place of the meeting, the meeting must be held at the "principal office" of the corporation. The principal office is defined in section 1.40 as the location of the principal executive office of the corporation and may or may not be its registered or official office under section 5.01. Section 16.21 requires that the address of the principal office be specified in the corporation's annual report.

Authority granted to the board of directors or some individual to fix the time and place of the annual meeting must be exercised in good faith. See *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971).

§ 7.02. SPECIAL MEETING

(a) A corporation shall hold a special meeting of shareholders:

(1) on call of its board of directors or the person or persons authorized to do so by the articles of incorporation or bylaws; or

(2) if the holders of at least 10% of all the votes entitled to be cast on an issue proposed to be considered at the proposed special meeting sign, date, and deliver to the corporation one or more written demands for the meeting describing the

purpose or purposes for which it is to be held, provided that the articles of incorporation may fix a lower percentage or a higher percentage not exceeding 25% of all the votes entitled to be cast on any issue proposed to be considered. Unless otherwise provided in the articles of incorporation, a written demand for a special meeting may be revoked by a writing to that effect received by the corporation prior to the receipt by the corporation of demands sufficient in number to require the holding of a special meeting.

(b) If not otherwise fixed under section 7.03 or 7.07, the record date for determining shareholders entitled to demand a special meeting is the date the first shareholder signs the demand.

(c) Special shareholders' meetings may be held in or out of this state at the place stated in or fixed in accordance with the bylaws. If no place is stated or fixed in accordance with the bylaws, special meetings shall be held at the corporation's principal office.

(d) Only business within the purpose or purposes described in the meeting notice required by section 7.05(c) may be conducted at a special shareholders' meeting.

CROSS-REFERENCES

Action without meeting, see § 7.04.

Annual meeting, see § 7.01.

Articles of incorporation, see § 2.02.

Bylaws, see § 2.06, ch. 10B.

Court-ordered meeting, see § 7.03.

Notice of meeting, see § 7.05.

Objection to extraneous business, see § 7.06.

"Principal office":

  defined, see § 1.40.

  designated in annual report, see § 16.21.

Quorum and voting requirements, see §§ 7.25–7.27.

Shareholders' list at meeting, see § 7.20.

Voting entitlement generally, see § 7.21.

"Voting group" defined, see § 1.40.

Waiver of notice, see § 7.06.

OFFICIAL COMMENT

Any meeting other than an annual meeting is a special meeting under section 7.02. The principal formal differences between an annual and a special meeting are that at an annual meeting directors are elected and, subject to the special notice requirements of section 7.05(b), any relevant issue pertaining to the corporation may be considered, while a special meeting must be called for specific purposes and may only consider matters within those purposes.

1. Who May Call a Special Meeting

A special meeting may be called under section 7.02(a) by the board of directors or the person or persons authorized to do so by the articles of incorporation or bylaws. Typically, the person or persons holding certain designated offices within the corporation, e.g., the president, chairman of the board of directors, or chief executive officer, are given authority to call special meetings of the shareholders. In addition, the holders of at least 10% of the votes entitled to be cast on a proposed issue at the special meeting may require the corporation to hold a special meeting by signing, dating, and delivering one or more writings that demand a special meeting and set forth the purpose or purposes of the desired meeting. That percentage may be decreased or increased (but to not more than 25%) by a provision in the articles of incorporation fixing a different percentage. Shareholders demanding a special meeting do not have to sign a single piece of paper, but the writings signed must all describe essentially the same purpose or purposes. Revocations of written demands will be effective if delivered to the corporation in the manner contemplated by section 1.41(d) and received before the corporation receives the requisite number of demands requiring that a special meeting be called. However, revocations received after that time will be a nullity and shall be given no effect. Upon receipt of writings evidencing a demand by holders with the requisite number of votes, the corporation (through an appropriate officer) must call the special meeting at a reasonable time and place. The shareholders' demand may suggest a time and place but the final decision on such matters is the corporation's. If no meeting is held within the time periods specified in section 7.03, the shareholders may obtain a summary court order under that section requiring that the meeting be held.

Section 7.02(b) fixes a record date for determining the shareholders entitled to sign a demand for a special shareholders' meeting. Unless a record date is otherwise fixed for this purpose, the record date is the date the first shareholder signs the demand. If a shareholder initially signs a demand but later seeks to withdraw that demand, the corporation may permit the shareholder to do so.

2. Discretion as to Calls of Special Meeting

Under section 7.02(a)(2) it is possible that more than one faction of shareholders may demand meetings at roughly the same time or that a single (or changing) faction of shareholders may request consecutive, overlapping, or repetitive meetings. The responsible corporate officers have some discretion as to the call and purposes of a meeting, and where demands are repetitious or overlapping, they may refuse to call a meeting for a purpose identical or similar to a purpose for which a previous special meeting was held in the recent past. Similarly, they may decline to call a special meeting when an annual meeting will be held in the near future. This limited discretion of the corporation to deny repetitive or overlapping demands may ultimately be tested under section 7.03, which itself gives the court discretion whether or not to compel the holding of a special meeting under these circumstances. See the Official Comment to section 7.03.

3. The Business That May Be Conducted at a Special Meeting

Section 7.05(c) provides that a notice of a special meeting must include a "description of the purpose or purposes for which the meeting is called." Section 7.02(d) states that only business that is within that purpose or those purposes may be conducted at the special meeting.

The word "within" was chosen, rather than a broader phrase like "reasonably related to," to describe the relationship between the notice and the authorized business to assure a shareholder who does not attend a special meeting that new or unexpected matters will not be considered in the shareholder's absence.

§ 7.03. COURT-ORDERED MEETING

(a) The [name or describe] court of the county where a corporation's principal office (or, if none in this state, its registered office) is located may summarily order a meeting to be held:

(1) on application of any shareholder of the corporation entitled to participate in an annual meeting if an annual meeting was not held or action by written consent in lieu thereof did not become effective within the earlier of 6 months after the end of the corporation's fiscal year or 15 months after its last annual meeting; or

(2) on application of a shareholder who signed a demand for a special meeting valid under section 7.02, if:

(i) notice of the special meeting was not given within 30 days after the date the demand was delivered to the corporation's secretary; or

(ii) the special meeting was not held in accordance with the notice.

(b) The court may fix the time and place of the meeting, determine the shares entitled to participate in the meeting, specify a record date for determining shareholders entitled to notice of and to vote at the meeting, prescribe the form and content of the meeting notice, fix the quorum required for specific matters to be considered at the meeting (or direct that the votes represented at the meeting constitute a quorum for action on those matters), and enter other orders necessary to accomplish the purpose or purposes of the meeting.

CROSS-REFERENCES

Annual meeting, see § 7.01.
Effective date of notice, see § 1.41.
Notice of meeting, see § 7.05.
"Principal office":
  defined, see § 1.40.
  designated in annual report, see § 16.21.
Quorum and voting requirements, see §§ 7.25–7.27.
Registered office:
  designated in annual report, see § 16.21.
  required, see §§ 2.02 & 5.01.
Shareholders' list for voting at meeting, see § 7.20.
Voting entitlement generally, see § 7.21.

OFFICIAL COMMENT

Section 7.03 provides the remedy for shareholders if the corporation refuses or fails to hold a shareholders' meeting lieu thereof as required by section 7.01 or 7.02. A shareholder entitled to participate in a meeting may apply for a summary court order to command the holding of a meeting if (1) an annual meeting or action by written consent in lieu thereof is not held within 6 months after the end of the corporation's fiscal year or 15 months after its last annual meeting, or (2) a special meeting is not properly noticed within 30 days after a valid demand is delivered to the secretary of the corporation or, if properly noticed, is not held in accordance with the notice. Since a meeting must be held within 60 days of the notice date under section 7.05, the maximum delay between the demand for a special meeting and the right to petition a court for a summary order is 90 days.

1. The Court with Jurisdiction to Administer Section 7.03

The identity of the specific court with jurisdiction to order a shareholder's meeting under section 7.03(a) must be supplied by each state when enacting this section. It is intended that this should be a court of general civil jurisdiction. Generally, all matters relating to a corporation should be addressed to the court in the county where the corporation's principal office is located in the state or, if the corporation does not have a principal office in the state, to the court in the county in which its registered office is located.

2. The Discretion of the Court to Order a Meeting

The court has broad discretion under section 7.03 since the language of the statute is that the court "may summarily section 7.03 as to whether to order" that a meeting be held. A court, for example, may refuse to order a special meeting if the specified purpose is repetitive of the purpose of a special meeting held in the recent past. See the Official Comment to section 7.02. Alternatively, the court may view the demand as a good faith request for reconsideration of an action taken in the recent past and may order a meeting to be held. Similarly, even though a demand for an annual meeting is not a formal prerequisite for an application for a summary order under this section, the court may withhold setting a time and date for the annual meeting for a reasonably short period in order to permit the corporation to do so.

3. Burden of Proof

In any event, a shareholder applying for a summary order to hold a meeting has the burden of showing entitlement to such an order. In the case of a special meeting, the shareholder has the burden of showing that the demand was signed by the holders of at least 10% of the votes entitled to be cast on the record date and that the demand was duly delivered to the corporation's secretary.

4. Notice, Time, Place, and Quorum and Other Requirements

If the court orders that a meeting be held, it may fix the time and place of the meeting, determine the voting groups entitled to participate in the meeting, set the record date, order notice to be given as required by section 7.05, and enter such other orders as may be appropriate for the holding of the meeting. The court may also establish the quorum requirements for specific matters to be considered at the meeting or direct that the votes represented at the meeting automatically constitute a quorum for the taking of any action without regard to section 7.25 or any provision to the contrary in the corporation's articles of incorporation or bylaws. The latter alternative prevents a holder of the majority of the votes (who may not desire that a meeting be held) from frustrating the court-ordered meeting by not attending to prevent the existence of a quorum. In order to prevent misunderstanding about a special quorum requirement, if one is imposed, it is appropriate for the court to order that the notice of the meeting state specifically and conspicuously that a special quorum requirement is applicable to the court-ordered meeting. The court may also enter orders overriding the articles of incorporation or bylaws relating to matters such as notice (including advance notice requirements), *and* time and place of the meeting.

5. Status as Annual Meeting

The court may provide that a meeting it has ordered is to be the annual meeting. If so provided, the meeting should be viewed as compliance with section 7.01, precluding all other shareholder requests for an annual meeting for that year.

§ 7.04. ACTION WITHOUT MEETING

(a) Action required or permitted by this Act to be taken at a shareholders' meeting may be taken without a meeting if the action is taken by all the shareholders entitled to vote on the action. The action must be evidenced by one or more written consents bearing the date of signature and describing the action taken, signed by all the shareholders entitled to vote on the action and delivered to the corporation for inclusion in the minutes or filing with the corporate records.

(b) The articles of incorporation may provide that any action required or permitted by this Act to be taken at a shareholders' meeting may be taken without a meeting, and without prior notice, if consents in writing setting forth the action so taken are signed by the holders of outstanding shares having not less than the minimum number of votes that would be required to authorize or take the action at a meeting at which all shares entitled to vote on the action were present and voted. The written consent shall bear the date of signature of the shareholder who signs the consent and be delivered to the corporation for inclusion in the minutes or filing with the corporate records.

(c) If not otherwise fixed under section 7.07 and if prior board action is not required respecting the action to be taken without a meeting, the record date for determining the shareholders entitled to take action without a meeting shall be the first date on which a signed written consent is delivered to the corporation. If not otherwise fixed under section 7.07 and if prior board action is required respecting the action to be taken without a meeting, the record date shall be the close of business on the day the resolution of the board taking such prior action is adopted. No written consent shall be effective to take the corporate action referred to therein unless, within 60 days of the earliest date on which a consent delivered to the corporation as required by this section was signed, written consents signed by sufficient shareholders to take the action have been delivered to the corporation. A written consent may be revoked by a writing to that effect delivered to the corporation before unrevoked written consents sufficient in number to take the corporate action are delivered to the corporation.

(d) A consent signed pursuant to the provisions of this section has the effect of a vote taken at a meeting and may be described as such in any document. Unless the articles of incorporation, bylaws or a resolution of the board of directors provides for a reasonable delay to permit tabulation of written consents, the action taken by written consent shall be effective when written consents signed by sufficient shareholders to take the action are delivered to the corporation.

(e) If this Act requires that notice of a proposed action be given to nonvoting shareholders and the action is to be taken by written consent of the voting shareholders, the corporation must give its nonvoting shareholders written notice of the action not more than 10 days after (i) written consents sufficient to take the action have been delivered to the corporation, or (ii) such later date that tabulation of consents is completed pursuant to an authorization under subsection (d). The notice must reasonably describe the action taken and contain or be accompanied by the same material that, under any provision of this Act, would have been required to be sent to nonvoting shareholders in a notice of a meeting at which the proposed action would have been submitted to the shareholders for action.

(f) If action is taken by less than unanimous written consent of the voting shareholders, the corporation must give its nonconsenting voting shareholders written notice of the action not more than 10 days after (i) written consents sufficient to take the action have been delivered to the corporation, or (ii) such later date that tabulation of consents is completed pursuant to an authorization under subsection (d). The notice must reasonably describe the action taken and contain or be accompanied by the same material that, under any provision of this Act, would have been required to be sent to voting shareholders in a notice of a meeting at which the action would have been submitted to the shareholders for action.

(g) The notice requirements in subsections (e) and (f) shall not delay the effectiveness of actions taken by written consent, and a failure to comply with such notice requirements shall not invalidate actions taken by written consent, provided that this subsection shall not be deemed to limit judicial power to fashion any appropriate remedy in favor of a shareholder adversely affected by a failure to give such notice within the required time period.

(h) An electronic transmission may be used to consent to an action, if the electronic transmission contains or is accompanied by information from which the corporation can determine the date on which the electronic transmission was signed and that the electronic transmission was authorized by the shareholder, the shareholder's agent or the shareholder's attorney-in-fact.

(i) Delivery of a written consent to the corporation under this section is delivery to the corporation's registered agent at its registered office or to the secretary of the corporation at its principal office.

CROSS-REFERENCES

Acceptance of consents, see § 7.24.
Amendment of articles of incorporation, see ch. 10A.
"Deliver," see § 1.40.
Disposition of assets, see ch. 12.
Dissolution, see ch. 14.
Merger and share exchange, see ch. 11.
"Notice" defined, see § 1.41.
"Secretary" defined, see § 1.40.
"Sign," see § 1.40.
Voting entitlement generally, see § 7.21.

OFFICIAL COMMENT

Section 7.04 permits shareholders to act by written consent without holding a meeting. Section 7.04(a) permits shareholders to take action by unanimous written consent and is applicable to all corporations. As a practical matter, unanimous written consent is obtainable only for matters on which there are relatively few shareholders entitled to vote, and is thus generally not used by public corporations. Under section 7.04(b) a corporation may include in its articles of incorporation a provision that permits shareholder action by less than unanimous written consent. For closely held corporations, this provision provides an opportunity to eliminate formalities that the owners may consider unnecessary. In considering whether to include this provision, one should take into account that some shareholders may oppose the elimination of the annual meeting because of their desire to meet with the corporation's management and directors at that meeting. The availability of shareholder action by less than unanimous consent may also facilitate a sudden change in control.

The unanimous written consent permitted in section 7.04(a) is applicable to any shareholder action, including, without limitation, election of directors, approval of mergers or sales of substantially all the corporate property not in the ordinary course of business, amendments of articles of incorporation, and dissolution. If the articles of incorporation permit action by less than unanimous written consent, they may also limit or otherwise specify the shareholder actions that may be approved by less than unanimous consent. If a corporation has determined to elect directors by cumulative voting, such directors may not be elected by less than unanimous written consent. See sections 7.01(a) and 7.28. Action by written consent has the same effect as a meeting vote and may be described as such in any document, including documents delivered to the secretary of state for filing.

1. Form of Written Consent

To be effective, a consent must be in writing, dated and delivered to the corporation's registered agent at its registered office or to its secretary at its principal office. A written consent may be delivered by means of an electronic transmission. See section 1.40(5).

A shareholder or proxy may use an electronic transmission to consent to an action. If an electronic transmission is used to consent to an action, the corporation must be able to determine from the transmission the date of the signature and that the consent was authorized by the shareholder or a person authorized to act for the shareholder. See sections 1.40(7A), 1.40(22A) and 7.22(b).

A unanimous written consent must be signed by all the shareholders entitled to vote on the action. A less than unanimous written consent must be signed by those shareholders entitled to cast not less than the minimum number of votes necessary to take the action if all shares entitled to vote on the action were present and voted at a meeting of shareholders. In some cases, more votes may be required to approve an action by less than unanimous written consent than would be required to approve the same action at a meeting that is not attended by all shareholders. For example, if an action requires the approval of a majority of shares represented at a meeting where a quorum (a majority of the votes entitled to be cast) is present, a corporation with 1,000 shares eligible to vote on the action will need 501 votes to approve the action by less than unanimous written consent; at a meeting at which only a quorum is present the same action will be approved if the votes cast in favor of the proposed action exceed the votes cast opposing the action, resulting in approval by as few as 251 votes (assuming no abstentions). Where the Model Act or a corporation's articles of incorporation provide for a greater voting requirement, however, the number of shares required to consent to an action may be the same as the number of shares required to approve the action at a meeting of shareholders.

The phrase "one or more written consents" is included in section 7.04 to make it clear that shareholders do not need to sign the same piece of paper. For actions that do not require prior board action, the record date for determining who is entitled to vote, if not otherwise fixed by or in accordance with the bylaws, is the date the first signed consent is delivered to the corporation. For actions that require prior board action, if not otherwise fixed by the board, the record date is the date the board's prior action is adopted. To minimize the possibility that action by written consent will be authorized by action of persons who may no longer be shareholders at the time the action is taken, section 7.04(c) requires that all consents be signed within 60 days of the earliest signature date of the consents delivered to the corporation.

2. Notice to Nonconsenting Shareholders

When action is taken by less than unanimous written consent, the Model Act requires that notice be given to nonconsenting shareholders not more than 10 days after the later of the date (a) written consents sufficient for the action to be valid are delivered to the corporation and (b) tabulation of consents is completed. The notice must describe the action that was taken and be accompanied by any materials required to be given to shareholders in a notice of a meeting at which the action was to be considered. The failure to give notice within the required time period will not invalidate or delay the effectiveness of a shareholder action, although a shareholder may seek other remedies. By requiring notice only after shareholder action has been taken, the Model Act preserves the practical utility of the less than unanimous written consent when action needs to be taken quickly, without the delay that would result from a mandatory prior notice requirement. Of course a corporation may provide for advance notice in its articles of incorporation.

3. *Effectiveness and Revocation of Consent*

Shareholder approval in the form of action by written consent is effective only when the last shareholder required to validly take action by written consent has signed the written consent and all consents have been delivered to the corporation. Before that time, a shareholder may withdraw a consent simply by delivering a written revocation of the consent to the corporation. Cf. *Calumet Industries, Inc. v. McClure*, 464 F. Supp. 19 (N.D. Ill. 1978). The withdrawal of a single consent, of course, destroys the unanimous written consent but may not impact a less than unanimous written consent. If a shareholder seeks to withdraw a consent after the requisite number of shareholders to validly take an action by written consent have signed written consents and filed them with the corporation, such withdrawal will be a nullity and shall be given no effect.

4. *Consent to Fundamental Corporate Changes*

Section 7.04(a) is applicable to all shareholder actions, including the approval of fundamental corporate changes described in chapters 10, 11, 12, and 14. If permitted by a corporation's articles of incorporation, shareholders may also approve fundamental corporate changes by less than unanimous written consent. If action approving fundamental corporate changes were taken at an annual or special meeting, shareholders who were not entitled to vote on the matter would nevertheless be entitled to receive notice of the meeting, including a description of the transaction proposed to be considered at the meeting. See, e.g., sections 10.03 (notice of proposed amendment), 11.04 (notice of proposed merger). If action is taken by written consent rather than at a meeting, section 7.04(e) provides that nonvoting shareholders must be given the same written notice of the action not more than 10 days after the later of the date (a) written consents sufficient for the action to be valid are delivered to the corporation and (b) tabulation of consents is completed. The notice must be accompanied by the same materials required by the Model Act to be given to nonvoting shareholders in a notice of meeting at which the action was to be considered.

§ 7.05. NOTICE OF MEETING

(a) A corporation shall notify shareholders of the date, time, and place of each annual and special shareholders' meeting no fewer than 10 nor more than 60 days before the meeting date. Unless this Act or the articles of incorporation require otherwise, the corporation is required to give notice only to shareholders entitled to vote at the meeting.

(b) Unless this Act or the articles of incorporation require otherwise, notice of an annual meeting need not include a description of the purpose or purposes for which the meeting is called.

(c) Notice of a special meeting must include a description of the purpose or purposes for which the meeting is called.

(d) If not otherwise fixed under section 7.03 or 7.07, the record date for determining shareholders entitled to notice of and to vote at an annual or special shareholders' meeting is the day before the first notice is delivered to shareholders.

(e) Unless the bylaws require otherwise, if an annual or special shareholders' meeting is adjourned to a different date, time, or place, notice need not be given of the new date, time, or place if the new date, time, or place is announced at the meeting before adjournment. If a new record date for the adjourned meeting is or must be fixed under section 7.07, however, notice of the adjourned meeting must be given under this section to persons who are shareholders as of the new record date.

CROSS-REFERENCES

Annual meeting, see § 7.01.

"Deliver," see § 1.40.

Effective date of notice, see § 1.41.

"Notice" defined, see § 1.41.

Notice otherwise required:

amendment, see § 10.03.

directors' conflicting interest transactions, approval by shareholders, see §§ 8.61(b) & 8.63.

disposition of assets, see § 12.02.

dissolution, see § 14.02.

merger and share exchange, see § 11.04.

Special meeting, see § 7.02.

Waiver of notice, see § 7.06.

OFFICIAL COMMENT

Shareholders entitled to notice must be given notice of annual and special meetings pursuant to section 7.05 unless the notice is waived pursuant to section 7.06. Notice must be given at least 10 but not more than 60 days before the meeting date.

1. Shareholders Entitled to Notice

Generally, only shareholders who are entitled to vote at a meeting are entitled to notice. Thus, notice usually needs to be sent only to holders of shares entitled to vote for an election of directors or generally on other matters (in the case of an annual meeting), and on matters within the specified purposes set forth in the notice (in the case of a special meeting), and only to holders of shares of those classes or series of shares on the record date. The last sentence of section 7.05(a), however, recognizes that other sections of the Act require that notice of meetings at which certain types of fundamental corporate changes are to be considered must be sent to all shareholders, including holders of shares who are not entitled to vote on any matter at the meeting. See sections 10.03, 11.04, 12.02, and 14.02. In addition, the articles of incorporation may require that notice of meetings be given to all or specified voting groups of shareholders who are not entitled to vote on the matters considered at those meetings.

2. Statement of Matters to Be Considered at an Annual Meeting

Notice of all special meetings must include a description of the purpose or purposes for which the meeting is called and the matters acted upon at the meeting are limited to those within the notice of meeting. By contrast, the Model Act does not require that the notice of an annual meeting refer to any specific purpose or purposes, and any matter appropriate for shareholder action may be considered. As recognized in subsection (b), however, other provisions of the Model Act provide that certain types of fundamental corporate changes may be considered at an annual meeting only if specific reference to the proposed action appears in the notice of meeting. See sections 10.03, 11.04, 12.02, and 14.02. In addition, as a condition to relying upon shareholder action to establish the safe harbor protection of section 8.61(b), section 8.63 requires notice to shareholders providing information regarding any director's conflict of interest in a transaction. If the board of directors chooses, a notice of an annual meeting may contain references to purposes or proposals not required by statute. In the event that management intends to present nonroutine proposals for a shareholder vote and shareholders have not otherwise been informed of such proposals, good corporate practice suggests that references to such proposals be made in the notice. In any event, if a notice of an annual meeting refers specifically to one or more purposes, the meeting is not limited to those purposes.

3. Record Date

Section 7.05(d) is a catch-all record date provision for both annual and special meetings. If the record date for notice and for voting entitlement is not otherwise fixed pursuant to sections 7.03 or 7.07, the record date for purposes of determining who is entitled to notice and to vote at the meeting is the day before the notice is mailed to the voting groups of shareholders. If notice is mailed to shareholders over a period of more than one day, the day before the notice is delivered to the first shareholders is the record date.

The selection of the day before the notice is mailed as the catch-all record date is intended to permit the corporation to mail notices to shareholders on a given day without regard to any requests for transfer that may have been received during that day. For this reason, this section is not inconsistent with the general principle set forth in the last sentence of section 7.07(a) that the board of directors may not fix a retroactive record date.

4. Notice of Adjourned Meetings

Section 7.05(e) provides rules for adjourned meetings and determines whether new notice must be given to shareholders. Under this subsection a meeting may be adjourned to a different date, time, or place without additional notice to the shareholders (unless the bylaws require otherwise) if the new date, time, or place is announced before adjournment. But new notice is required if a new record date is or must be fixed under section 7.07(c). If a new record date is or must be fixed, the 10-to-60-day notice requirement and all other requirements of section 7.05

must be complied with as notice is given to the persons who are shareholders as of the new record date. A new quorum for the adjourned meeting must also be established. See section 7.25.

Section 7.25 provides that if a quorum exists for a meeting, it is deemed to continue to exist automatically for an adjourned meeting unless a new record date is or must be set for the adjourned meeting.

§ 7.06. WAIVER OF NOTICE

(a) A shareholder may waive any notice required by this Act, the articles of incorporation, or bylaws before or after the date and time stated in the notice. The waiver must be in writing, be signed by the shareholder entitled to the notice, and be delivered to the corporation for inclusion in the minutes or filing with the corporate records.

(b) A shareholder's attendance at a meeting:

(1) waives objection to lack of notice or defective notice of the meeting, unless the shareholder at the beginning of the meeting objects to holding the meeting or transacting business at the meeting;

(2) waives objection to consideration of a particular matter at the meeting that is not within the purpose or purposes described in the meeting notice, unless the shareholder objects to considering the matter when it is presented.

CROSS-REFERENCES

Acceptance of waiver, see § 7.24.

Action without meeting, see § 7.04.

Meeting notice, see § 7.05.

"Notice" defined, see § 1.41.

Proxies, see § 7.22.

Waiver of quorum objection, see § 7.25.

OFFICIAL COMMENT

Section 7.06(a) permits any shareholder to waive any notice required by section 7.05 by a written waiver, signed by the shareholder and delivered to the corporation. A waiver is effective even though it is signed at or after the time set for the meeting.

1. Informal Waiver of Notice

A notice of shareholder meetings serves two principal purposes: (1) it advises shareholders of the date, time, and place of the annual or special meeting, and (2) in the case of a special meeting (or an annual meeting at which fundamental changes may be made), it advises shareholders of the purposes of the meeting. If a shareholder attends a meeting, the shareholder has probably received some form of notice of the date, time, and place of the meeting, whether from the corporation or from another source. As a result, section 7.06(b)(1) provides that attendance at a meeting constitutes waiver of any failure to receive the notice or defects in the statement of the date, time, and place of any meeting. Defects waived by attendance for this purpose include a failure to send the notice altogether, delivery to the wrong address, a misstatement of the date, time, or place of the meeting, and a failure to notice the meeting within the time periods specified in section 7.05(a). If a shareholder believes that the defect in or failure of notice was in some way prejudicial, the share-older may state at the beginning of the meeting an objection to holding the meeting or transacting any business. If this objection is made, the corporation may correct the defect by sending proper notice to the shareholders for a subsequent meeting or by obtaining written waivers of notice from all shareholders who did not receive the notice required by section 7.05.

For purposes of this section, "attendance" at a meeting involves the presence of the shareholder in person or by proxy. A shareholder who attends a meeting solely for the purpose of objecting to the notice may be counted as present for purposes of determining whether a quorum is present. See the Official Comment to section 7.25.

In the case of special meetings, or annual meetings at which fundamental corporate changes are considered, a second purpose of the notice is to tell shareholders what is to be considered at the meeting. An objection that a particular matter is not within the stated purposes of the meeting obviously cannot be raised until the matter is presented. Thus section 7.06(b)(2) provides that a shareholder waives this kind of objection by failing to object promptly after the matter is first presented. If this objection is made, the corporation may correct the defect by sending proper notice to the shareholders for a subsequent meeting or obtaining written waivers of notice from all shareholders. Of course, whether a specific matter is within a stated purpose of a meeting is ultimately a matter for judicial determination, typically in a suit to invalidate action taken at the meeting brought by a shareholder who was not present at the meeting or who was present at the meeting and preserved an objection under section 7.06(b).

The purpose of both waiver rules in section 7.06(b) is to require shareholders with technical objections to holding the meeting or considering a specific matter to raise them at the outset and not reserve them to be raised only if they are unhappy with the outcome of the meeting. The rules set forth in this section differ in some respects from the waiver rules for directors set forth in section 8.23 where a waiver is inferred if the director acquiesces in the action taken at a meeting even if the director raised a technical objection to the notice of a meeting at the outset.

2. Waiver of Notice Where Fundamental Corporate Actions Are Considered

Other sections of the Model Act require that shareholders who are not entitled to vote are entitled to notice of meetings at which certain fundamental corporate changes are to be considered. See sections 10.03, 11.04, 12.02, and 14.02. In order to obtain an effective waiver of notice for these meetings under this section, waivers must be obtained from the nonvoting shareholders who are entitled to notice as well as from the voting shareholders.

§ 7.07. RECORD DATE

(a) The bylaws may fix or provide the manner of fixing the record date for one or more voting groups in order to determine the shareholders entitled to notice of a shareholders' meeting, to demand a special meeting, to vote, or to take any other action. If the bylaws do not fix or provide for fixing a record date, the board of directors of the corporation may fix a future date as the record date.

(b) A record date fixed under this section may not be more than 70 days before the meeting or action requiring a determination of shareholders.

(c) A determination of shareholders entitled to notice of or to vote at a shareholders' meeting is effective for any adjournment of the meeting unless the board of directors fixes a new record date, which it must do if the meeting is adjourned to a date more than 120 days after the date fixed for the original meeting.

(d) If a court orders a meeting adjourned to a date more than 120 days after the date fixed for the original meeting, it may provide that the original record date continues in effect or it may fix a new record date.

CROSS-REFERENCES

Annual meeting, see § 7.01.

Bylaws, see § 2.06 & ch. 10B.

Court-ordered meeting, see § 7.03.

Other record date provisions:

action without meeting, see § 7.04.

distributions to shareholders, see § 6.40.\

notice of meeting, see § 7.05.

special meeting, see § 7.02.

"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 7.07 authorizes the board of directors to fix record dates for any action unless the bylaws themselves fix or provide for the fixing of a record date. A separate record date may be established for each voting group entitled to vote separately on a matter at a meeting, or a single record date may be established for all voting groups entitled to participate in the meeting. If neither the bylaws nor the board of directors fix a record date for a specific action, the section of this Act that deals with that action itself fixes the record date. For example, section 7.05(d), relating to giving notice of a meeting, provides that the record date for determining who is entitled to notice of a meeting (if not fixed by the directors or the bylaws) is the close of business on the day before the date the corporation first gives notice to shareholders of the meeting.

A record date may not be fixed more than 70 days before the meeting or action in question and may not be fixed retroactively. Once set, the same record date may be utilized for an adjournment of the meeting that reconvenes within 120 days after the date fixed for the original meeting or the board of directors may fix a new record date. If the adjourned meeting takes place more than 120 days after the date fixed for the original meeting, section 7.07(c) requires that a new record date be fixed. But if an adjournment is ordered by a court, section 7.07(d) allows the court to provide that the original record date continues to be applicable or to fix a different date. In any event, if a different record date is or must be fixed under this section, section 7.05 requires that new notice be given to the persons who are shareholders as of the new record date, and section 7.25 requires that a quorum be reestablished for that meeting.

§ 7.08. CONDUCT OF THE MEETING

(a) At each meeting of shareholders, a chair shall preside. The chair shall be appointed as provided in the bylaws or, in the absence of such provision, by the board.

(b) The chair, unless the articles of incorporation or bylaws provide otherwise, shall determine the order of business and shall have the authority to establish rules for the conduct of the meeting.

(c) Any rules adopted for, and the conduct of, the meeting shall be fair to shareholders.

(d) The chair of the meeting shall announce at the meeting when the polls close for each matter voted upon. If no announcement is made, the polls shall be deemed to have closed upon the final adjournment of the meeting. After the polls close, no ballots, proxies or votes nor any revocations or changes thereto may be accepted.

CROSS-REFERENCES

Annual meeting, see § 7.01.
Articles of incorporation, see § 2.02.
Bylaws, see § 2.06 & ch. 10B.
Court-ordered meeting, see § 7.03.
Proxies, see § 7.22.
Special meeting, see § 7.02.

OFFICIAL COMMENT

Section 7.08 provides that, at any meeting of the shareholders, there shall be a chair who shall preside over the meeting. The chair is appointed in accordance with the bylaws. Generally, the chair of the board of directors presides over the meeting. However, the bylaws could provide that the chief executive officer, if different than the chair of the board, preside over the meeting and they should provide a means of designating an alternate if that individual is for any reason unable to preside.

Section 7.08(b) gives the chair, unless the articles of incorporation or bylaws provide otherwise, the authority to determine in what order items of business should be discussed and decided. Inherent in the chair's power to establish rules for the conduct of the meeting is the authority to require that the order of business be observed and that any discussion or comments from shareholders or their proxies be confined to the business item under discussion. However, it is also expected that the chair will not misuse the power to determine the order of business and to establish rules for the conduct of the meeting so as to unfairly foreclose the right of shareholders—subject to the Act, the articles of incorporation and the bylaws—to raise items which are properly a subject for shareholder discussion or action at some point in the meeting prior to adjournment.

The Act provides that only business within the purpose or purposes described in the meeting notice may be conducted at a special shareholders' meeting. See sections 7.02(d) and 7.05(c). In addition, a corporation's articles of incorporation or, more typically, its bylaws, may contain advance notice provisions requiring that shareholder nominations for election to the board of directors or resolutions intended to be voted on at the annual meeting must be made in writing and received by the corporation a prescribed number of days in advance of the meeting. Such advance notice bylaws are permitted provided (1) there is reasonable opportunity for shareholders to comply with them in a timely fashion, and (2) the requirements of the bylaws are reasonable in relationship to corporate needs.

Among the considerations to be taken into account in determining reasonableness are (a) how and with what frequency shareholders are advised of the specific bylaw provisions, and (b) whether the time frame within which director nominations or shareholder resolutions must be submitted is consistent with the corporation's need, if any, (i) to prepare and publish a proxy statement, (ii) to verify that the director nominee meets any established qualifications for director and is willing to serve, (iii) to determine that a proposed resolution is a proper subject for shareholder action under the Act or other state law, or (iv) to give interested parties adequate opportunity to communicate a recommendation or response with respect to such matters, or to solicit proxies. Whether or not an advance notice provision has been adopted, if a public company receives advance notice of a matter to be raised for a vote at an annual meeting, management may exercise its discretionary authority only in compliance with SEC Rule 14a-4(c)(1) adopted under the Securities Exchange Act of 1934.

Section 7.08(b) also provides that the chair shall have the authority to establish rules for the conduct of the meeting. Complicated parliamentary rules (such as Robert's Rules of Order) ordinarily are not appropriate for shareholder meetings. The rules may cover such subjects as the proper means for obtaining the floor, who shall have the right to address the meeting, the manner in which shareholders will be recognized to speak, time limits per speaker, the number of times a shareholder may address the meeting, and the person to whom questions should be addressed. The substance of the rules should be communicated to shareholders prior to or at the beginning of the meeting. The chair is entitled to wide latitude in conducting the meeting and, unless inconsistent with a previously prescribed rule, may set requirements, observe practices, and follow customs that facilitate a fair and orderly meeting. Since, absent a modifying bylaw provision, the chair has exclusive authority with respect to the rules for and the conduct of the meeting, rulings by the chair may not be overruled by shareholders. On the other hand, any rule for or conduct of the meeting which does not satisfy the fairness mandate of section 7.08(c) would be subject to a judicial remedy.

Section 7.08(d) requires that an announcement be made at the meeting of shareholders specifying when the polls will close for each matter voted upon. It also provides that, once the polls close, no ballots, proxies, or votes and no changes thereto may be accepted. This statutory provision eliminates an area of uncertainty which had developed in the relatively sparse case law dealing with the effect of closing the polls, some of which suggested that, notwithstanding the closing of the polls, votes could be changed up until the time that the inspectors of election announced the results. *Young v. Jebbett*, 211 N.Y.S. 61 (N.Y. App. Div. 1925); *State ex rel. David v. Dailey*, 168 P.2d 330 (Wash. 1945). Any abusive use of the poll-closing power would be subject to judicial review under subsection (c) as well as under that line of cases requiring that meetings of shareholders be conducted fairly and proscribing inequitable manipulations of the shareholder voting machinery. See, e.g., *Duffy v. Loft, Inc*., 151 A. 223 (Del. Ch. 1930); *Schnell v. Chris-Craft Ind., Inc.*, 285 A.2d 437 (Del. 1971).

Subchapter B.
VOTING

§ 7.20. SHAREHOLDERS' LIST FOR MEETING

(a) After fixing a record date for a meeting, a corporation shall prepare an alphabetical list of the names of all its shareholders who are entitled to notice of a shareholders' meeting. The list must be arranged by voting group (and within each voting group by class or series of shares) and show the address of and number of shares held by each shareholder.

(b) The shareholders' list must be available for inspection by any shareholder, beginning two business days after notice of the meeting is given for which the list was prepared and continuing through the meeting, at the corporation's principal office or at a place identified in the meeting notice in the city where the meeting will be held. A shareholder, or the shareholder's agent or attorney, is entitled on written demand to inspect and, subject to the requirements of section 16.02(c), to copy the list, during regular business hours and at the shareholder's expense, during the period it is available for inspection.

(c) The corporation shall make the shareholders' list available at the meeting, and any shareholder, or the shareholder's agent or attorney, is entitled to inspect the list at any time during the meeting or any adjournment.

(d) If the corporation refuses to allow a shareholder, or the shareholder's agent or attorney. to inspect the shareholders' list before or at the meeting (or copy the list as permitted by subsection (b)), the [name or describe] court of the county where a corporation's principal office (or, if none in this state, its registered office) is located, on application of the shareholder, may summarily order the inspection or copying at the corporation's expense and may postpone the meeting for which the list was prepared until the inspection or copying is complete.

(e) Refusal or failure to prepare or make available the shareholders' list does not affect the validity of action taken at the meeting.

CROSS-REFERENCES

Annual meeting, see § 7.01.
Charge for providing copy, see § 16.03.
Effective date of notice, see § 1.41.
Inspection of corporate records generally, see ch. 16A.
"Notice" defined, see § 1.41.
Notice of meeting, see § 7.05.
"Principal office":
  defined, see § 1.40.
  designated in annual report, see § 16.21.
Proper purpose for copying, see § 16.02.
Record date, see § 7.07.

Record of shareholders, see § 16.01.
Registered office:
designated in annual report, see § 16.21.
required, see §§ 2.02 & 5.01.
"Shareholder" defined, see § 1.40.
Special meeting, see § 7.02.
Voting entitlement generally, see § 7.21.
"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 7.20 requires the preparation of a list of shareholders entitled to notice of a meeting and requires that this list be made available on request to shareholders within two business days after the meeting notice is given.

The list of shareholders is often referred to as the "voting list" and usually the list will include only the names of those shareholders entitled to vote at the meeting. The list, however, must also include the names and shareholdings of shareholders of nonvoting shares if they are entitled to notice of the meeting by reason of the nature of the actions proposed to be taken at the meeting. See section 7.05 and its Official Comment.

Making the list of shareholders available before the meeting marks a change from the 1969 version of the Model Act. Through this device, a shareholder may learn the identity of the owners of substantial blocks of shares or the owners of shares similarly situated and communicate with them to see if the shareholder's concerns are shared and should be pursued.

1. When the List Must Be Available

The list must generally be available for inspection two business days after notice of the meeting is given and continuously thereafter until the meeting occurs. If, however, notice of the meeting is waived by all the shareholders, the list need be available only at the meeting itself under section 7.20(c) unless one or more waivers are conditioned upon receipt of the list.

2. Where the List Must Be Maintained

Section 7.20(b) permits the list to be maintained either at the corporation's principal office or at another location in the city in which the meeting is to be held, the precise location to be designated in the notice of meeting. If the corporation changes the location of its annual meeting, it thus may correspondingly change the location of the list of shareholders pursuant to this subsection.

Section 7.20(c) also requires a copy of the shareholders' list to be available at the meeting itself for inspection. This list may be used to determine attendance, the presence or absence of a quorum, and the right to vote.

3. The Form in Which the List Is Maintained

Section 7.20 does not require the list of shareholders to be in any particular form. It may be maintained, for example, in electronic form. If the list is maintained in other than written form, however, suitable equipment must be provided so that a comprehensible list may be inspected by a shareholder as permitted by this section.

4. Consequences of Failing to Prepare the List or Refusal to Make it Available

Section 7.20 creates a corporate obligation rather than an obligation imposed upon a corporate officer. If the corporation fails to prepare the list or refuses to permit a shareholder to inspect it, either before the meeting as required by section 7.20(b) or at the meeting itself as required by section 7.20(c), a shareholder may apply to the appropriate court under section 7.20(d) for a summary order permitting inspection of the list; the court may further order the meeting to be postponed for a reasonable time. If the court orders a copy of the list to be provided to the shareholders, the copying is at the corporation's expense; if the corporation produces the list voluntarily pursuant to section 7.20(b) or (c), any inspection and copying are at the shareholder's expense.

This judicial remedy is the only sanction for violation of section 7.20 since section 7.20(e) provides that the failure to prepare, maintain, or produce the list does not affect the validity of any action taken at the meeting.

5. The Right to Obtain a Copy of the List

Section 7.20(b) permits shareholders to "inspect" the list without limitation, but permits the shareholder to "copy" the list only if the shareholder complies with the requirement of section 16.02(c), that the demand be "made in good faith and for a proper purpose." The right to copy the list includes, if reasonable, the right to receive a copy of the list upon payment of a reasonable charge. See sections 16.03(b) and (c). The distinction between "inspection" and "copying" set forth in section 7.20(b) reflects an accommodation between competing considerations of permitting shareholders access to the list before a meeting and possible misuse of the list.

6. Relationship to Right to Inspect Corporate Records Generally

Section 7.20 creates a right of shareholders to inspect a list of shareholders in advance of and at a meeting that is independent of the rights of shareholders to inspect corporate records under chapter 16A. A shareholder may obtain the right to inspect the list of shareholders as provided in chapter 16A without regard to the provisions relating to the pendency of a meeting in section 7.20, and similarly the limitations of chapter 16A are not applicable to the right of inspection created by section 7.20 except to the extent the shareholder seeks to copy the list in advance of the meeting.

The right to inspect under chapter 16A is also broader in the sense that in some circumstances the shareholder may be entitled to receive copies of the documents the shareholder may inspect. See section 16.03.

§ 7.21. VOTING ENTITLEMENT OF SHARES

(a) Except as provided in subsections (b) and (d) or unless the articles of incorporation provide otherwise, each outstanding share, regardless of class, is entitled to one vote on each matter voted on at a shareholders' meeting. Only shares are entitled to vote.

(b) Absent special circumstances, the shares of a corporation are not entitled to vote if they are owned, directly or indirectly, by a second corporation, domestic or foreign, and the first corporation owns, directly or indirectly, a majority of the shares entitled to vote for directors of the second corporation.

(c) Subsection (b) does not limit the power of a corporation to vote any shares, including its own shares, held by it in a fiduciary capacity.

(d) Redeemable shares are not entitled to vote after notice of redemption is mailed to the holders and a sum sufficient to redeem the shares has been deposited with a bank, trust company, or other financial institution under an irrevocable obligation to pay the holders the redemption price on surrender of the shares.

CROSS-REFERENCES

Acceptance of votes, see § 7.24.
Articles of incorporation, see § 2.02.
Business combinations, see § 11.03.
Cumulative voting, see § 7.28.
Director establishment of voting rights, see § 6.02.
"Notice" defined, see § 1.41.
Proxy voting, see § 7.22.
Redeemable shares, see § 6.01.
Series of shares, see § 6.02.
"Share" defined, see § 1.40.
Shareholders' meetings, see §§ 7.01–7.03.
Voting by nominees, see § 7.23.
Voting by voting groups, see §§ 1.40, 7.25, 7.26.
Voting rights generally, see § 7.01.

OFFICIAL COMMENT

Section 7.21 deals with the entitlement of shareholders to vote, while section 7.22 deals with voting by proxy and section 7.24 establishes rules for the corporation's acceptance or rejection of proxy votes.

1. Voting Power of Shares

Section 7.21(a) provides that each outstanding share, regardless of class, is entitled to one vote per share unless otherwise provided in the articles of incorporation. See section 6.01 and its Official Comment. The articles of incorporation may provide for multiple or fractional votes per share, and may provide that some classes of shares are nonvoting on some or all matters, or that some classes have a single vote per share or different multiple or fractional votes per share, or that some classes constitute one or more separate voting groups and are entitled to vote separately on the matter.

The articles of incorporation may also authorize the board of directors to create classes or series of shares with preferential rights, which may be voting or nonvoting in whole or in part. See section 6.02 and its Official Comment.

Fractional or multiple votes per share, or nonvoting shares, are often used in the planning of business ventures, particularly closely held ventures, when the contributions of participants vary in kind or quality. It is possible through these devices, for example, to give persons with relatively small financial contributions a relatively large voting power within the corporation.

The power to vary or condition voting power is also often used to give increased protection to financial interests in the corporation. It is customary, for example, to make classes of shares with preferential rights nonvoting, but the power to vote may be granted to those classes if distributions are omitted for a specified period. This conditional right to vote may permit the class of shares with preferential rights to vote separately as a voting group to elect one or more directors or to vote with the shares having general voting rights in the election of the directors.

In order to reflect the possibility that shares may have multiple or fractional votes per share, all provisions relating to quorums, voting, and similar matters in the Model Act are phrased in terms of "votes" rather than "shares."

2. Voting Power of Nonshareholders

Under the last sentence of section 7.21(a), the power to vote cannot be granted generally to nonshareholders. The statutes of some states permit bondholders to be given the power to vote under certain specified circumstances; this option is not available under the Model Act. But creditors may in effect be given the power to vote, e.g., by creating a special class of redeemable voting shares for them, by creating a voting trust at the time the credit is extended with power in the creditors to name the voting trustees, by registering the shares in the name of the creditors as pledgees with power to vote, or by granting the creditors a revocable or irrevocable proxy to vote some or all of the outstanding shares. See the Official Comment to section 7.22.

3. Circular Holdings

Section 7.21(b) prohibits the voting of shares held by a domestic or foreign corporation that is itself a majority-owned subsidiary of the corporation issuing the shares. The purpose of this prohibition is to prevent management from using a corporate investment to perpetuate itself in power. Similar public policy considerations may be present in situations where the issuing corporation owns a large but not a majority interest in the corporation voting the shares. The inclusion of section 7.2 1(b) is not intended to affect the possible application of common law principles that may invalidate circular holding situations not within its literal prohibition. As to the possible existence of these common law principles, see, e.g., *Cleveland Trust Co. v. Eaton*, 11 Ohio Misc. 151, 229 N.E.2d 850 (1967), rev'd on the basis of statutory amendment, 20 Ohio St. 2d 129, 256 N.E.2d 198 (1970). The phrase "absent special circumstances" is included to enable a court to permit the voting of shares where it deems that the purpose of the section is not violated.

4. Shares Held in a Fiduciary Capacity

Section 7.21(c) makes the prohibition against voting of circularly-owned shares of section 7.21(b) inapplicable to shares held in a fiduciary capacity. Compare DEL. GEN. CORP. LAW § 160(c). The Ohio statute involved in the Eaton case authorized a bank to vote its own shares that were held by it in a fiduciary capacity. A state may grant or prohibit such voting by another statute; section 7.21(c) provides only that such voting is not prohibited by the Model Act.

5. Redeemable Shares

Redeemable shares are often redeemed in connection with a transaction such as a merger or the issuance of a new senior class of shares that requires shareholder approval. Section 7.21(d) avoids subjecting a transaction to approval by a class of redeemable shares that will be redeemed as a result of the transaction if adequate provision has been made to ensure that the holders of the redeemable shares will in fact receive the amount payable to them on redemption.

§ 7.22. PROXIES

(a) A shareholder may vote the shareholder's shares in person or by proxy.

(b) A shareholder, or the shareholder's agent or attorney-in-fact, may appoint a proxy to vote or otherwise act for the shareholder by signing an appointment form, or by an electronic transmission. An electronic transmission must contain or be accompanied by information from which one can determine that the shareholder, the shareholder's agent, or the shareholder's attorney-in-fact authorized the transmission.

(c) An appointment of a proxy is effective when a signed appointment form or an electronic transmission of the appointment is received by the inspector of election or the officer or agent of the corporation authorized to tabulate votes. An appointment is valid for 11 months unless a longer period is expressly provided in the appointment form.

(d) An appointment of a proxy is revocable unless the appointment form or electronic transmission states that it is irrevocable and the appointment is coupled with an interest. Appointments coupled with an interest include the appointment of:

(1) a pledgee;

(2) a person who purchased or agreed to purchase the shares;

(3) a creditor of the corporation who extended it credit under terms requiring the appointment;

(4) an employee of the corporation whose employment contract requires the appointment; or

(5) a party to a voting agreement created under section 7.31.

(e) The death or incapacity of the shareholder appointing a proxy does not affect the right of the corporation to accept the proxy's authority unless notice of the death or incapacity is received by the secretary or other officer or agent authorized to tabulate votes before the proxy exercises authority under the appointment.

(f) An appointment made irrevocable under subsection (d) is revoked when the interest with which it is coupled is extinguished.

(g) A transferee for value of shares subject to an irrevocable appointment may revoke the appointment if the transferee did not know of its existence when acquiring the shares and the existence of the irrevocable appointment was not noted conspicuously on the certificate representing the shares or on the information statement for shares without certificates.

(h) Subject to section 7.24 and to any express limitation on the proxy's authority stated in the appointment form or electronic transmission, a corporation is entitled to accept the proxy's vote or other action as that of the shareholder making the appointment.

CROSS-REFERENCES

Acceptance of proxy votes, see § 7.24.
Certificateless shares, see § 6.26.
"Conspicuous" defined, see § 1.40.
"Electronic transmission" defined, see § 1.40.
Information on share certificates, see § 6.25.
"Notice" defined, see § 1.41.
"Secretary" defined, see § 1.40.
"Transmitted electronically" defined, see § 1.40.

OFFICIAL COMMENT

Section 7.22 provides that shareholders may vote in person or by proxy and establishes the basic rules for appointing a proxy. As business organizations have increased in size and complexity, the number of shareholders has also increased. As a result, proxy voting is an essential step in the governance of many corporations.

1. Nomenclature

The word "proxy" is often used ambiguously, sometimes referring to the grant of authority to vote, sometimes to the document granting the authority, and sometimes to the person to whom the authority is granted. In the Model Act the word "proxy" is used only in the last sense; the terms "appointment form" and "electronic transmission" are used to describe the document or communication appointing the proxy; and the word "appointment" is used to describe the grant of authority to vote.

2. Appointment of Proxy

A shareholder may appoint a proxy to vote by signing an appointment form, either personally or by the shareholder's agent or attorney-in-fact. An electronic transmission which appoints a proxy is deemed the equivalent of a signed appointment form if it contains or is accompanied by information from which it can be reasonably verified that the transmission was authorized by the shareholder or by the shareholder's agent or attorney-in-fact. "Electronic transmission" as used in this section means any process of communication not directly involving the physical transfer of paper that is suitable for the retention, retrieval, and reproduction of information by the recipient. See section 1.40(7A). Section 7.22(b) is intended to sanction the practice whereby shareholders who have been provided in proxy materials with a personal identification number may call in their vote and identifying number to a person who, acting as the shareholder's agent, causes that information to be transmitted, directly or indirectly, to the inspector of election.

The appointment is effective when an appointment form or an electronic transmission (or documentary evidence thereof, including verification information) is received by the inspector of election or the officer or agent of the corporation authorized to receive and tabulate votes. The proxy has the same power to vote as that possessed by the shareholder, unless the appointment form or electronic transmission contains an express limitation on the power to vote or direction as to how to vote the shares on a particular matter, in which event the corporation must tabulate the votes in a manner consistent with that limitation or direction. See section 7.22(h).

3. Duration of Proxy

An appointment form that contains no expiration date is valid for 11 months. See section 7.22(c). This ensures that in the normal course a new appointment will be solicited at least once every 12 months. But an appointment form may validly specify a longer period if the parties agree.

The appointment of a proxy is essentially the appointment of an agent and is revocable in accordance with the principles of agency law unless it is "coupled with an interest." See section 7.22(d). Thus, an appointment may be revoked either expressly or by implication, as when a shareholder later signs a second appointment form inconsistent with an earlier one, or attends the meeting in person and seeks to vote on the shareholder's own behalf. The revised Model Act does not attempt to codify these common law principles of agency law.

While death or incapacity of the appointing shareholder revokes an agency appointment under common law principles, section 7.22(e) modifies the common law rule to provide that the corporation may accept the vote of the proxy until the appropriate corporate officer or agent receives notice of the shareholder's death or incapacity. In view of the widespread dispersal of shareholders in many corporations, it is not feasible for the corporation to learn of these events independently of notice. On the other hand, section 7.22(e) does not affect the validity of the proxy appointment or its manner of exercise as between the proxy and the personal representatives of the decedent or incompetent. That relationship is governed by the law of agency independent of the Model Act.

4. *Irrevocable Proxies*

Section 7.22(d) deals with the irrevocable appointment of a proxy. The general test adopted is the common law test that all appointments are revocable unless "coupled with an interest." But section 7.22(d) provides considerable certainty since it describes several accepted forms of relationship as examples of "proxies coupled with an interest." These examples are not exhaustive and other arrangements may also be held to be "coupled with an interest." See Comment, "The Irrevocable Proxy and Voting Control of Small Business Corporations," 98 U. PA. L. REV. 401, 405–7 (1950); see generally 1 RESTATEMENT OF AGENCY (SECOND) § 138 (1958).

Section 7.22(f) provides that an irrevocable proxy is revoked when the interest with which it was coupled is extinguished—for example, by repayment of the loan or release of the pledge.

A transferee for value of shares that are subject to an irrevocable appointment takes free of the appointment if (1) the transferee did not know of the existence of the appointment and (2) the existence of the irrevocable appointment was not noted conspicuously on the certificate or information statement. See section 7.22(g). Under this subsection, both the appointment and the irrevocable nature of the appointment must conspicuously appear on the certificate.

§ 7.23. SHARES HELD BY NOMINEES

(a) A corporation may establish a procedure by which the beneficial owner of shares that are registered in the name of a nominee is recognized by the corporation as the shareholder. The extent of this recognition may be determined in the procedure.

(b) The procedure may set forth:

(1) the types of nominees to which it applies;

(2) the rights or privileges that the corporation recognizes in a beneficial owner;

(3) the manner in which the procedure is selected by the nominee;

(4) the information that must be provided when the procedure is selected;

(5) the period for which selection of the procedure is effective; and

(6) other aspects of the rights and duties created.

CROSS-REFERENCES

"Shareholder" defined, see § 1.40.

OFFICIAL COMMENT

Traditionally, a corporation recognizes only the registered owner as the owner of shares. Indeed, section 1.40 defines "shareholder" basically as the registered owner of shares. But it has become a common practice for persons purchasing shares to have them registered in the "street name" of a broker-dealer or other financial institution, principally to facilitate transfer by eliminating the need for the beneficial owner's signature and delivery. In addition, in order to avoid the burdens of processing securities transfers, which caused a crisis in the securities industry in the late 1960s, a system of securities depositories (defined as "clearing corporations" in section 8-102(3) of the Uniform Commercial Code) has been developed. In this system, financial institutions deposit securities with the depository, which becomes the registered owner of the shares. Transfers between depositories are then accomplished by book entry of the depository. As a result, there may be two entities interposed between the corporation and the beneficial owner with the depository being the registered owner for the account of the brokerage firm that in turn holds the shares for the account of the beneficial owner.

The purpose of section 7.23 is to facilitate direct communication between the corporation and the beneficial owner by authorizing the corporation to create a procedure for bypassing both the registered owner and intermediate brokerage firms. The adoption of this procedure is discretionary with each corporation and affirmative action by the corporation is necessary to accomplish it. The procedure is also discretionary with the shareholder, who must elect to follow the applicable procedure prescribed by the corporation. The shareholder retains all rights except those granted to the beneficial owner.

The corporation may limit or qualify the procedure as it deems appropriate. For example, the corporation may:

(1) limit the procedure to certain classes of shareholders, such as depositories, broker-dealers and banks, or their nominees, or make the procedure available to all shareholders;

(2) permit a shareholder to adopt the procedure with respect to some but not all of the shares registered in the shareholder's name (and in that case the shareholder continues to be treated as the shareholder with respect to the balance);

(3) specify the purpose or purposes for which the certification is effective, e.g., for giving notice of, and voting at, shareholders' meetings, for the distribution of proxy statements and annual reports, or for payment of cash dividends;

(4) specify the form of the certification, e.g., a written list, computer tape, or some other form of compatible input;

(5) specify the type of information that must be provided, e.g., the name, address, and taxpayer identification number of the beneficial owner, , and the number of shares registered directly in the shareholder's name;

(6) establish deadlines for receipt of the certifications after the establishment of a record date so that the corporation may schedule its mailings; or

(7) provide that a new certification is required following each record date or that a certification as of a certain date may continue until changed by the certifying shareholder.

This listing is illustrative and not exhaustive. It is expected that experimentation with various devices under this section may reveal other areas which the corporation's plan should address.

The definition of "shareholder" in section 1.40 includes beneficial owners to the extent they obtain the rights of shareholders pursuant to the procedure authorized by this section.

§ 7.24. CORPORATION'S ACCEPTANCE OF VOTES

(a) If the name signed on a vote, consent, waiver, or proxy appointment corresponds to the name of a shareholder, the corporation if acting in good faith is entitled to accept the vote, consent, waiver, or proxy appointment and give it effect as the act of the shareholder.

(b) If the name signed on a vote, consent, waiver, or proxy appointment does not correspond to the name of its shareholder, the corporation if acting in good faith is nevertheless entitled to accept the vote, consent, waiver, or proxy appointment and give it effect as the act of the shareholder if:

(1) the shareholder is an entity and the name signed purports to be that of an officer or agent of the entity;

(2) the name signed purports to be that of an administrator, executor, guardian, or conservator representing the shareholder and, if the corporation requests, evidence of fiduciary status acceptable to the corporation has been presented with respect to the vote, consent, waiver, or proxy appointment;

(3) the name signed purports to be that of a receiver or trustee in bankruptcy of the shareholder and, if the corporation requests, evidence of this status acceptable to the corporation has been presented with respect to the vote, consent, waiver, or proxy appointment;

(4) the name signed purports to be that of a pledgee, beneficial owner, or attorney-in-fact of the shareholder and, if the corporation requests, evidence acceptable to the corporation of the signatory's authority to sign for the shareholder has been presented with respect to the vote, consent, waiver, or proxy appointment;

(5) two or more persons are the shareholder as co-tenants or fiduciaries and the name signed purports to be the name of at least one of the co-owners and the person signing appears to be acting on behalf of all the co-owners.

(c) The corporation is entitled to reject a vote, consent, waiver, or proxy appointment if the secretary or other officer or agent authorized to tabulate votes, acting in good faith, has reasonable basis for doubt about the validity of the signature on it or about the signatory's authority to sign for the shareholder.

(d) The corporation and its officer or agent who accepts or rejects a vote, consent, waiver, or proxy appointment in good faith and in accordance with the standards of this section or section 7.22(b) are not liable in damages to the shareholder for the consequences of the acceptance or rejection.

(e) Corporate action based on the acceptance or rejection of a vote, consent, waiver, or proxy appointment under this section is valid unless a court of competent jurisdiction determines otherwise.

CROSS-REFERENCES

Consents, see § 7.04.
"Entity" defined, see § 1.40.
Officers, see § 8.40.
Proxies, see § 7.22.
"Secretary" defined, see § 1.40.
"Shareholder" defined, see § 1.40.
"Sign," see § 1.40.
Voting by nominees, see § 7.23.
Waiver of notice, see § 7.06.

OFFICIAL COMMENT

Corporations are often asked to accept a written instrument as evidence of action by a shareholder. These instruments usually involve appointment forms for a proxy to vote the shares, but may also include waivers of notice, consents to action without a meeting, requests for a special meeting of shareholders, and similar instruments involving action by the shareholders. Usually the corporation or its officers will have no personal knowledge of the circumstances under which the instrument was executed and no way of verifying whether the signature on the instrument is in fact the signature of the shareholder. This problem is particularly acute in large corporations with thousands of shareholders.

Section 7.24 establishes general rules permitting the corporation and its officers or agents to accept these instruments if they appear to be signed by the shareholder or by a person who has authority to sign the instrument for the shareholder and they are accompanied by whatever authenticating evidence the corporation reasonably requests. The rules set forth in this section are not exclusive and may be supplemented by additional rules established by the corporation pursuant to section 2.06(b). Section 7.24(a) authorizes acceptance of an instrument if the name appearing on the instrument "corresponds" to the name of the shareholder, while section 7.24(b) permits the acceptance of an instrument signed by a person other than the shareholder if there is a designation or evidence of the capacity of the person executing the instrument that indicates the act of the person is the act of the shareholder. On the other hand, section 7.24(c) permits rejection of an instrument if the officer or agent tabulating votes has a "reasonable basis for doubt" about the validity of the signature or about the authority of the person acting on behalf of the shareholder. These principles are described in greater detail to follow.

The purpose of section 7.24 is to protect the corporation and its officers or agents from liability for damages to the shareholder if action is taken in accordance with the section. Thus section 7.24(d) provides that there is no liability to the shareholder if the corporation's officer or agent, acting in good faith, accepts an instrument that meets the requirements of section 7.24(a) or (b) or accepts an electronic transmission authorized by section 7.22(b), even if it turns out that the signing was invalid or unauthorized; similarly, no liability exists if the officer or agent, again acting in good faith, rejects an instrument because of a "reasonable basis for doubt," even though it turns out that the instrument was properly signed by the shareholder. But section 7.24 does not address the question whether an action was properly or improperly taken or approved, and section 7.24(e) makes clear that the validity or invalidity of corporate action is ultimately a matter for judicial resolution through review of the results of an election in a suit to enjoin or compel corporate action. It is contemplated that any such suit will be brought promptly, typically before the corporate action is consummated or the corporation's position otherwise changes in reliance on the vote, and that any suit that is not brought promptly under the circumstances would normally be barred because of laches.

Similarly, section 7.24 does not address the liability of the proxy to the shareholder for exercising authority beyond that granted or for disobeying instructions. These matters are governed by the law of agency and not by section 7.24.

The American Society of Corporate Secretaries has established principles for the acceptance of proxy appointments in routine elections in which there is no proxy contest. Many of the examples of the application of section 7.24 set forth below are based on these principles.

1. Examples of Signings "Corresponding with" the Name of the Shareholder

Assuming that shares are registered in the name of an individual, an instrument may be accepted as signed:

a. whether signed in ink, pencil, ballpoint, crayon, etc.;

b. regardless of where the signature appears on the instrument (whether or not in the space provided), if there is no reason to doubt the intent to execute;

c. whether the name is handwritten, handprinted, or rubber stamped in facsimile signature or printed form;

d. whether there are deviations between the registered name and the signature, provided that the deviations are not inconsistent with the registered name (for example, if the shares are registered in the name of "John F. Smith," the following are acceptable: "J. Foster Smith," "J. Smith," "J.F. Smith," "J.F.S.," "J.S.," "John F.," and even simply "Smith." Similarly, if "John Smith" is the name of the shareholder, "John F. Smith" and "J. Foster Smith" are also acceptable);

e. if marked by an "X" and witnessed by one other person;

f. the signature is illegible, unless it cannot reasonably be considered to be the signature of the shareholder (for example, if shares are registered in the name of "John F. Smith," the signature is not acceptable if the first letter of the signature is clearly an "M" or the first word is "Mark");

g. if it is a photocopy, facsimile transmission, or other reliable reproduction of a signed appointment form, provided that such a copy, facsimile transmission, or reproduction is a complete reproduction of the entire appointment form;

h. if the shares are registered in the maiden name of a woman, e.g., Mary Smith, and the instrument is signed:

   (1) in her married name, clearly indicated as such, e.g., "Mary Smith Jones (formerly Mary Smith)" or "Mary Smith (now Mrs. Mary Smith Jones)";

   (2) in her married name or in a form that implies her married status, e.g., "Mary Smith Anderson," "Mrs. Mary S. Anderson," "Mrs. Mary Smith Anderson," or "Mrs. Mary Anderson"; or

i. if the shares are registered in the name "Peter Smith, Sr." but the designation "Sr." is omitted, e.g., "Peter Smith." The execution "Peter Smith, Jr.," however, does not correspond with the shareholder.

2. Examples of Signings That "Indicate the Capacity" of the Person Signing

In all the following instances, the corporation may request additional evidence of authority but is not required to do so; officers and agents are protected from liability if they routinely accept the instrument without requiring additional evidence.

a. Assuming that the shares are registered in the name of a partnership, e.g., "Smith Bros.," an instrument may be accepted if signed either in the form "Smith Bros. by John Able, Partner" or simply "Smith Bros."

b. Assuming that the shares are registered in the name of a corporation, e.g., "Smith Corporation," an instrument may be accepted if signed in the name of the corporation, by an officer or agent designated as holding a responsible position, by a person with a surname similar to the corporate name, or simply in the name of the corporation, e.g., "Smith Corporation by John Able, President," "Smith Corporation by Peter Apt, Agent," "Smith Corporation by John Smith," or "Smith Corporation."

c. Assuming that the shares are registered in the name of an individual who is deceased, incompetent, a minor, in bankruptcy, or in receivership, an instrument may be accepted if it is signed by an executor, administrator, guardian, receiver, or trustee who signs as such. Shares registered in the name of a minor may be voted by a parent if identified as such, e.g., "Ralph Able by John Able, Father."

d. Assuming that the shares are registered in the name of an individual, an instrument may be accepted if it is signed by another individual who indicates that the individual (1) is signing as an agent or attorney-in-fact for the shareholder (see section 7.22); (2) has a close family or other relationship with the shareholder from which authority can be inferred; or (3) is the beneficial owner, pledge, or donee of the shares. For example: if shares are registered in the name of "Peter Jones," "Ed Smith, Agent," "Paul Smith, Son," "Mary Smith Jones, Wife," "Emelia Able, Attorney," "Arthur Peters, Private

Secretary," "Paul Jones, Trustee under Deed of Trust dated April 1, 1980," or "Mary Smith, Donee," are all acceptable absent some indication that the signing was unauthorized.

e. Assuming that the shares are registered in the names of two or more persons—as joint tenants or tenants in common, executors or administrators, guardians or conservators, a committee for an incompetent, or trustees—an instrument may be accepted if signed by or on behalf of fewer than all the persons named. This conclusion proceeds on the assumption that the signer or signers have authority to act for the others and there is nothing on the face of the instrument that rebuts this assumption.

3. Examples of "Reasonable Basis for Doubt"

The phrase "reasonable basis for doubt" about the validity of a signature or about the signer's authority creates an objective standard for the exercise of the authority granted by section 7.24(c) to reject proffered instruments. In the absence of a proxy fight or a seriously contested issue, instruments should be rejected only if there seems to be no basis for finding the signing regular on its face. In a proxy fight or other contested issue, the possibility of illegal or unauthorized signing is greatly increased, and a more cautious attitude should therefore be adopted. The following are examples in which a "reasonable basis for doubt" could be found to exist:

a. The shares are registered in the name of "John F. Smith" and the instrument is signed by "Joseph F. Smith" or by "Frank W. Smith."

b. The shares are registered in the name of "Ellen Smith, a Minor" or "John Smith, Custodian for Ellen Smith, a Minor," and the instrument is signed by "Ellen Smith." There is no "reasonable basis for doubt," however, if the instrument is accompanied by evidence satisfactory to the corporation that the shareholder is no longer a minor.

c. A proxy appointment is received that is regular on its face, and the secretary or other corporate officer or agent receives a telephone call from a person who identifies himself or herself as the shareholder and says either that he or she wishes to revoke the appointment or did not authorize its original signing.

d. Shares are registered in the name of two or more persons as co-owners, the instrument is signed by fewer than all of them, and the instrument shows on its face that not all the registered owners granted authority to the signers, as where the instrument states that it was not possible to obtain all the co-owners' signatures or that some refused to sign. For the normal rule of acceptability of proxies signed by fewer than all co-owners, however, see section 7.24(b)(5) and part 2.e. of this Official Comment.

e. The corporation receives a copy of letters of appointment of a receiver, executor, administrator or other fiduciary, and the instrument is signed in the name of the shareholder rather than by the fiduciary.

4. *Other Principles Applicable to Proxy Appointments*

As indicated in the Official Comment to section 7.22, a proxy is simply an agent of the shareholder, and the proxy's appointment therefore involves primarily the law of agency. The law of agency determines the rights and duties of the shareholder and the proxy, and it is important to recognize that section 7.24 is not intended to affect these rights and duties. Rather, it recognizes that the great bulk of instruments executed in the name or on behalf of a shareholder are in fact authorized and the corporation and its officers should be encouraged to accept them rather than to adopt unduly narrow requirements.

§ 7.25. QUORUM AND VOTING REQUIREMENTS FOR VOTING GROUPS

(a) Shares entitled to vote as a separate voting group may take action on a matter at a meeting only if a quorum of those shares exists with respect to that matter. Unless the articles of incorporation provides otherwise, a majority of the votes entitled to be cast on the matter by the voting group constitutes a quorum of that voting group for action on that matter.

(b) Once a share is represented for any purpose at a meeting, it is deemed present for quorum purposes for the remainder of the meeting and for any adjournment of that meeting unless a new record date is or must be set for that adjourned meeting.

(c) If a quorum exists, action on a matter (other than the election of directors) by a voting group is approved if the votes cast within the voting group favoring the action exceed the votes cast opposing the action, unless the articles of incorporation require a greater number of affirmative votes.

(d) An amendment of articles of incorporation adding, changing, or deleting a quorum or voting requirement for a voting group greater than specified in subsection (a) or (c) is governed by section 7.27.

(e) The election of directors is governed by section 7.28.

CROSS-REFERENCES

Adjourned meeting record date, see § 7.07.
Amendment of articles of incorporation, see § 10.03.
Amendment of bylaws, see ch. 10B.
Disposition of assets, see § 12.02.
Dissolution, see § 14.02.
Election of directors, see § 7.28.
Merger and share exchange, see § 11.04.
Multiple voting groups, see § 7.26.
Proxy voting, see § 7.22.
Record date, see § 7.07.
Supermajority requirements, see § 7.27.
"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 7.25 establishes general quorum and voting requirements for voting groups for purposes of the Act. As defined in section 1.40, a "voting group" consists of all shares of one or more classes or series that under the articles of incorporation or the revised Model Act are entitled to vote and be counted together collectively on a matter. Shares entitled to vote "generally" on a matter (that is, all shares entitled to vote on the matter by the articles of incorporation or the Act that do not expressly have the right to be counted or tabulated separately) are a single voting group. The determination of which shares form part of a single voting group must be made from the provisions of the articles of incorporation and of the Act. On most matters coming before shareholders' meetings, only a single voting group, consisting of a class of voting shares, will be involved, and action on such a matter is effective when approved by that voting group pursuant to section 7.25. See section 7.26(a).

The voting group concept permits a single section of the revised Model Act to deal with quorum and voting rules applicable to a variety of single and multiple voting group situations. Section 7.25 covers, for example, quorum and voting requirements for all actions by the shareholders of a corporation with a single class of voting shares; it also covers quorum and voting requirements for a matter on which only a class of shares with preferential rights is entitled to vote under the articles of incorporation because of a default in the payment of dividends (a vote which is often described as a "class vote"); and it covers quorum and voting requirements for a matter on which both common and preferred shares are entitled to vote, either together as a single voting group under the articles of incorporation or separately as two voting groups under either the articles of incorporation or the Act.

1. Determination of Voting Groups under the Model Act

Under the Model Act, classes or series of shares are generally not entitled to vote separately by voting group except to the extent specifically authorized by the articles of incorporation. But sections 10.04 and 11.04 of the Act grant classes or series of shares the right to vote separately when fundamental changes are proposed that may adversely affect that class or series. Section 10.04 provides, further, that when two or more classes or series are affected in essentially the same way, the classes or series are lumped together and must vote as a single voting group rather than as multiple voting groups on the matter. Under the Model Act even a class or series of shares that is expressly described as nonvoting under the articles of incorporation may be entitled to vote separately on a matter affecting the class or series in a designated way. See section 10.04(e).

In addition to the provisions of the Act, separate voting by voting group may be authorized by the articles of incorporation in such instances and on such terms as may be desired (except that the statutory privilege of voting by separate voting groups cannot be diluted or reduced). Finally, on some matters the board of directors may condition their submission of matters to shareholders on their approval by specific voting groups designated by the board of directors. Sections 7.25 and 7.26 establish the mechanics by which all voting by single or multiple voting groups is carried out.

In some situations, shares of a single class or series may be entitled to vote in two different voting groups. See the Official Comment to section 7.26.

2. Quorum and Voting Requirements in General

Implicit in section 7.25 is the concept that the determination of the voting groups entitled to vote, and the quorum and voting requirements applicable thereto, must be determined separately for each "matter" coming before a meeting. As a result, different quorum and voting requirements may be applicable to different portions of a meeting, depending on the matter being considered. In this respect, sections 7.25 and 7.26 differ in structure from earlier versions of the Model Act and state statutes which contemplated that a single set of quorum and voting requirements would be applicable to a "meeting." There is no difference in substance, however, since it was generally recognized that different quorum and voting requirements should be applicable in class voting situations. And, under the revised Model Act, in the normal case where only a single voting group is entitled to vote on all matters coming before a meeting of shareholders, a single quorum and voting requirement will usually be applicable to the entire meeting.

3. Quorum Requirements for Action by Voting Group

Sections 7.25(a) and (b) provide standard rules for the determination of a quorum for each voting group required to act at a shareholders' meeting on a matter. In the absence of a provision in the articles of incorporation, section 7.25(a) provides that a quorum consists of a majority of the votes entitled to be cast on the matter at the meeting.

Section 7.25(b) retains the common law view that once a share is present at a meeting, it is deemed present for quorum purposes throughout the meeting. Thus, a voting group may continue to act despite the withdrawal of persons having the power to vote one or more shares in an effort "to break the quorum." In this respect, a meeting of shareholders is governed by a different rule than a meeting of directors, where a sufficient number of directors must be present to constitute a quorum at the time action is taken. See section 8.24 and its Official Comment.

Once a share is present at a meeting it is also deemed to be present at any adjourned meeting unless a new record date is or must be set for that adjourned meeting. See section 7.07. If a new record date is set, new notice must be given to holders of shares of a voting group and a quorum must be established from within the holders of shares of that voting group on the new record date.

The shares owned by a shareholder who comes to the meeting to object on grounds of lack of notice may be counted toward the presence of a quorum. Similarly, the holdings of a shareholder who attends a meeting solely for purposes of raising the objection that a quorum is not present is counted toward the presence of a quorum. Attendance at a meeting, however, does not constitute a waiver of other objections to the meeting such as the lack of notice. Such waivers are governed by section 7.06(b).

As used in sections 7.25 and 7.26, "represented at the meeting" means the physical presence of the shareholder (whether in person or by the shareholder's written authorization) in the meeting room after the meeting has been called to order or the presiding officer has commenced consideration of the business of the meeting, and before the final adjournment of the meeting. If a person owns shares of different classes or series that are entitled to vote in separate voting groups, the presence of the person at the meeting constitutes representation at the meeting of all the shares owned by that person.

4. Voting Requirements for Approval by Voting Group

Section 7.25(c) provides that an action (other than the election of directors, which is governed by section 7.28) is approved by a voting group at a meeting at which a quorum is present if the votes cast in favor of the action exceed the votes cast opposing the action. This section changes the traditional rule appearing in earlier versions of the Model Act and many state statutes that an action is approved at a meeting at which a quorum is present if it receives the affirmative vote "of a majority of the shares represented at that meeting." The traditional rule in effect treated abstentions as negative votes; the revised Model Act treats them truly as abstentions. The rule set forth in section 7.25(c) is considered desirable in part because it permits action to be taken by the shareholders when considered appropriate by a majority of those with views on the matter in question. Potential concern about the effect of abstentions in public corporations has also been increased by changes in the SEC proxy regulations that permit shareholders of such companies to abstain on issues.

The treatment of abstaining votes under the traditional rule gave rise to anomalous results in some situations. For example, if a corporation has 1,000 shares of a single class outstanding, all entitled to cast one vote each, a quorum consists of 501 shares; if 600 shares are represented and the vote on a proposed action is 280 in favor, 225 opposed, and 95 abstaining, the action is not approved since fewer than a majority of the 600 shares attending voted in favor of the action. This is anomalous since if the shares abstaining had not been present at the meeting at all a quorum would have been present and the action would have been approved. Under section 7.25(c) the action would not be defeated by the 95 abstaining votes.

In the absence of specific provision in the articles of incorporation, shares of classes or series that are entitled by statute to vote as a separate voting group are entitled to one vote per share. See section 7.21.

5. Modification of Standard Requirements

The articles of incorporation may modify the quorum and voting requirements of section 7.25 for a single voting group or for all voting groups entitled to vote on any matter. The articles of incorporation may increase the quorum and voting requirements to any extent desired up to and including unanimity upon compliance with section 7.27; they may also require that shares of different classes or series are entitled to vote separately or together on specific issues or provide that actions are approved only if they receive the favorable vote of a majority of the shares of a voting group present at a meeting at which a quorum is present. The articles may also decrease the quorum requirement as desired. Earlier versions of the Model Act limited the power to reduce the quorum to a minimum of $^{1}/_{3}$; this restriction was eliminated from the Revised Model Act because it was thought to be unreasonably confining in certain situations, such as where a class of shares with preferential rights is given a limited right to vote that may be exercisable only rarely.

Section 7.25(d) provides that section 7.27 governs the adoption or amendment of provisions in the articles of incorporation that impose greater quorum or voting requirements than provided for in this section.

§ 7.26. ACTION BY SINGLE AND MULTIPLE VOTING GROUPS

(a) If the articles of incorporation or this Act provide for voting by a single voting group on a matter, action on that matter is taken when voted upon by that voting group as provided in section 7.25.

(b) If the articles of incorporation or this act provide for voting by two or more voting groups on a matter, action on that matter is taken only when voted upon by each of those voting groups counted separately as provided in section 7.25. Action may be taken by one voting group on a matter even though no action is taken by another voting group entitled to vote on the matter.

CROSS-REFERENCES

Amendment of articles of incorporation, see § 10.04.
Change of voting group requirements, see § 7.27.
Disposition of assets, see § 12.02.
Merger and share exchange, see § 11.04.
Number of votes per share, see § 7.21.
Quorum and voting requirements, see § 7.25.
Supermajority requirements, see § 7.27.
Voting by voting groups on amendments of articles of incorporation, see § 10.04.
"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 7.26(a) provides that when a matter is to be voted upon by a single voting group, action is taken when the voting group votes upon the action as provided in section 7.25. In most instances the single voting group will consist of all the shares of the class or classes entitled to vote by the articles of incorporation; voting by two or more voting groups as contemplated by section 7.26(b) is the exceptional case.

Section 7.26(b) basically requires that if more than one voting group is entitled to vote on a matter, favorable action on a matter is taken only when it is voted upon favorably by each voting group, counted separately. Implicit in this section are the concepts that (1) different quorum and voting requirements may be applicable to different matters considered at a single meeting and (2) different quorum and voting requirements may be applicable to different voting groups voting on the same matter. See the Official Comment to section 7.25. Thus, each group entitled to vote must independently meet the quorum and voting requirements established by section 7.25. But if a quorum is present for one or more voting groups but not for all voting groups, section 7.26(b) provides that the voting groups for which a quorum is present may vote upon the matter.

A single meeting, furthermore, may consider matters on which action by several voting groups is required and also matters on which only a single voting group may act. Action may be taken on the matters on which the single voting group may act even though no quorum is present to take action on other matters. For example, in a corporation with one class of nonvoting shares with preferential rights ("preferred shares") and one class of general voting shares without preferential rights ("common shares"), a matter to be considered at the annual meeting may be a proposed amendment to the articles of incorporation that reduces the cumulative dividend right of the preferred shares (a matter on which the preferred shares have a statutory right to vote as a separate voting group). Other matters to be considered may include the election of directors and the appointment of an auditor, both matters on which the preferred shares have no vote. If a quorum of the voting group consisting of the common shares but no quorum of the voting group consisting of the preferred shares is present, the common shares may proceed to elect directors and appoint the auditor. The common shares voting group may also vote to approve the proposed amendment to the articles of the incorporation, but that amendment will not be approved until the preferred shares voting group also votes to approve the amendment.

As described in section 7.26(b), if voting by multiple voting groups is required, the votes of members of each voting group must be separately tabulated. Normally, each class or series of shares will participate in only a single voting group. But since holders of shares entitled by the articles of incorporation to vote generally on a matter are always entitled to vote in the voting group consisting of the general voting shares, in some instances classes or series of shares may be entitled to be counted simultaneously in two voting groups. This will occur whenever a class or series of shares entitled to vote generally on a matter under the articles of incorporation is affected by the matter in a way that gives rise to the right to have its vote counted separately as an independent voting group under the Act. For example, assume that corporation Y has outstanding one class of general voting shares without preferential rights ("common shares"), 500 shares issued, and one class of shares with preferential rights ("preferred shares"), 100 shares issued, that also have full voting rights under the articles of incorporation, i.e., the preferred may vote for election of directors and on all other matters on which common may vote. The preferred and the common therefore are part of the general voting group. The directors propose to amend the articles of incorporation to change the preferential dividend rights of the preferred from cumulative to noncumulative. All shares are present at the meeting and they divide as follows on the proposal to adopt the amendment.

Yes	Common	230
	Preferred	80
No	Common	270
	Preferred	20

Both the preferred and the common are entitled to vote on the amendment to the articles of incorporation since they are part of a general voting group pursuant to the articles. But the vote of the preferred is also entitled to be counted separately on the proposal by section 10.04(a) (4) of the Model Act. The result is that the proposal passes by a vote of 310 to 290 in the voting group consisting of the shares entitled to vote generally and 80 to 20 in the voting group consisting solely of the preferred shares.

(a) First voting group

Yes	Common	230
	Preferred	80
		310
No	Common	270
	Preferred	20
		290

(b) Second voting group (preferred)

Yes	Preferred	80
No	Preferred	20

In this situation, in the absence of a special quorum requirement, a meeting could approve the proposal to amend the articles of incorporation if—and only if—a quorum of each voting group is present, i.e., at least 51 shares of preferred and 301 shares of common and preferred were represented at the meeting.

§ 7.27. GREATER QUORUM OR VOTING REQUIREMENTS

(a) The articles of incorporation may provide for a greater quorum or voting requirement for shareholders (or voting groups of shareholders) than is provided for by this Act.

(b) An amendment to the articles of incorporation that adds, changes, or deletes a greater quorum or voting requirement must meet the same quorum requirement and be adopted by the same vote and voting groups required to take action under the quorum and voting requirements then in effect or proposed to be adopted, whichever is greater.

CROSS-REFERENCES

Amendment of articles of incorporation, see ch. 10A.
Quorum and voting requirements in general, see § 7.25.
Voting by voting group, see § 7.26.
"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 7.27(a) permits the articles of incorporation to increase the quorum or voting requirements for approval of an action by shareholders up to any desired amount including unanimity. These provisions may relate both to routine actions or action on fundamental changes, such as mergers, by the general voting group (which otherwise may be acted upon under section 7.25 if the number of affirmative votes exceeds the number of negative votes at a meeting at which a quorum of that voting group is present).

A provision that increases the requirement for approval of an ordinary matter or a fundamental change is usually referred to as a "supermajority" provision.

Section 7.27(b) requires any amendment of the articles of incorporation that adds, modifies, or repeals any supermajority provision to be approved by the greater of the proposed quorum and vote requirement or by the quorum and vote required by the articles before their amendment. Thus, a supermajority provision that requires an 80% affirmative vote of all eligible votes of a voting group present at the meeting may not be removed from the articles of incorporation or reduced in any way except by an 80% affirmative vote. If the 80% requirement is coupled with a quorum requirement for a voting group that shares representing $^2/_3$ of the total votes must be present in person or by proxy, both the 80% voting requirement and the $^2/_3$ quorum requirement are immune from reduction except at a meeting of the voting group at which the $^2/_3$ quorum requirement is met and the reduction is approved by an 80% affirmative vote. If the proposal is to increase the 80% voting requirement to 90%, that proposal must be approved by a 90% affirmative vote at a meeting of the voting group at which the $^2/_3$ quorum requirement is met; if the proposal is to increase the $^2/_3$ quorum requirement to $^3/_4$ without changing the 80% voting requirement, that proposal must be approved by an 80% affirmative vote at a meeting of the voting group at which a $^3/_4$ quorum requirement is met.

§ 7.28. VOTING FOR DIRECTORS; CUMULATIVE VOTING

(a) Unless otherwise provided in the articles of incorporation, directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting at which a quorum is present.

(b) Shareholders do not have a right to cumulate their votes for directors unless the articles of incorporation so provide.

(c) A statement included in the articles of incorporation that "[all] [a designated voting group of] shareholders are entitled to cumulate their votes for directors" (or words of similar import) means that the shareholders designated are entitled to multiply the number of votes they are entitled to cast by the number of directors for whom they are entitled to vote and cast the product for a single candidate or distribute the product among two or more candidates.

(d) Shares otherwise entitled to vote cumulatively may not be voted cumulatively at a particular meeting unless:

  (1) the meeting notice or proxy statement accompanying the notice states conspicuously that cumulative voting is authorized; or

  (2) a shareholder who has the right to cumulate his votes gives notice to the corporation not less than 48 hours before the time set for the meeting of the shareholder's intent to cumulate votes during the meeting, and if one shareholder gives this notice all other shareholders in the same voting group participating in the election are entitled to cumulate their votes without giving further notice.

CROSS-REFERENCES

Articles of incorporation:
  amendment, see ch. 10A.

content, see § 2.02.
"Conspicuous" defined, see § 1.40.
"Deliver," see § 1.40.
Notice of meeting, see § 7.05.
"Notice" to the corporation, see § 1.41.
Proxies, see § 7.22.
Quorum of shareholders, see § 7.25.
Voting for directors by voting group, see § 8.04.
"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 7.28(a) provides that directors are elected by a plurality of the votes cast in an election of directors at a meeting at which a quorum is present of the voting group entitled to participate in the election. A "plurality" means that the individuals with the largest number of votes are elected as directors up to the maximum number of directors to be chosen at the election. In elections in which several factors are competing within a voting group, the individuals elected may have fewer than a majority of all the votes cast in the election. The articles of incorporation of the corporation may, however, provide a different manner of election of directors and the bylaws may also do so to the extent provided in section 10.22.

The entire board of directors may be elected by a single voting group or the articles of incorporation may provide that different voting groups are entitled to elect a designated number or fraction of the board of directors. See section 8.04. Elections are contested only within specific voting groups.

Under section 7.28(b) each corporation may determine whether or not to elect its directors by cumulative voting. If directors are elected by different voting groups, the articles of incorporation may provide that specified voting groups are entitled to vote cumulatively while others are not. Cumulative voting affects the manner in which votes may be cast by shares participating in the election but does not affect the plurality principle set forth in section 7.28(a).

If a corporation has determined to elect directors by cumulative voting, such directors may not be elected by less than unanimous written consent. See section 7.01(a).

1. The Manner of Electing Cumulative Voting

Section 7.28(b) provides basically for an "opt in" election. A corporation has cumulative voting with respect to a voting group only if an affirmative provision to that effect appears in its articles of incorporation. Under section 7.28(c) this election may be made simply by inserting a statement that "all directors are elected by cumulative voting" or "holders of class A shares are entitled to cumulate their votes," or words of similar import. The effect of such a statement is to make applicable automatically the detailed provisions of subsections (c) and (d) describing the cumulative right to vote at elections of directors by the voting group or groups specified.

2. The Mechanics of Cumulative Voting

Section 7.28(c) describes the mechanics of cumulative voting: each shareholder may multiply the number of votes to be cast (based on the number of shares held by the shareholder) by the number of directors to be elected by the voting group at the meeting and may cast the product for a single candidate or distribute the product among two or more candidates. By casting all of the shareholder's votes for a single candidate or a limited number of candidates, a minority shareholder's voting power can be increased and such shareholder may be able to elect one or more directors.

Section 7.28(d) applies only if cumulative voting is potentially available under section 7.28(b). It is designed to ensure that all shareholders participating in the election understand the rules and to avoid the distortions that may be created when some shareholders vote cumulatively while others do not. Cumulative voting will be employed if the notice of meeting or accompanying proxy statement conspicuously announces that a shareholder is entitled to cumulate votes or a shareholder who is entitled to vote gives notice to the corporation of such shareholder's intent to do so at least 48 hours before the meeting. This notice puts the corporation and all shareholders who are entitled to vote in the election with that shareholder on notice that voting will be on a cumulative basis. If this notice is given by any shareholder, all other shareholders who are part of the same voting group are entitled to vote cumulatively without giving further notice.

The proxy regulations of the Securities and Exchange Commission require proxy statements to include a statement that persons have the right to vote cumulatively, if that is the case, and briefly to describe that right.

§ 7.29. INSPECTORS OF ELECTION

(a) A public corporation shall, and any other corporation may, appoint one or more inspectors to act at a meeting of shareholders and make a written report of the inspectors' determinations. Each inspector shall take and sign an oath faithfully to execute the duties of inspector with strict impartiality and according to the best of the inspector's ability.

(b) The inspectors shall:

- (1) ascertain the number of shares outstanding and the voting power of each;
- (2) determine the shares represented at a meeting;
- (3) determine the validity of proxies and ballots;
- (4) count all votes; and
- (5) determine the result.

(c) An inspector may be an officer or employee of the corporation.

CROSS-REFERENCES

Officers of the corporation, see § 8.40.
Proxies, see § 7.22.
"Public corporation" defined, see § 1.40.

OFFICIAL COMMENT

Section 7.29(a) requires that a public corporation must, and any other corporation may, appoint one or more inspectors of election to act at each meeting of shareholders and make a written report of the determinations made pursuant to section 7.29(b). It is contemplated that the selection of inspectors would be made by responsible officers or by the directors, as authorized either generally or specifically in the corporation's bylaws. Alternate inspectors could also be designated to replace any inspector who fails to act. The requirement of a written report is to facilitate judicial review of determinations made by inspectors.

Section 7.29(b) specifies the duties of inspectors of election. If no challenge of a determination by the inspectors within the authority given them under this section is timely made, such determination shall be conclusive. In the event of a challenge of any determination by the inspectors in a court of competent jurisdiction, the court should give such weight to determinations of fact by the inspectors as it shall deem appropriate, taking into account the relationship of the inspectors, if any, to the management of the company and other persons interested in the outcome of the vote, the evidence available to inspectors, whether their determinations appear to be reasonable, and such other circumstances as the court shall regard as relevant. The court should review de novo all determinations of law made implicitly or explicitly by the inspectors.

Normally, in making the determinations contemplated by section 7.29(b), the only facts before the inspectors should be appointment forms and electronic transmissions (or written evidence thereof), envelopes submitted with appointment forms, ballots and the regular books and records of the corporation, including lists of holders obtained from depositories. However, inspectors may consider other reliable information for the limited purpose of reconciling appointment forms, electronic transmissions, and ballots submitted by or on behalf of banks, brokers, their nominees, and similar persons which represent more votes than the holder of a proxy is authorized by the record owner to cast or more votes than the shareholder holds of record. If the inspectors do consider such other information, it should be specifically referred to in their written report, including the person or persons from whom they obtained the information, when the information was obtained, the means by which the information was obtained, and the basis for the inspectors' belief that such information is accurate and reliable.

Section 7.29(c) provides that an inspector may be an officer or employee of the corporation. However, in the case of publicly held corporations, good corporate practice suggests that such inspectors should be independent persons who are neither employees nor officers if there is a contested matter or a shareholder proposal to be considered. Not only will the issue of independent inspectors enhance investor perception as to the fairness of the voting process, but also the report of independent inspectors can be expected to be given greater evidentiary weight by any court reviewing a contested vote.

Subchapter C.
VOTING TRUSTS AND AGREEMENTS

§ 7.30. VOTING TRUSTS

(a) One or more shareholders may create a voting trust, conferring on a trustee the right to vote or otherwise act for them, by signing an agreement setting out the provisions of the trust (which may include anything consistent with its purpose) and transferring their shares to the trustee. When a voting trust agreement is signed, the trustee shall prepare a list of the names and addresses of all owners of beneficial interests in the trust, together with the number and class of shares each transferred to the trust, and deliver copies of the list and agreement to the corporation's principal office.

(b) A voting trust becomes effective on the date the first shares subject to the trust are registered in the trustee's name. A voting trust is valid for not more than 10 years after its effective date unless extended under subsection (c).

(c) All or some of the parties to a voting trust may extend it for additional terms of not more than 10 years each by signing written consent to the extension. An extension is valid for 10 years from the date the first shareholder signs the extension agreement. The voting trustee must deliver copies of the extension agreement and list of beneficial owners to the corporation's principal office. An extension agreement binds only those parties signing it.

CROSS-REFERENCES

"Deliver," see § 1.40.
Delivery to corporation, see § 1.41.
Inspection of shareholder lists, see § 7.20, ch. 16A.
"Principal office":
    defined, see § 1.40.
    designated in annual report, see § 16.21.
"Shareholder" defined, see § 1.40.
Shares held by nominees, see § 7.23.
"Sign," see § 1.40.
Voting agreements, see § 7.31.

OFFICIAL COMMENT

A voting trust is a device by which one or more shareholders divorce the voting rights of their shares from the ownership, retaining the latter but transferring the former to one or more trustees in whom the voting rights of all the shareholders who are parties to the trust are pooled. Following the long-established pattern of earlier versions of the Model Act and the statutes of many states, a voting trust under section 7.30(b) is valid for a maximum of 10 years after its effective date.

At common law, voting trusts were often viewed with hostility and were narrowly construed. They are, however, a reasonable voting device to accomplish legitimate objectives. As a result, much of the original judicial hostility to these arrangements has disappeared. See, e.g., *Oceanic Exploration Co. v. Grynberg*, 428 A.2d 1 (Del. 1981).

1. Creation of a Voting Trust

Section 7.30(a) provides a simple and direct procedure for the creation of an enforceable voting trust. The shareholders sign an agreement to participate in the trust and the shares must be registered in the name of the trustee. Typically, the trust agreement provides that all attributes of beneficial ownership other than the power to vote are retained by the beneficial owners. In addition, the voting trustees may issue to the beneficial owners voting trust certificates which may be transferable in much the same way as shares.

Upon the creation of the voting trust, the trustees must prepare a list of the beneficial owners and deliver it, together with a copy of the agreement, to the corporation's principal office, where both documents are available for inspection by shareholders under section 7.20. This simple disclosure requirement eliminates the possibility that the voting trust may be used to create "secret, uncontrolled combinations of stockholders to acquire control of the corporation to the possible detriment of nonparticipating shareholders," *Lehrman v. Cohen*, 222 A.2d 800, 807 (Del. 1966).

The purpose of section 7.30 is not to impose narrow or technical requirements on voting trusts. For example, a voting trust that by its terms extends beyond the 10-year maximum should be treated as being valid for the maximum permissible term of 10 years.

2. Extension or Renewal of Voting Trust

Section 7.30(c) permits a voting trust to be extended for successive terms of 10 years commencing with the date the first shareholder signs the extension agreement. Shareholders who do not agree to an extension are entitled to the return of their shares upon the expiration of the original term.

§ 7.31. VOTING AGREEMENTS

(a) Two or more shareholders may provide for the manner in which they will vote their shares by signing an agreement for that purpose. A voting agreement created under this section is not subject to the provisions of section 7.30.

(b) A voting agreement created under this section is specifically enforceable.

CROSS-REFERENCES

Irrevocable proxies, see § 7.22.
Voting trust, see § 7.30.

OFFICIAL COMMENT

Section 7.31(a) explicitly recognizes agreements among two or more shareholders as to the voting of shares and makes clear that these agreements are not subject to the rules relating to a voting trust. These agreements are often referred to as pooling agreements." The only formal requirements are that they be in writing and signed by all the participating shareholders; in other respects their validity is to be judged as any other contract. They are not subject to the 10-year limitation applicable to voting trusts.

Section 7.31(b) provides that voting agreements may be specifically enforceable. A voting agreement may provide its own enforcement mechanism, as by the appointment of a proxy to vote all shares subject to the agreement; the appointment may be made irrevocable under section 7.22. If no enforcement mechanism is provided, a court may order specific enforcement of the agreement and order the votes cast as the agreement contemplates. This section recognizes that damages are not likely to be an appropriate remedy for breach of a voting agreement, and also avoids the result reached in *Ringling Bros. Barnum & Bailey Combined Shows v. Ringling*, 53 A.2d 441 (Del. 1947), where the court held that the appropriate remedy to enforce a pooling agreement was to refuse to permit any voting of the breaching party's shares.

§ 7.32. SHAREHOLDER AGREEMENTS

(a) An agreement among the shareholders of a corporation that complies with this section is effective among the shareholders and the corporation even though it is inconsistent with one or more other provisions of this Act in that it:

(1) eliminates the board of directors or restricts the discretion or powers of the board of directors;

(2) governs the authorization or making of distributions whether or not in proportion to ownership of shares, subject to the limitations in section 6.40;

(3) establishes who shall be directors or officers of the corporation, or their terms of office or manner of selection or removal;

(4) governs, in general or in regard to specific matters, the exercise or division of voting power by or between the shareholders and directors or by or among any of them, including use of weighted voting rights or director proxies;

(5) establishes the terms and conditions of any agreement for the transfer or use of property or the provision of services between the corporation and any shareholder, director, officer or employee of the corporation or among any of them;

(6) transfers to one or more shareholders or other persons all or part of the authority to exercise the corporate powers or to manage the business and affairs of the corporation, including the resolution of any issue about which there exists a deadlock among directors or shareholders;

(7) requires dissolution of the corporation at the request of one or more of the shareholders or upon the occurrence of a specified event or contingency; or

(8) otherwise governs the exercise of the corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors and the corporation, or among any of them, and is not contrary to public policy.

(b) An agreement authorized by this section shall be:

(1) as set forth (A) in the articles of incorporation or bylaws and approved by all persons who are shareholders at the time of the agreement or (B) in a written agreement that is signed by all persons who are shareholders at the time of the agreement and is made known to the corporation;

(2) subject to amendment only by all persons who are shareholders at the time of the amendment, unless the agreement provides otherwise; and

(3) valid for 10 years, unless the agreement provides otherwise.

(c) The existence of an agreement authorized by this section shall be noted conspicuously on the front or back of each certificate for outstanding shares or on the information statement required by section 6.26(b). If at the time of the agreement the corporation has shares outstanding represented by certificates, the corporation shall recall the outstanding certificates and issue substitute certificates that comply with this subsection. The failure to note the existence of the agreement on the certificate or information statement shall not affect the validity of the agreement or any action taken pursuant to it. Any purchaser of shares who, at the time of purchase, did not have knowledge of the existence of the agreement shall be entitled to rescission of the purchase. A purchaser shall be deemed to have knowledge of the existence of the agreement if its existence is noted on the certificate or information statement for the shares in compliance with this subsection and, if the shares are not represented by a certificate, the information statement is delivered to the purchaser at or prior to the time of purchase of the shares. An action to enforce the right of rescission authorized by this subsection must be commenced within the earlier of 90 days after discovery of the existence of the agreement or two years after the time of purchase of the shares.

(d) An agreement authorized by this section shall cease to be effective when the corporation becomes a public corporation. If the agreement ceases to be effective for any reason, the board of directors may, if the agreement is contained or referred to in the corporation's articles of incorporation or bylaws, adopt an amendment to the articles of incorporation or bylaws, without shareholder action, to delete the agreement and any references to it.

(e) An agreement authorized by this section that limits the discretion or powers of the board of directors shall relieve the directors of, and impose upon the person or persons in whom such discretion or powers are vested, liability for acts or omissions imposed by law on directors to the extent that the discretion or powers of the directors are limited by the agreement.

(f) The existence or performance of an agreement authorized by this section shall not be a ground for imposing personal liability on any shareholder for the acts or debts of the corporation even if the agreement or its performance treats the corporation as if it were a partnership or results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement.

(g) Incorporators or subscribers for shares may act as shareholders with respect to an agreement authorized by this section if no shares have been issued when the agreement is made.

CROSS-REFERENCE

"Conspicuous" defined, see § 1.40
"Public corporation" defined, see § 1.40.

OFFICIAL COMMENT

Shareholders of closely held corporations, ranging from family businesses to joint ventures owned by large public corporations, frequently enter into agreements that govern the operation of the enterprise. In the past, various types of shareholder agreements were invalidated by courts for a variety of reasons, including so-called "sterilization" of the board of directors and failure to follow the statutory norms of the applicable corporation act. See, e.g., *Long Park, Inc. v. Trenton-New Brunswick Theatres Co.*, 297 N.Y. 174, 77 N.E.2d 633 (1948). The more modern decisions reflect a greater willingness to uphold shareholder agreements. See, e.g., *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577 (1964). In addition, many state corporation acts now contain provisions validating shareholder agreements. Before the introduction of section 7.32 in 1990, the Model Act did not expressly validate shareholder agreements, other than voting agreements provided for in section 7.31.

Rather than relying on further uncertain and sporadic development of the law in the courts, section 7.32 rejects the older line of cases. It adds an important element of predictability currently absent from the Model Act and affords participants in closely held corporations greater contractual freedom to tailor the rules of their enterprise.

Section 7.32 is not intended to establish or legitimize an alternative form of corporation. Instead, it is intended to add, within the context of the traditional corporate structure, legal certainty to shareholder agreements that embody various aspects of the business arrangement established by the shareholders to meet their business and personal needs. The subject matter of these arrangements includes governance of the entity, allocation of the economic return from the business, and other aspects of the relationships among shareholders, directors, and the corporation which are part of the business arrangement. Section 7.32 also recognizes that many of the corporate norms contained in the Model Act, as well as the corporation statutes of most states, were designed with an eye towards public corporations, where management and share ownership are quite distinct. Cf. 1 O'NEAL & THOMPSON, O'NEAL'S CLOSE CORPORATIONS, section 5.06 (3d ed.). These functions are often conjoined in the close corporation. Thus, section 7.32 validates for nonpublic corporations various types of agreements among shareholders even when the agreements are inconsistent with the statutory norms contained in the Act.

Importantly, section 7.32 only addresses the parties to the shareholder agreement, their transferees, and the corporation, and does not have any binding legal effect on the state, creditors, or other third persons.

Section 7.32 supplements the other provisions of the Model Act. If an agreement is not in conflict with another section of the Model Act, no resort need be made to section 7.32, with its requirement of unanimity. For example, special provisions can be included in the articles of incorporation or bylaws with less than unanimous shareholder agreement so long as such provisions are not in conflict with other provisions of the Act. Similarly, section 7.32 would not have to be relied upon to validate typical buy-sell agreements among two or more shareholders or the covenants and other terms of a stock purchase agreement entered into in connection with the issuance of shares by a corporation.

The types of provisions validated by section 7.32 are many and varied. Section 7.32(a) defines the range of permissible subject matter for shareholder agreements largely by illustration, enumerating seven types of agreements that are expressly validated to the extent they would not be valid absent section 7.32. The enumeration of these types of agreements is not exclusive; nor should it give rise to a negative inference that an agreement of a type that is or might be embraced by one of the categories of section 7.32(a) is, ipso facto, a type of agreement that is not valid unless it complies with section 7.32. Section 7.32(a) also contains a "catch all" which adds a measure of flexibility to the seven enumerated categories.

Omitted from the enumeration in section 7.32(a) is a provision found in statutes of some states that are specifically designated for close corporations (as defined), broadly validating any arrangement the effect of which is to treat the corporation as a partnership. This type of provision was considered to be too elastic and indefinite, as well as unnecessary in light of the more detailed enumeration of permissible subject areas contained in section 7.32(a). Note, however, that under section 7.32(f) the fact that an agreement authorized by section 7.32(a) or its performance treats the corporation as a partnership is not a ground for imposing personal liability on the parties if the agreement is otherwise authorized by subsection (a).

1. Section 7.32(a)

Subsection (a) is the heart of section 7.32. It states that certain types of agreements are effective among the shareholders and the corporation even if inconsistent with another provision of the Model Act. Thus, an agreement authorized by section 7.32 is, by virtue of that section, "not inconsistent with law" within the meaning of sections 2.02(b)(2) and 2.06(b) of the Act. In contrast, a shareholder agreement that is not inconsistent with any provisions of the Model Act is not subject to the requirements of section 7.32.

The range of agreements validated by section 7.32(a) is expansive though not unlimited. The most difficult problem encountered in crafting a shareholder agreement validation provision is to determine the reach of the provision. Some states have tried to articulate the limits of a shareholder agreement validation provision in terms of negative grounds, stating that no shareholder agreement shall be invalid on certain specified grounds. See, e.g., DEL. CODE ANN. tit. 8, sections 350, 354; N.C. GEN. STAT. section 55-73(b). The deficiency in this type of statute is the uncertainty introduced by the ever present possibility of articulating another ground on which to challenge the validity of the agreement. Other states have provided that shareholder agreements may waive or alter all provisions in the corporation act except certain enumerated provisions that cannot be varied. See, e.g., CAL. CORP. CODE section 300(b)–(c). The difficulty with this approach is that any enumeration of the provisions that can never be varied will almost inevitably be subjective, arbitrary, and incomplete.

The approach chosen in section 7.32 is more pragmatic. It defines the types of agreements that can be validated largely by illustration. The seven specific categories that are listed are designed to cover the most frequently used arrangements. The outer boundary is provided by section 7.32(a)(8), which provides an additional "catch-all" for any provisions that, in a manner inconsistent with any other provision of the Model Act, otherwise govern the exercise of the corporate powers, the management of the business and affairs of the corporation, or the relationship between and among the shareholders, the directors, and the corporation or any of them. Section 7.32(a) validates virtually all types of shareholder agreements that, in practice, normally concern shareholders and their advisors.

Given the breadth of section 7.32(a), any provision that may be contained in the articles of incorporation with a majority vote under sections 2.02(b)(2)(ii) and (iii), as well as under section 2.02(b)(4), may also be effective if contained in a shareholder agreement that complies with section 7.32.

The provisions of a shareholder agreement authorized by section 7.32(a) will often, in operation, conflict with the literal language of more than one section of the Act, and courts should in such cases construe all related sections of the Act flexibly and in a manner consistent with the underlying intent of the shareholder agreement. Thus, for example, in the case of an agreement that provides for weighted voting by directors, every reference in the Act to a majority or other proportion of directors should be construed to refer to a majority or other proportion of the votes of the directors.

While the outer limits of the catch-all provision of subsection 7.32(a)(8) are left uncertain, there are provisions of the Model Act that cannot be overridden by resort to the catch-all. Subsection (a) (8), introduced by the term "otherwise," is intended to be read in context with the preceding seven subsections and to be subject to a *ejusdem generis* rule of construction. Thus, in defining the outer limits, courts should consider whether the variation from the Model Act under consideration is similar to the variations permitted by the first seven subsections. Subsection (a)(8) is also subject to a public policy limitation, intended to give courts express authority to restrict the scope of the catch-all where there are substantial issues of public policy at stake. For example, a shareholder agreement that provides that the directors of the corporation have no duties of care or loyalty to the corporation or the shareholders would not be within the purview of section 7.32(a)(8), because it is not sufficiently similar to the types of arrangements suggested by the first seven subsections of section 7.32(a) and because such a provision could be viewed as contrary to a public policy of substantial importance. Similarly, a provision that exculpates directors from liability more broadly than permitted by section 2.02(b)(4) likely would not be validated under section 7.32, because, as the Official Comment to section 2.02(b) (4) states, there are serious public policy reasons which support the few limitations that remain on the right to exculpate directors from liability. Further development of the outer limits is left, however, for the courts.

As noted above, shareholder agreements otherwise validated by section 7.32 are not legally binding on the state, on creditors, or on other third parties. For example, an agreement that dispenses with the need to make corporate filings required by the Act would be ineffective. Similarly, an agreement among shareholders that provides that only the president has authority to enter into contracts for the corporation would not, without more, be binding against third parties, and ordinary principles of agency, including the concept of apparent authority, would continue to apply.

2. Section 7.32(b)

Section 7.32 minimizes the formal requirements for a shareholder agreement so as not to restrict unduly the shareholders' ability to take advantage of the flexibility the section provides. Thus, unlike comparable provisions in special close corporation legislation, it is not necessary to "opt in" to a special class of close corporations in order to obtain the benefits of section 7.32. An agreement can be validated under section 7.32 whether it is set forth in the articles of incorporation, the bylaws or in a separate agreement, and whether or not section 7.32 is specifically referenced in the agreement. The principal requirements are simply that the agreement be in writing and be approved or agreed to by all persons who are then shareholders. Where the corporation has a single shareholder, the requirement of an "agreement among the shareholders" is satisfied by the unilateral action of the shareholder in establishing the terms of the agreement, evidenced by provisions in the articles or bylaws, or in a writing signed by the sole shareholder. Although a writing signed by all the shareholders is not required where the agreement is contained in articles of incorporation or bylaws unanimously approved, it may be desirable to have all the shareholders actually sign the instrument in order to establish unequivocally their agreement. Similarly, while transferees are bound by a valid shareholder agreement, it may be desirable to obtain the affirmative written assent of the transferee at the time of the transfer. Subsection (b) also establishes and permits amendments by less than unanimous agreement if the shareholder agreement so provides.

Section 7.32(b) requires unanimous shareholder approval regardless of entitlement to vote. Unanimity is required because an agreement authorized by section 7.32 can effect material organic changes in the corporation's operation and structure, and in the rights and obligations of shareholders.

The requirement that the shareholder agreement be made known to the corporation is the predicate for the requirement in subsection (c) that share certificates or information statements be legended to note the existence of the agreement. No specific form of notification is required and the agreement need not be filed with the corporation. In the case of shareholder agreements in the articles or bylaws, the corporation will necessarily have notice. In the case of shareholder agreements outside the articles or bylaws, the requirement of signatures by all of the shareholders will in virtually all cases be sufficient to constitute notification to the corporation, as one or more signatories will normally also be a director or an officer.

3. Section 7.32(c)

Section 7.32(c) addresses the effect of a shareholder agreement on subsequent purchasers or transferees of shares. Typically, corporations with shareholder agreements also have restrictions on the transferability of the shares as authorized by section 6.27 of the Model Act, thus lessening the practical effects of the problem in the context of voluntary transferees. Transferees of shares without knowledge of the agreement or those acquiring shares upon the death of an original participant in a close corporation may, however, be heavily impacted. Weighing the burdens on transferees against the burdens on the remaining shareholders in the enterprise, section 7.32(c) affirms the continued validity of the shareholder agreement on all transferees, whether by purchase, gift, operation of law, or otherwise. Unlike restrictions on transfer, it may be impossible to enforce a shareholder agreement against less than all of the shareholders. Thus, under section 7.32, one who inherits shares subject to a shareholder agreement must continue to abide by the agreement. If that is not the desired result, care must be exercised at the initiation of the shareholder agreement to ensure a different outcome, such as providing for a buy-back upon death.

Where shares are transferred to a purchaser without knowledge of a shareholder agreement, the validity of the agreement is similarly unaffected, but the purchaser is afforded a rescission remedy against the seller. The term "purchaser" imports consideration. Under subsection (c) the time at which notice to a purchaser is relevant for purposes of determining entitlement to rescission is the time when a purchaser acquires the shares rather than when a commitment is made to acquire the shares. If the purchaser learns of the agreement after committing to purchase but before acquiring the shares, the purchaser should not be permitted to proceed with the purchase and still obtain the benefit of the remedies in section 7.32(c). Moreover, under contract principles and the securities laws a failure to disclose the existence of a shareholder agreement would in most cases constitute the omission of a material fact and may excuse performance of the commitment to purchase. The term "purchaser" includes a person acquiring shares upon initial issue or by transfer, and also includes a pledgee, for whom the time of purchase is the time the shares are pledged.

Section 7.32 addresses the underlying rights that accrue to shares and shareholders and the validity of shareholder action which redefines those rights, as contrasted with questions regarding entitlement to ownership of the security, competing ownership claims, and disclosure issues. Consistent with this dichotomy, the rights and remedies available to purchasers under section 7.32(c) are independent of those provided by contract law, article 8 of the Uniform Commercial Code, the securities laws, and other law outside the Model Act. With respect to the related subject of restrictions on transferability of shares, note that section 7.32 does not directly address or validate such restrictions, which are governed instead by section 6.27 of the Act. However, if such restrictions are adopted as a part of a shareholder agreement that complies with the requirements of section 7.32, a court should construe broadly the concept of reasonableness under section 6.27 in determining the validity of such restrictions.

Section 7.32(c) contains an affirmative requirement that the share certificate or information statement for the shares be legended to note the existence of a shareholder agreement. No specified form of legend is required, and a simple statement that "[t]he shares represented by this certificate are subject to a shareholder agreement" is sufficient. At that point a purchaser must obtain a copy of the shareholder agreement from the transferor or proceed at the purchaser's peril. In the event a corporation fails to legend share certificates or information statements, a court may, in an appropriate case, imply a cause of action against the corporation in favor of an injured purchaser without knowledge of a shareholder agreement. The circumstances under which such a remedy would be implied, the proper measure of damages, and other attributes of and limitations on such an implied remedy are left to development in the courts.

A purchaser who has no actual knowledge of a shareholder agreement and is not charged with knowledge by virtue of a legend on the certificate or information statement, has a rescission remedy against the transferor (which would be the corporation in the case of a new issue of shares). While the statutory rescission remedy provided in subsection (c) is nonexclusive, it is intended to be a purchaser's primary remedy.

If the shares are certificated and duly legended, a purchaser is charged with notice of the shareholder agreement even if the purchaser never saw the certificate. Thus, a purchaser is exposed to risk by not asking to see the certificate at or prior to the purchase of the shares. In the case of uncertificated shares, however, the purchaser is not charged with notice of the shareholder agreement unless a duly-legended information statement is delivered to the purchaser at or prior to the time of purchase. This different rule for uncertificated shares is intended to provide an additional safeguard to protect innocent purchasers, and is necessary because section 6.26(b) of the Act and section 8-408 of the U.C.C. permit delivery of information statements after a transfer of shares.

4. Section 7.32(d)

Section 7.32(d) contains a self-executing termination provision for a shareholder agreement when the shares of the corporation become publicly traded, and the corporation thereby becomes a public corporation as defined in section 1.40(18A). The statutory norms in the Model Act become more necessary and appropriate as the number of shareholders increases, as there is greater opportunity to acquire or dispose of an investment in the corporation, and as there is less opportunity for negotiation over the terms under which the enterprise will be conducted. Given that section 7.32 requires unanimity, however, in most cases a practical limit on the availability of a shareholder agreement will be reached before a public market develops. Subsection (d) rejects the use of an absolute number of shareholders in determining when the shelter of section 7.32 is lost.

5. Miscellaneous Provisions

Sections 7.32(e) through (g) contain a number of technical provisions. Subsection (e) provides a shift of liability from the directors to any person or persons in whom the discretion or powers otherwise exercised by the board of directors are vested. A shareholder agreement which provides for such a shift of responsibility, with the concomitant shift of liability provided by subsection (e), could also provide for exculpation from that liability to the extent otherwise authorized by the Act. The transfer of liability provided by subsection (e) covers liabilities imposed on directors "by law," which is intended to include liabilities arising under the Act, the common law, and statutory law outside the Act. Nevertheless, there could be cases where subsection (e) is ineffective and where a director is exposed to liability qua director, even though under a shareholder agreement he may have given up some or all of the powers normally exercised by directors.

Subsection (f) narrows the grounds for imposing personal liability on shareholders for the liabilities of a corporation for acts or omissions authorized by a shareholder agreement validated by section 7.32. Subsection (g) addresses shareholder agreements for corporations that are in the process of being organized and do not yet have shareholders.

Subchapter D.
DERIVATIVE PROCEEDINGS

INTRODUCTORY COMMENT

Subchapter D deals with the requirements applicable to shareholder derivative suits. A great deal of controversy has surrounded the derivative suit, and widely different perceptions as to the value and efficacy of this litigation continue to exist. On the one hand, the derivative suit has historically been the principal method of challenging allegedly illegal action by management. On the other hand, it has long been recognized that the derivative suit may be instituted more with a view to obtaining a settlement resulting in fees to the plaintiff's attorney than to righting a wrong to the corporation (the so-called "strike suit").

Subchapter D replaces section 7.40 of the Revised Model Business Corporation Act which at the time of its adoption was stated to reflect a reappraisal of the various procedural devices designed to control abuses of the derivative suit "in light of major developments in corporate governance, the public demand for corporate accountability, and the corporate response in the form of greater independence and sense of responsibility in boards of directors."

Subchapter D reflects a further reappraisal of the requirements for a derivative suit particularly in the light of the large number of judicial decisions dealing with (a) whether demand upon the board of directors is required and (b) the power of independent ("qualified") directors to dismiss a derivative suit. The first of these issues was dealt with indirectly in former section 7.40 by requiring that the complaint state whether demand was made and, if not, why not; the second issue was not covered at all.

Section 7.42 of subchapter D requires a demand on the corporation in all cases. The demand must be made at least 90 days before commencement of suit unless irreparable injury to the corporation would result. It is believed that this provision will eliminate the often excessive time and expense for both litigants and the court in litigating the question whether demand is required but at the same time will not unduly restrict the legitimate derivative suit.

Section 7.44 expressly requires the dismissal of a derivative suit if qualified directors have determined that the maintenance of the suit is not in the best interests of the corporation. This section confirms the basic principle that a derivative suit is an action on behalf of the corporation and therefore should be controlled by those directors who can exercise an unbiased and independent business judgment with respect to its continuance. At the same time, the court is required to assess whether the directors making the recommendation were qualified directors, as well as their good faith and the reasonableness of their inquiry. If a majority of the board does not consist of qualified directors, the burden is placed on the corporation to prove each of these elements.

Section 7.44 also provides a procedure for the determination to be made by a panel appointed by the court.

§ 7.40. SUBCHAPTER DEFINITIONS

In this subchapter:

(1) "Derivative proceeding" means a civil suit in the right of a domestic corporation or, to the extent provided in section 7.47, in the right of a foreign corporation.

(2) "Shareholder" includes a beneficial owner whose shares are held in a voting trust or held by a nominee on the beneficial owner's behalf.

CROSS-REFERENCES

Shares held by nominees, see § 7.23.
Voting trusts, see § 7.30.

OFFICIAL COMMENT

The definition of "derivative proceeding" makes it clear that the subchapter applies to foreign corporations only to the extent provided in section 7.47. Section 7.47 provides that the law of the jurisdiction of incorporation governs except for sections 7.43 (stay of proceedings), 7.45 (discontinuance or settlement) and 7.46 (payment of expenses). See the Official Comment to section 7.47.

The definition of "shareholder," which applies only to subchapter D, includes all beneficial owners and therefore goes beyond the definition in section 1.40(22) which includes only record holders and beneficial owners who are certified by a nominee pursuant to the procedure specified in section 7.23. Similar definitions are found in section 13.01 (appraisal rights) and section 16.02(f) (inspection of records by a shareholder). In the context of subchapter D, beneficial owner means a person having a direct economic interest in the shares. The definition is not intended to adopt the broad definition of beneficial ownership in SEC Rule 13d-2 under the Securities Exchange Act of 1934, 17 C.F.R. § 240.13d-2, which includes persons with the right to vote or dispose of the shares even though they have no economic interest in them.

§ 7.41. STANDING

A shareholder may not commence or maintain a derivative proceeding unless the shareholder:

(1) was a shareholder of the corporation at the time of the act or omission complained of or became a shareholder through transfer by operation of law from one who was a shareholder at that time; and

(2) fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.

CROSS-REFERENCES

"Derivative proceeding" defined, see § 7.40.

"Shareholder" defined, see § 7.40.

OFFICIAL COMMENT

The Model Act and the statutes of many states have long imposed a "contemporaneous ownership" rule, i.e., the plaintiff must have been an owner of shares at the time of the transaction in question. This rule has been criticized as being unduly narrow and technical and unnecessary to prevent the transfer or purchase of lawsuits. A few states, particularly California, Cal. Corp. Code section 800(B), have relaxed this rule in order to grant standing to some subsequent purchasers of shares in limiting circumstances.

The decision to retain the contemporaneous ownership rule in section 7.41(1) was based primarily on the view that it was simple, clear, and easy to apply. In contrast, the California approach might encourage the acquisition of shares in order to bring a lawsuit, resulting in litigation on peripheral issues such as the extent of the plaintiff's knowledge of the transaction in question when the plaintiff acquired the shares. Further, there has been no persuasive showing that the contemporaneous ownership rule has prevented the litigation of substantial suits, at least with respect to publicly held corporations where there are many persons who might qualify as plaintiffs to bring suit even if subsequent purchasers are disqualified.

Section 7.41 requires the plaintiff to be a shareholder and therefore does not permit creditors or holders of options, warrants, or conversion rights to commence a derivative proceeding.

Section 7.41(2) follows the requirement of Federal Rule of Civil Procedure 23.1 with the exception that the plaintiff must fairly and adequately represent the interests of *the corporation* rather than *shareholders similarly situated* as provided in the rule. The clarity of the rule's language in this regard has been questioned by the courts. See *Nolen v. Shaw-Walker Company*, 449 F.2d 506, 508 n.4 (6th Cir. 1972). Furthermore, it is believed that the reference to the corporation in section 7.41(2) more properly reflects the nature of the derivative suit.

The introductory language of section 7.41 refers both to the commencement and maintenance of the proceeding to make it clear that the proceeding should be dismissed if, after commencement, the plaintiff ceases to be a shareholder or a fair and adequate representative. The latter would occur, for example, if the plaintiff were using the proceeding for personal advantage. If a plaintiff no longer has standing, courts have in a number of instances provided an opportunity for one or more other shareholders to intervene.

§ 7.42. DEMAND

No shareholder may commence a derivative proceeding until:

(1) a written demand has been made upon the corporation to take suitable action; and

(2) 90 days have expired from the date the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.

CROSS-REFERENCES

"Derivative proceeding" defined, see § 7.40.
"Shareholder" defined, see § 7.40.

OFFICIAL COMMENT

Section 7.42 requires a written demand on the corporation in all cases. The demand must be made at least 90 days before commencement of suit unless irreparable injury to the corporation would result. This approach has been adopted for two reasons. First, even though no director may be "qualified" (see section 1.43), the demand will give the board of directors the opportunity to re-examine the act complained of in the light of a potential lawsuit and take corrective action. Secondly, the provision eliminates the time and expense of the litigants and the court involved in litigating the question whether demand is required. It is believed that requiring a demand in all cases does not impose an onerous burden since a relatively short waiting period of 90 days is provided and this period may be shortened if irreparable injury to the corporation would result by waiting for the expiration of the 90-day period. Moreover, the cases in which demand is excused are relatively rare. Many plaintiffs' counsel as a matter of practice make a demand in all cases rather than litigate the issue whether demand is excused.

1. Form of Demand

Section 7.42 specifies only that the demand shall be in writing. The demand should, however, set forth the facts concerning share ownership and be sufficiently specific to apprise the corporation of the action sought to be taken and the grounds for that action so that the demand can be evaluated. See *Allison v. General Motors Corp.*, 604 F. Supp. 1106, 1117 (D. Del. 1985). Detailed pleading is not required since the corporation can contact the shareholder for clarification if there are any questions. In keeping with the spirit of this section, the specificity of the demand should not become a new source of dilatory motions.

2. Upon Whom Demand Should Be Made

Section 7.42 states that demand shall be made upon the corporation. Reference is not made specifically to the board of directors as in previous section 7.40(b) since there may be instances such as a decision to sue a third party for an injury to the corporation, in which the taking of, or refusal to take, action would fall within the authority of an officer of the corporation. Nevertheless, it is expected that in most cases the board of directors will be the appropriate body to review the demand.

To ensure that the demand reaches the appropriate person for review, it should be addressed to the board of directors, chief executive officer, or corporate secretary of the corporation at its principal office.

2. The 90-Day Period

Section 7.42(2) provides that the derivative proceeding may not be commenced until 90 days after demand has been made. Ninety days has been chosen as a reasonable minimum time within which the board of directors can meet, direct the necessary inquiry into the charges, receive the results of the inquiry and make its decision. In many instances a longer period may be required. See, e.g., *Mozes v. Welch*, 638 F. Supp. 215 (D. Conn. 1986) (eight month delay in responding to demand not unreasonable). However, a fixed time period eliminates further litigation over what is or is not a reasonable time. The corporation may request counsel for the shareholder to delay filing suit until the inquiry is completed or, if suit is commenced, the corporation can apply to the court for a stay under section 7.43.

Two exceptions are provided to the 90-day waiting period. The first exception is the situation where the shareholder has been notified of the rejection of the demand prior to the end of the 90 days. The second exception is where irreparable injury to the corporation would otherwise result if the commencement of the proceeding is delayed for the 90-day period. The standard to be applied is intended to be the same as that governing the entry of a preliminary injunction. Compare *Gimbel v. Signal Cos.*, 316 A.2d 599 (Del. Ch. 1974) with *Gelco Corp. v. Coniston Partners*, 811 F.2d 414 (8th Cir. 1987). Other factors may also be considered, such as the possible expiration of the statute of limitations, although this would depend on the period of time during which the shareholder was aware of the grounds for the proceeding.

It should be noted that the shareholder bringing suit does not necessarily have to be the person making the demand. Only one demand need be made in order for the corporation to consider whether to take corrective action.

4. Response by the Corporation

There is no obligation on the part of the corporation to respond to the demand. However, if the corporation, after receiving the demand, decides to institute litigation or, after a derivative proceeding has commenced, decides to assume control of the litigation, the shareholder's right to commence or control the proceeding ends unless it can be shown that the corporation will not adequately pursue the matter. As stated in *Lewis v. Graves*, 701 F.2d 245, 247-48 (2d Cir. 1983):

> The [demand] rule is intended "to give the derivative corporation itself the opportunity to take over a suit which was brought on its behalf in the first place, and thus to allow the directors the chance to occupy their normal status as conductors of the corporation's affairs." Permitting corporations to assume control over shareholder derivative suits also has numerous practical advantages. Corporate management may be in a better position to pursue alternative remedies, resolving grievances without burdensome and expensive litigation. Deference to directors' judgments may also result in the termination of meritless actions brought solely for their settlement or harassment value. Moreover, where litigation is appropriate, the derivative corporation will often be in a better position to bring or assume the suit because of superior financial resources and knowledge of the challenged transactions. [Citations omitted.]

§ 7.43. STAY OF PROCEEDINGS

If the corporation commences an inquiry into the allegations made in the demand or complaint, the court may stay any derivative proceeding for such period as the court deems appropriate.

CROSS-REFERENCES

Demand, see § 7.41.
"Derivative proceeding" defined, see § 7.40.

OFFICIAL COMMENT

Section 7.43 provides that if the corporation undertakes an inquiry, the court may in its discretion stay the proceeding for such period as the court deems appropriate. This might occur where the complaint is filed 90 days after demand but the inquiry into matters raised by the demand has not been completed or where a demand has not been investigated but the corporation commences the inquiry after the complaint has been filed. In either case, it is expected that the court will monitor the course of the inquiry to ensure that it is proceeding expeditiously and in good faith.

§ 7.44. DISMISSAL

(a) A derivative proceeding shall be dismissed by the court on motion by the corporation if one of the groups specified in subsection (b) or subsection (e) has determined in good faith, after conducting a reasonable inquiry upon which its conclusions are based, that the maintenance of the derivative proceeding is not in the best interests of the corporation.

(b) Unless a panel is appointed pursuant to subsection (e), the determination in subsection (a) shall be made by:

(1) a majority vote of qualified directors present at a meeting of the board of directors if the qualified directors constitute a quorum; or

(2) a majority vote of a committee consisting of two or more qualified directors appointed by majority vote of qualified directors present at a meeting of the board of directors, regardless of whether such qualified directors constitute a quorum.

(c) If a derivative proceeding is commenced after a determination has been made rejecting a demand by a shareholder, the complaint shall allege with particularity facts establishing either (1) that a majority of the board of directors did not consist of qualified directors at the time the determination was made or (2) that the requirements of subsection (a) have not been met.

(d) If a majority of the board of directors consisted of qualified directors at the time the determination was made, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met; if not, the corporation shall have the burden of proving that the requirements of subsection (a) have been met.

(e) Upon motion by the corporation, the court may appoint a panel of one or more individuals to make a determination whether the maintenance of the derivative proceeding is in the best interests of the corporation. In such case, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met.

CROSS-REFERENCES

Board of directors:
- committees, see § 8.25.
- meetings, see § 8.20.
- quorum and voting, see § 8.24.

Demand, see § 7.41.
"Derivative proceeding" defined, see § 7.40.
"Qualified director" defined, see § 1.43.
"Shareholder" defined, see § 7.40.

OFFICIAL COMMENT

At one time, the Model Act did not expressly provide what happens when a board of directors properly rejects a demand to bring an action. In such event, judicial decisions indicate that the rejection should be honored and any ensuing derivative action should be dismissed. See *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984). The Model Act was also silent on the effect of a determination by a special litigation committee of qualified directors that a previously commenced derivative action should be dismissed. Section 7.44(a) specifically provides that the proceeding shall be dismissed if there is a proper determination that the maintenance of the proceeding is not in the best interests of the corporation. That determination can be made prior to commencement of the derivative action in response to a demand or after commencement of the action upon examination of the allegations of the complaint.

The procedures set forth in section 7.44 are not intended to be exclusive. As noted in the comment to section 7.42, there may be instances where a decision to commence an action falls within the authority of an officer of the corporation, depending upon the amount of the claim and the identity of the potential defendants.

1. The Persons Making the Determination

Section 7.44(b) prescribes the persons by whom the determination in subsection (a) may be made. Subsection (b) provides that the determination may be made (1) at a board meeting by a majority vote of qualified directors if the qualified directors constitute a quorum, or (2) by a majority vote of a committee consisting of two or more qualified directors appointed at a board meeting by a vote of the qualified directors in attendance, regardless of whether they constitute a quorum. (For the definition of "qualified director," see section 1.43 and the related official comment.) These provisions parallel the mechanics for determining entitlement to indemnification (section 8.55), for authorizing directors' conflicting interest transactions (section 8.62), and for renunciation of the corporation's interests in a business opportunity (section 8.70). Subsection (b)(2) is an exception to section 8.25 of the Model Act, which requires the approval of at least a majority of all the directors in office to create a committee and appoint members.

This approach has been taken to respond to the criticism expressed in a few cases that special litigation committees suffer from a structural bias because of their appointment by vote of directors who at that time are not qualified directors. See *Hasan v. Trust Realty Investors*, 729 F.2d 372, 376-77 (6th Cir. 1984).

Subsection (e) provides, as an alternative, for a determination by a panel of one or more individuals appointed by the court. The subsection provides for the appointment only upon motion by the corporation. This would not, however, prevent the court on its own initiative from appointing a special master pursuant to applicable state rules of procedure. (Although subsection (b)(2) requires a committee of at least two qualified directors, subsection (e) permits the appointment by the court of only one person in recognition of the potentially increased costs to the corporation for the fees and expenses of an outside person.)

This panel procedure may be desirable in a number of circumstances. If there are no qualified directors available, the corporation may not wish to enlarge the board to add qualified directors or may be unable to find persons willing to serve as qualified directors. In addition, even if there are directors who are qualified, they may not be in a position to conduct the inquiry in an expeditious manner.

Appointment by the court should also eliminate any question about the qualifications of the individual or individuals constituting the panel making the determination. Although the corporation may wish to suggest to the court possible appointees, the court will not be bound by those suggestions and, in any case, will want to satisfy itself with respect to each candidate's impartiality. When the court appoints a panel, subsection (e) places the burden on the plaintiff to prove that the requirements of subsection (a) have not been met.

2. Standards to Be Applied

Section 7.44(a) requires that the determination, by the appropriate person or persons, be made "in good faith, after conducting a reasonable inquiry upon which their conclusions are based." The phrase "in good faith" modifies both the determination and the inquiry. This standard, which is also found in sections 8.30 (general standards of conduct for directors) and 8.51 (authority to indemnify) of the Model Act, is a subjective one, meaning "honestly or in an honest manner." See also *Corporate Director's Guidebook* (Fifth Edition), 59 BUS. LAW. 1057, 1068 (2007). As stated in *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 800 (E.D. Va. 1982), "the inquiry intended by this phrase goes to the spirit and sincerity with which the investigation was conducted, rather than the reasonableness of its procedures or basis for conclusions."

The word "inquiry"—rather than "investigation"—has been used to make it clear that the scope of the inquiry will depend upon the issues raised and the knowledge of the group making the determination with respect to those issues. In some cases, the issues may be so simple or the knowledge of the group so extensive that little additional inquiry is required. In other cases, the group may need to engage counsel and possibly other professionals to make an investigation and assist the group in its evaluation of the issues.

The phrase "upon which its conclusions are based" requires that the inquiry and the conclusions follow logically. This standard authorizes the court to examine the determination to ensure that it has some support in the findings of the inquiry. The burden of convincing the court about this issue lies with whichever party has the burden under subsection (d). This phrase does not require the persons making the determination to prepare a written report that sets forth their determination and the bases therefor, since circumstances will vary as to the need for such a report. There will be, in all likelihood, many instances where good corporate practice will commend such a procedure.

Section 7.44 is not intended to modify the general standards of conduct for directors set forth in section 8.30 of the Model Act, but rather to make those standards somewhat more explicit in the derivative proceeding context. In this regard, the qualified directors making the determination would be entitled to rely on information and reports from other persons in accordance with section 8.30(d).

Section 7.44 is similar in several respects and differs in certain other respects from the law as it has developed in Delaware and been followed in a number of other states. Under the Delaware cases, the role of the court in reviewing the directors' determination varies depending upon whether the plaintiff is in a demand-required or demand-excused situation.

Since section 7.42 requires demand in all cases, the distinction between demand-excused and demand-required cases does not apply. Subsections (c) and (d) carry forward that distinction, however, by establishing pleading rules and allocating the burden of proof depending on whether there is a majority of qualified directors on the board. Subsection (c), like Delaware law, assigns to the plaintiff the threshold burden of alleging facts establishing that the majority of the directors on the board are not qualified. If there is a majority, then the burden remains with the plaintiff to plead and establish that the requirements of subsection (a) section 7.44(a) have not been met. If there is not a majority of qualified directors on the board, then the burden is on the corporation to prove that the issues delineated in subsection (a) have been satisfied; that is, the corporation must prove both the eligibility of the decision makers to act on the matter and the propriety of their inquiry and determination.

Thus, the burden of proving that the requirements of subsection (a) have not been met will remain with the plaintiff in several situations. First, where the determination to dismiss the derivative proceeding is made in accordance with subsection (b)(1), the burden of proof will generally remain with the plaintiff since the subsection requires a quorum of qualified directors and a quorum is normally a majority. See section 8.24. The burden will also remain with the plaintiff if a majority of qualified directors has appointed a committee under subsection (b)(2), and the qualified directors constitute a majority of the board. Under subsection (e), the burden of proof also remains with the plaintiff in the case of a determination by a panel appointed by the court.

The burden of proof will shift to the corporation, however, where a majority of the board members are not qualified and the determination is made by a committee under subsection (b)(2). It can be argued that, if the directors making the determination under subsection (b)(2) are qualified and have been delegated full responsibility for making the decision, the composition of the entire board is irrelevant. This argument is buttressed by the section's method of appointing the group specified in subsection (b)(2), since it departs from the general method of appointing committees and allows only qualified directors, rather than a majority of the entire board, to appoint the committee that will make the determination. Subsection (d)'s response to objections suggesting structural bias is to place the burden of proof on the corporation (despite the fact that the committee making the determination is composed exclusively of qualified directors).

Finally, section 7.44 does not authorize the court to review the reasonableness of the determination to reject a demand or seek dismissal. This contrasts with the approach in some states that permits a court, at least in some circumstances, to review the merits of the determination (see *Zapata Corp. v. Maldonado*, 430 A.2d 779, 789 (Del. 1981)) and is similar to the approach taken in other states (see *Auerbach v. Bennett*, 393 N.E.2d 994, 1002-03 (N.Y. 1979)).

3. Pleading

The Model Act previously provided that the complaint in a derivative proceeding must allege with particularity either that demand had been made on the board of directors, together with the board's response, or why demand was excused. This requirement is similar to rule 23.1 of the Federal Rules of Civil Procedure. Since demand is now required in all cases, this provision is no longer necessary.

Subsection (c) sets forth a modified pleading rule to cover the typical situation where the plaintiff makes demand on the board, the board rejects that demand, and the plaintiff commences an action. In that scenario, in order to state a cause of action, subsection (c) requires the complaint to allege with particularity facts demonstrating either (1) that no majority of qualified directors exists or (2) why the determination made by qualified directors does not meet the standards in subsection (a). Discovery should be available to the plaintiff only after the plaintiff has successfully stated a cause of action by making either of these two showings.

§ 7.45. DISCONTINUANCE OR SETTLEMENT

A derivative proceeding may not be discontinued or settled without the court's approval. If the court determines that a proposed discontinuance or settlement will substantially affect the interests of the corporation's shareholders or a class of shareholders, the court shall direct that notice be given to the shareholders affected.

CROSS-REFERENCES

"Derivative proceeding" defined, see § 7.40.
"Shareholder" defined, see § 7.40.

OFFICIAL COMMENT

Section 7.45 follows the Federal Rules of Civil Procedure and the statutes of a number of states, and requires that all proposed settlements and discontinuances must receive judicial approval. This requirement seems a natural consequence of the proposition that a derivative suit is brought for the benefit of all shareholders and avoids many of the evils of the strike suit by preventing the individual shareholder-plaintiff from settling privately with the defendants.

Section 7.45 also requires notice to all affected shareholders if the court determines that the proposed settlement may substantially affect their interests. This provision permits the court to decide that no notice need be given if, in the court's judgment, the proceeding is frivolous or has become moot. The section also makes a distinction between classes of shareholders, an approach which is not in Federal Rule of Civil Procedure 23.1, but is adapted from the New York and Michigan statutes. This procedure could be used, for example, to eliminate the costs of notice to preferred shareholders where the settlement does not have a substantial effect on their rights as a class, such as their rights to dividends or a liquidation preference.

Unlike the statutes of some states, section 7.45 does not address the issue of which party should bear the cost of giving this notice. That is a matter left to the discretion of the court reviewing the proposed settlement.

§ 7.46. PAYMENT OF EXPENSES

On termination of the derivative proceeding the court may:

(1) order the corporation to pay the plaintiff's expenses incurred in the proceeding if it finds that the proceeding has resulted in a substantial benefit to the corporation;

(2) order the plaintiff to pay any defendant's expenses incurred in defending the proceeding if it finds that the proceeding was commenced or maintained without reasonable cause or for an improper purpose; or

(3) order a party to pay an opposing party's expenses incurred because of the filing of a pleading, motion or other paper, if it finds that the pleading, motion or other paper was not well grounded in fact, after reasonable inquiry, or warranted by existing law or a good faith argument for the extension, modification or reversal of existing law and was interposed for an improper purpose, such as to harass or cause unnecessary delay or needless increase in the cost of litigation.

CROSS-REFERENCES

"Derivative proceeding" defined, see § 7.40.

"Expenses" defined, see § 1.40.

OFFICIAL COMMENT

Section 7.46(1) is intended to be a codification of existing case law. See, e.g., *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970). It provides that the court may order the corporation to pay the plaintiff's expenses (as defined in section 1.40(9AA) if it finds that the proceeding has resulted in a substantial benefit to the corporation. The subsection requires that there be a "substantial" benefit to the corporation to prevent the plaintiff from proposing inconsequential changes in order to justify the payment of counsel fees. The subsection does not specify the method for calculating attorneys' fees since there is a substantial body of court decisions delineating this issue, which usually includes taking into account the amount or character of the benefit to the corporation.

Section 7.46(2) provides that on termination of a proceeding the court may require the plaintiff to pay the defendants' expenses if it finds that the proceeding "was commenced or maintained without reasonable cause or for an improper purpose." The phrase "for an improper purpose" has been added to parallel Federal Rule of Civil Procedure 11 in order to prevent proceedings which may be brought to harass the corporation or its officers. The test in this section is similar to but not identical with the test utilized in section 13.31, relating to dissenters' rights, where the standard for award of expenses is that dissenters "acted arbitrarily, vexatiously or not in good faith" in demanding a judicial appraisal of their shares. The derivative action situation is sufficiently different from the dissenters' rights situation to justify a different and less onerous test for imposing costs on the plaintiff. The test of section 7.46 that the action was brought without reasonable cause or for an improper purpose is appropriate to deter strike suits, on the one hand, and on the other hand to protect plaintiffs whose suits have a reasonable foundation.

Section 7.46(3) has been added to deal with other abuses in the conduct of derivative litigation which may occur on the part of the defendants and their counsel as well as by the plaintiffs and their counsel. The section follows generally the provisions of rule 11 of the Federal Rules of Civil Procedure. Section 7.46(3) will not be necessary in states which already have a counterpart to rule 11.

§ 7.47. APPLICABILITY TO FOREIGN CORPORATIONS

In any derivative proceeding in the right of a foreign corporation, the matters covered by this subchapter shall be governed by the laws of the jurisdiction of incorporation of the foreign corporation except for sections 7.43, 7.45, and 7.46.

CROSS-REFERENCES

"Derivative proceeding" defined, see § 7.40.
Foreign corporations, generally, see §§ 15.01–15.32.

OFFICIAL COMMENT

Section 7.47 clarifies the application of the provisions of subchapter D to foreign corporations. Previous section 7.40 referred to proceedings in the right of both domestic and foreign corporations, but neither the section nor the comment discussed the interaction between section 7.40 as it applied to a foreign corporation and the law of its state of incorporation. Under generally prevailing practice, a court will look to the choice-of-law rules of the forum state to determine which law shall apply. If the issue is "procedural,' the law of the forum state will apply; if the issue is "substantive," relating to the internal affairs of the corporation, the law of the state of incorporation will apply. See, e.g., *Hausman v. Buckley*, 299 F.2d 696, 700–06 (2d Cir. 1962); *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980). Compare RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 302, 303, 304, 306, 309 (1988) (the local law of the state of incorporation will be applied except in the unusual case where, with respect to the particular issue, some other state has a more significant relationship under the principles stated in section 6 of the Restatement to the parties and the corporation or the transaction).

However, the distinction between what is procedural and what is substantive is not clear. See, e.g., *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 555–57 (1949). For example, in *Susman v. Lincoln American Corp.*, 550 F. Supp. 442, 446 n.6 (N.D. Ill. 1982), the court suggested that the standing requirement might be considered a federal procedural question under Federal Rule of Civil Procedure 23.1 and a matter of substantive law under the Delaware statute.

In view of the uncertainties created by these decisions, section 7.47 sets forth a choice of law provision for foreign corporations. It provides, subject to three exceptions, that the matters covered by the subchapter shall be governed by the laws of the jurisdiction of incorporation of the foreign corporation. In this respect, the section is similar to section 901 of the Revised Uniform Limited Partnership Act which provides that the laws of the state under which a foreign limited partnership is organized govern its organization and internal affairs.

The three exceptions to the general rule are areas which are traditionally part of the forum's oversight of the litigation process: section 7.43, dealing with the ability of the court to stay proceedings; section 7.45, setting forth the procedure for settling a proceeding; and section 7.46, providing for the assessment of reasonable expenses (including counsel fees) in certain situations.

Subchapter E.
PROCEEDING TO APPOINT CUSTODIAN OR RECEIVER

§ 7.48. SHAREHOLDER ACTION TO APPOINT CUSTODIAN OR RECEIVER

(a) The [name or describe court or courts] may appoint one or more persons to be custodians, or, if the corporation is insolvent, to be receivers, of and for a corporation in a proceeding by a shareholder where it is established that:

(1) the directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered; or

(2) the directors or those in control of the corporation are acting fraudulently and irreparable injury to the corporation is threatened or being suffered.

(b) The court

(1) may issue injunctions, appoint a temporary custodian or temporary receiver with all the powers and duties the court directs, take other action to preserve the corporate assets wherever located, and carry on the business of the corporation until a full hearing is held;

(2) shall hold a full hearing, after notifying all parties to the proceeding and any interested persons designated by the court, before appointing a custodian or receiver; and

(3) has jurisdiction over the corporation and all of its property, wherever located.

(c) The court may appoint an individual or domestic or foreign corporation (authorized to transact business in this state) as a custodian or receiver and may require the custodian or receiver to post bond, with or without sureties, in an amount the court directs.

(d) The court shall describe the powers and duties of the custodian or receiver in its appointing order, which may be amended from time to time. Among other powers,

(1) a custodian may exercise all of the powers of the corporation, through or in place of its board of directors, to the extent necessary to manage the business and affairs of the corporation; and

(2) a receiver (i) may dispose of all or any part of the assets of the corporation wherever located, at a public or private sale, if authorized by the court; and (ii) may sue and defend in the receiver's own name as receiver in all courts of this state.

(e) The court during a custodianship may redesignate the custodian a receiver, and during a receivership may redesignate the receiver a custodian, if doing so is in the best interests of the corporation.

(f) The court from time to time during the custodianship or receivership may order compensation paid and expense disbursements or reimbursements made to the custodian or receiver from the assets of the corporation or proceeds from the sale of its assets.

CROSS REFERENCE

“Expenses defined, see § 1.40.

OFFICIAL COMMENT

Previously, the Model Act’s procedures for the appointment of a receiver or custodian were ancillary to an action for judicial dissolution under section 14.30. Section 7.48 has been added to provide a basis for relief for shareholders of any corporation, regardless of whether it is or is not a public corporation, in the two situations, both requiring a showing of actual or threatened irreparable injury, specified in (1) and (2) of section 7.48(a). These two grounds are narrower than those found in an shareholder’s action for judicial dissolution of a nonpublic corporation under section 14.30(a)(2). See the Official Comment to Section 14.30(a)(2). Section 7.48 is in addition to other shareholder remedies provided by the Act and could, for example, be sought by a shareholder of a nonpublic corporation in lieu of involuntary dissolution under section 14.30(a)(2).

CHAPTER 8

Directors and Officers

Subchapter A.
BOARD OF DIRECTORS

Subchapter B.
MEETINGS AND ACTION OF THE BOARD

Subchapter C.
DIRECTORS

Subchapter D.
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Subchapter E.
INDEMNIFICATION AND ADVANCE FOR EXPENSES

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DIRECTORS' CONFLICTING INTEREST TRANSACTIONS

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Subchapter A.
BOARD OF DIRECTORS

§ 8.01. REQUIREMENT FOR AND FUNCTIONS OF BOARD OF DIRECTORS

(a) Except as provided in section 7.32, each corporation must have a board of directors.

(b) All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32.

(c) In the case of a public corporation, the board's oversight responsibilities include attention to:

(1) business performance and plans;

(2) major risks to which the corporation is or may be exposed;

(3) the performance and compensation of senior officers;

(4) policies and practices to foster the corporation's compliance with law and ethical conduct;

(5) preparation of the corporation's financial statements;

(6) the effectiveness of the corporation's internal controls;

(7) arrangements for providing adequate and timely information to directors; and

(8) the composition of the board and its committees, taking into account the important role of independent directors.

CROSS-REFERENCES

Amendment of articles of incorporation, see ch. 10A.

Articles of incorporation, see § 2.02.

Director standards of conduct, see § 8.30.

Indemnification, see § 8.50-8.59.

Officers, see § 8.40-8.42.

"Public corporation" defined, see § 1.40.

OFFICIAL COMMENT

Section 8.01(a) requires that every corporation have a board of directors except that a shareholder agreement authorized by section 7.32 may dispense with or limit the authority of the board of directors. Section 8.0 1(b) also recognizes that the powers of the board of directors may be limited by express provisions in the articles of incorporation or by an agreement among all shareholders under section 7.32.

Obviously, some form of governance is necessary for every corporation. The board of directors is the traditional form of governance but it need not be the exclusive form. Patterns of management may also be tailored to specific needs in connection with family-controlled enterprises, wholly or partially owned subsidiaries, or corporate joint ventures through a shareholder agreement under section 7.32.

Under section 7.32, an agreement among all shareholders can provide for a nontraditional form of governance until the corporation becomes a public corporation as defined in section 1.40(18A). This is a change from the 50 or fewer shareholder test in place in section 8.01 prior to 1990. As the number of shareholders increases and a market for the shares develops, there is (i) an opportunity for unhappy shareholders to dispose of shares-a "market out' (ii) a correlative opportunity for others to acquire shares with related expectations regarding the applicability of the statutory norms of governance, and (iii) no real opportunity to negotiate over the terms upon which the enterprise will be conducted. Moreover, tying the availability of nontraditional governance structures to an absolute number of shareholders at the time of adoption took no account of subsequent events, was overly mechanical, and was subject to circumvention. If a corporation does not have a shareholders agreement that satisfies the requirements of section 7.32, or if it is a public corporation, it must adopt the traditional board of directors as its governing body.

Section 8.01(b) states that if a corporation has a board of directors "its business and affairs shall be managed by or under the direction, and subject to the oversight, of its board of directors." The phrase "by or under the direction, and subject to the oversight, of' encompasses the varying functions of boards of directors of different corporations. In some closely held corporations, the board of directors may be involved in the day-to-day business and affairs and it may be reasonable to describe management as being "by" the board of directors. But in many other corporations, the business and affairs are managed "under the direction, and subject to the oversight, of" the board of directors, since operational management is delegated to executive officers and other professional managers.

While section 8.01(b), in providing for corporate powers to be exercised under the authority of the board of directors, allows the board of directors to delegate to appropriate officers, employees or agents of the corporation authority to exercise powers and perform functions not required by law to be exercised or performed by the board of directors itself, responsibility to oversee the exercise of that delegated authority nonetheless remains with the board of directors. The scope of that oversight responsibility will vary depending on the nature of the corporation's business. For public corporations, subsection (c) provides that the scope of the directors' oversight responsibility includes the matters identified in that subsection. For other corporations, that responsibility may, depending on the circumstances, include some or all of those matters as well. At least for public corporations, subsections (c)(3) and (4) encompass oversight of the corporation's dealings and relationships with its directors and officers, including processes designed to prevent improper related party transactions. See also, chapter 8, subchapter F, sections 8.60 *et seq.* Subsection (c)(5) encompasses the corporation's compliance with the requirements of sections 16.01 and 16.20, while subsection (c)(6) extends also to the internal control processes in place to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Subsection (c)(7) reflects that the board of directors should devote attention to whether the corporation has information and reporting systems in place to provide directors with appropriate information in a timely manner in order to permit them to discharge their responsibilities. See *In re Caremark Int'l Derivative Litig.,* 698 A.2d 959 (Del. Ch. 1996).

Subsection (c)(7) calls for the board of a public corporation, in giving attention to the composition of the board and its committees, to take into account the important role of independent directors. It is commonly accepted that where ownership is separated from management, as is the case with public corporations, having non-management independent directors who participate actively in the board's oversight functions increases the likelihood that actions taken by the board will serve the best interests of the corporation and its shareholders and generally will be given deference in judicial proceedings. The listing standards of most public securities markets have requirements for independent directors to serve on boards; in many cases, they must constitute a majority of the board, and certain board committees must be composed entirely of independent directors. The listing standards have differing rules as to what constitutes an independent director. The Act does not attempt to define "independent director." Ordinarily, an independent director may not be a present or recent member of senior management. Also, to be considered independent, the individual usually must be free of significant professional, financial or similar relationships with the corporation-directly or as a partner, major shareholder or officer of an organization with such a relationship-and the director and members of the director's immediate family must be free of similar relationships with the corporation's senior management. Judgment is required to determine independence in light of the particular circumstances, subject to any specific requirements of a listing standard. The qualities of disinterestedness required of directors under the Act for specific purposes are similar but not necessarily identical. For the requirements for a director to be eligible to act in those situations, see section 1.43. An individual who is generally an independent director for purposes of subsection (c) may not be eligible to act in a particular case under those other provisions of the Act. Conversely, a director who is not independent for purposes of subsection (c) (for example, a member of management) may be so eligible in a particular case.

Although delegation does not relieve the board of directors from its responsibilities of oversight, directors should not be held personally responsible for actions or omissions of officers, employees, or agents of the corporation so long as the directors have relied reasonably and in good faith upon these officers, employees, or agents. See sections 8.30 and 8.31 and their Official Comments. Directors generally have the power to probe into day-to-day management to any depth they choose, but they have the obligation to do so only to the extent that the directors' oversight responsibilities may require, or, for example, when they become aware of matters which make reliance on management or other persons unwarranted.

§ 8.02. QUALIFICATIONS OF DIRECTORS

The articles of incorporation or bylaws may prescribe qualifications for directors. A director need not be a resident of this state or a shareholder of the corporation unless the articles of incorporation or bylaws so prescribe.

CROSS-REFERENCES

Articles of incorporation, see § 2.02, ch. 10A.
Bylaws, see § 2.06, ch. 10B.

OFFICIAL COMMENT

The elimination of mandatory special qualifications for directors is now nearly universal. The articles of incorporation or bylaws, however, may prescribe special qualifications, an option that is most likely to be utilized in closely held corporations, where qualifications for directors may be used as a device for ensuring representation and voting power on the board of directors.

§ 8.03. NUMBER AND ELECTION OF DIRECTORS

(a) A board of directors must consist of one or more individuals, with the number specified in or fixed in accordance with the articles of incorporation or bylaws.

(b) The number of directors may be increased or decreased from time to time by amendment to, or in the manner provided in, the articles of incorporation or the bylaws.

(c) Directors are elected at the first annual shareholders' meeting and at each annual meeting thereafter unless their terms are staggered under section 8.06.

CROSS-REFERENCES

Annual shareholders' meeting, see § 7.01.
Articles of incorporation, see § 2.02, ch. 10A.
Bylaws, see § 2.06, ch. 10B.
Classification of board of directors, see **§** 8.06.
Cumulative voting, see **§** 7.28.
Deadlocked board of directors as ground for dissolution, see **§** 14.30.

Election of directors, see § 7.28.
Staggered terms, see § 8.06.
Terms generally, see § 8.05.

OFFICIAL COMMENT

Section 8.03 prescribes rules for (i) the determination of the size of the board of directors of corporations that have not dispensed with a board of directors under section 7.32(a)(1), and (ii) changes in the number of directors once the board's size has been established.

1. Minimum Number of Directors

Section 8.03(a) provides that the size of the initial board of directors may be "specified in or fixed in accordance with" the articles of incorporation or bylaws. The size of the board of directors may thus be fixed initially in one or more of the fundamental corporate documents, or the decision as to the size of the initial board of directors may be made thereafter in the manner authorized in those documents.

Before 1969 the Model Act required a board of directors to consist of at least three directors. Since then, the Model Act (as well as the corporation statutes of an increasing number of states) has provided that the board of directors may consist of one or more members. A board of directors consisting of one or two individuals may be appropriate for corporations with one or two shareholders, or for corporations with more than two shareholders where in fact the full power of management is vested in only one or two persons. The requirement that every corporation have a board of directors of at least three directors may require the introduction into these closely held corporations of persons with no financial interest in the corporation.

2. Changes in the Size of the Board of Directors

Section 8.03(b) provides a corporation with the freedom to design its articles of incorporation and bylaw provisions relating to the size of the board with a view to achieving the combination of flexibility for the board of directors and protection for shareholders that it deems appropriate. The articles of incorporation could provide for a specified number of directors or a variable-range board, thereby requiring shareholder action to change the fixed size of the board, to change the limits established for the size of the variable-range board or to change from a variable-range board to a fixed board or vice versa. An alternative would be to have the bylaws provide for a specified number of directors or a variable range for the board of directors. Any change would be made in the manner provided by the bylaws. The bylaws could permit amendment by the board of directors or the bylaws could require that any amendment, in whole or in part, be made only by the shareholders in accordance with section 10.20(a). Typically the board of directors would be permitted to change the board size within the established variable range. If a corporation wishes to ensure that any change in the number of directors be approved by shareholders, then an appropriate restriction would have to be included in the articles or bylaws.

The board's power to change the number of directors, like all other board powers, is subject to compliance with applicable standards governing director conduct. In particular, it may be inappropriate to change the size of the board for the primary purpose of maintaining control or defeating particular candidates for the board. See *Blasius Indus., Inc. v. Atlas Corp.,* 564 A.2d 651 (Del. Ch. 1988).

Experience has shown, particularly in larger corporations, that it is desirable to grant the board of directors authority to change its size without incurring the expense of obtaining shareholder approval. In closely held corporations, shareholder approval for a change in the size of the board of directors may be readily accomplished if that is desired. In many closely held corporations a board of directors of a fixed size may be an essential part of a control arrangement. In these situations, an increase or decrease in the size of the board of directors by even a single member may significantly affect control. In order to maintain control arrangements dependent on a board of directors of a fixed size, the power of the board of directors to change its own size must be negated. This may be accomplished by fixing the size of the board of directors in the articles of incorporation or by expressly negating the power of the board of directors to change the size of the board, whether by amendment of the bylaws or otherwise. See section 10.20(a).

3. Annual Elections of Directors

Section 8.03(c) makes it clear that all directors are elected annually unless the board is staggered. See section 8.05 and its Official Comment.

§ 8.04. ELECTION OF DIRECTORS BY CERTAIN CLASSES OF SHAREHOLDERS

If the articles of incorporation authorize dividing the shares into classes, the articles may also authorize the election of all or a specified number of directors by the holders of one or more authorized classes of shares. A class (or classes) of shares entitled to elect one or more directors is a separate voting group for purposes of the election of directors.

CROSS-REFERENCES

Articles of incorporation, see § 2.02, ch. 10A.
Classes of shares, see § 6.01.
Cumulative voting, see § 7.28.
Election of directors generally, see § 7.28.
Removal of directors, see § 8.08 & 8.09.
Voting by voting groups:
  quorum and voting requirements for election of directors, see § 7.28.
  quorum and voting requirements generally, see § 7.25 & 7.26.
"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 8.04 makes explicit that the articles of incorporation may provide that a specified number (or all) of the directors may be elected by the holders of one or more classes of shares. This approach is widely used in closely held corporations to effect an agreed upon allocation of control, for example, to ensure minority representation on the board of directors by issuing to that minority a class of shares entitled to elect one or more directors. A class (or classes) of shares entitled to elect separately one or more directors constitutes a separate voting group for purposes of the election of directors; within each voting group directors are elected by a plurality of votes and quorum and voting requirements must be separately met by each voting group. See sections 7.25, 7.26, and 7.28.

§ 8.05. TERMS OF DIRECTORS GENERALLY

(a) The terms of the initial directors of a corporation expire at the first shareholders' meeting at which directors are elected.

(b) The terms of all other directors expire at the next, or if their terms are staggered in accordance with section 8.06, at the applicable second or third, annual shareholders' meeting following their election, except to the extent (i) provided in section 10.22 if a bylaw electing to be governed by that section is in effect or (ii) a shorter term is specified in the articles of incorporation in the event of a director nominee failing to receive a specified vote for election.

(c) A decrease in the number of directors does not shorten an incumbent director's term.

(d) The term of a director elected to fill a vacancy expires at the next shareholders' meeting at which directors are elected.

(e) Except to the extent otherwise provided in the articles of incorporation or under section 10.22 if a bylaw electing to be governed by that section is in effect, despite the expiration of a director's term, the director continues to serve until the director's successor is elected and qualifies or there is a decrease in the number of directors.

CROSS-REFERENCES

Annual shareholders' meeting, see § 7.01.
Court-ordered shareholders' meeting, see § 7.03.
Removal, see § 8.08 & 8.09.
Resignation, see § 8.07.
Size of board, see § 8.03.
Staggered terms, see § 8.06.
Vacancies, see § 8.10.

OFFICIAL COMMENT

Section 8.05 provides for the annual election of directors at the annual shareholders' meeting with the single exception that terms may be staggered as permitted in section 8.06. Section 8.05 also provides that a director term may expire before the next, or applicable second or third, annual shareholders' meeting if a bylaw invoking section 10.22 is in effect or the articles of incorporation provide for a shorter term in the event a director nominee fails to receive a specified vote for election.

Section 8.05(c) provides that a decrease in the number of directors does not shorten the term of an incumbent director or divest any director of office. Rather, the incumbent director's term expires at the annual meeting at which a successor would otherwise be elected.

Section 8.05(d) provides that the terms of all directors elected to fill vacancies expire at the next meeting of shareholders at which directors are elected. Thus, if terms are staggered under section 8.06, the term of a director elected to fill a vacant term with more than a year to run is shorter than the term of the director's predecessor. The board of directors may take appropriate steps, by designation of short terms or otherwise, to return the rotation of election of directors to the original terms established or fixed by the articles or bylaws.

Section 8.05(e) provides for "holdover" directors so that directorships do not automatically become vacant at the expiration of their terms but the same persons continue in office until successors qualify for office. Thus the power of the board of directors to act continues uninterrupted even though an annual shareholders' meeting is not held or the shareholders are deadlocked or otherwise unable to elect directors at the meeting. Section 8.05 does provide for two possible exceptions to the general rule that directors hold over. First, it permits the articles of incorporation to modify or eliminate the holdover concept. Second, it recognizes that, if a bylaw is adopted invoking section 10.22, the effect will be that directors who are elected by a plurality vote but receive more votes against than for their election will not hold over following the abbreviated 90day term of office specified in section 10.22.

§ **8.06. STAGGERED TERMS FOR DIRECTORS**

The articles of incorporation may provide for staggering the terms of directors by dividing the total number of directors into two or three groups, with each group containing 1/2 or 1/3 of the total, as near as may be practicable. In that event, the terms of directors in the first group expire at the first annual shareholders' meeting after their election, the terms of the second group expire at the second annual shareholders' meeting after their election, and the terms of the third group, if any, expire at the third annual shareholders' meeting after their election. At each annual shareholders' meeting held thereafter, directors shall be chosen for a term of two years or three years, as the case may be, to succeed those whose terms expire.

CROSS-REFERENCES

Annual shareholders' meeting, see § 7.01.
Cumulative voting, see § 7.28.
Election of directors generally, see § 7.28.
Number of directors, see § 8.03.
Removal, see § 8.08 & 8.09.
Resignation, see § 8.07.
Terms of directors generally, see § 8.05.
Vacancies, see § 8.10.

OFFICIAL COMMENT

Section 8.06 recognizes the practice of "classifying" the board or "staggering" the terms of directors so that only 1/2 or 1/3 of them are elected at each annual shareholders' meeting and directors are elected for two- or three-year terms rather than one-year terms.

The traditional purpose of a staggered board has been to assure the continuity and stability of the corporation's business strategies and policies as determined by the board. In recent years the practice has been employed with increasing frequency to ensure that a majority of the board of directors remains in place following a sudden change in shareholdings or a proxy contest. It also reduces the impact of cumulative voting since a greater number of votes is required to elect a director if the board is staggered than is required if the entire board is elected at each annual meeting. A staggered board of directors also can have the effect of making unwanted takeover attempts more difficult, particularly where the articles of incorporation provide that the shareholders may remove directors only with cause or by a supermajority vote, or both.

§ **8.07. RESIGNATION OF DIRECTORS**

(a) A director may resign at any time by delivering a written resignation to the board of directors, or its chair, or to the secretary of the corporation.

(b) A resignation is effective when the resignation is delivered unless the resignation specifies a later effective date or an effective date determined upon the happening of an event or events. A resignation that is conditioned upon failing to receive a specified vote for election as a director may provide that it is irrevocable.

CROSS-REFERENCES

"Deliver," see § 1.40.
Delivery to corporation, see § 1.40.
"Notice" defined, see § 1.41.
"Secretary" defined, see § 1.40. Vacancies, see § 8.10.

OFFICIAL COMMENT

The resignation of a director is effective when the written notice is delivered unless the notice specifies a later effective date or an effective date determined upon the happening of an event or events, in which case the director continues to serve until that later date. Under section 8.10, a vacancy that will occur at a specific later date by reason of a resignation effective at a later date may be filled before the vacancy occurs. Since the individual giving the notice is still a member of the board, he or she may participate in all decisions until the specified date, including the choice of his or her successor under section 8.10. Section 8.10 does not permit vacancies that occur by virtue of a resignation conditioned upon a future event or events to be filled until such events occur.

The provisions in section 8.07(b) that a resignation may be made effective upon a date determined upon the happening of a future event or events, coupled with authority granted in the same section to make resignations conditioned at least in part upon failing to receive a specified vote for election irrevocable, are intended to clarify the enforceability of a director resignation conditioned upon "events" such as the director failing to achieve a specified vote for reelection, e.g., more votes for than against, coupled with board acceptance of the resignation. These provisions thus permit corporations and individual directors to agree voluntarily and give effect, in a manner subsequently enforceable by the corporation, to voting standards for the election of directors that exceed the plurality default standard in section 7.28. The provisions of section 8.07(b) also make it clear that such arrangements do not contravene public policy. The express reference to the failure to receive a specified vote is not to be construed to address or negate the possible validity of other appropriate conditions for an irrevocable resignation.

§ 8.08. REMOVAL OF DIRECTORS BY SHAREHOLDERS

(a) The shareholders may remove one or more directors with or without cause unless the articles of incorporation provide that directors may be removed only for cause.

(b) 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 that director.

(c) If cumulative voting is authorized, a director may not be removed if the number of votes sufficient to elect the director under cumulative voting is voted against removal. If cumulative voting is not authorized, a director may be removed only if the number of votes cast to remove exceeds the number of votes cast not to remove the director.

(d) A director may be removed by the shareholders only at a meeting called for the purpose of removing the director and the meeting notice must state that the purpose, or one of the purposes, of the meeting is removal of the director.

CROSS-REFERENCES

Articles of incorporation, see § 2.02, ch. 10A.
Court-ordered removal, see § 8.09.
Cumulative voting, see § 7.28.
Director standards of conduct, see § 8.30.
Election by voting group of shareholders, see § 8.04.
Election of directors generally, see § 7.28.
Meeting notice, see § 7.05.
Quorum for voting group, see § 7.25.
Shareholders' meetings, see § 7.01-7.03.
"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 8.08(a) accepts the view that since the shareholders are the owners of the corporation, they should normally have the power to change the directors at will. This section reverses the common law position that directors have a statutory entitlement to their office and can be removed only for cause-fraud, criminal conduct, gross abuse of office amounting to a breach of trust, or similar conduct. The power to remove directors is subject to several restrictions set forth in section 8.08:

(1) The power to remove a director without cause maybe eliminated by a provision in the articles of incorporation. Such a provision in effect guarantees the directors the same entitlement to office that directors enjoyed at common law. It is likely to be used in closely held corporations as an element of an agreed-upon allocation of power and control which ensures directors immunity from removal except for cause. It may also be used in publicly held corporations that fear changes in ownership of the majority of the

shares and desire to provide security to the directors.

(2) If the articles of incorporation provide that one or more classes of shares constitute a separate voting group entitled to elect a director (see section 8.04), only the shareholders of that voting group may participate in the vote whether or not to remove that director. But that director may be removed by court proceeding under section 8.09 despite this section.

(3) If cumulative voting is not authorized, a director is removed (with or without cause) only if the votes cast to remove exceed the votes cast to retain the director at a meeting of the voting group electing the director at which a quorum of shares entitled to vote on election of the director is present.

(4) If cumulative voting is authorized, a different standard for removal is involved. Under cumulative voting, a director may be removed (with or without cause) only if the votes cast in favor of retaining the director would not have been sufficient to elect the director pursuant to cumulative voting at that meeting. This provision guarantees that a minority faction with sufficient votes to guarantee the election of a director under cumulative voting will be able to protect that director from removal by the remaining shareholders. The director, however, may be removed by court proceeding under section 8.09 despite this section. In computing whether or not a director elected by cumulative voting is protected from removal from office by section 8.08(c), the votes should be counted as though (1) the vote to remove the director occurred in an election to elect the number of directors normally elected by the voting group along with the director whose removal is sought, (2) the number of votes cast cumulatively against removal had been cast for election of the director , and (3) all votes cast for removal of the director had been cast cumulatively in an efficient pattern for the election of a sufficient number of candidates so as to deprive the director whose removal is being sought of the director's office.

Removal of directors under section 8.08(d) requires the meeting notice to state that removal of specific directors will be proposed.

§ **8.09. REMOVAL OF DIRECTORS BY JUDICIAL PROCEEDING**

(a) The [name or describe] court of the county where a corporation's principal office (or, if none in this state, its registered office) is located may remove a director of the corporation from office in a proceeding commenced by or in the right of the corporation if the court finds that (1) the director engaged in fraudulent conduct with respect to the corporation or its shareholders, grossly abused the position of director, or intentionally inflicted harm on the corporation; and (2) considering the director's course of conduct and the inadequacy of other available remedies, removal would be in the best interest of the corporation.

(b) A shareholder proceeding on behalf of the corporation under subsection (a) shall comply with all of the requirements of sub-chapter 7D, except section 7.41(1).

(c) The court, in addition to removing the director, may bar the director from reelection for a period prescribed by the court.

(d) Nothing in this section limits the equitable powers of the court to order other relief.

CROSS-REFERENCES

Derivative proceedings, see § 7.40-7.47.
Director standards of conduct, see § 8.30.
"Principal office":

defined, see § 1.40.
designated in annual report, see § 16.21.
"Proceeding" defined, see § 1.40.
Registered office:
designated in annual report, see § **16.21.**
required, see § 2.02 & 5.01.
Removal by shareholders, see § 8.08.
"Shareholder" defined, see § 1.40.

OFFICIAL COMMENT

Section 8.09 is designed to operate in the limited circumstance where other remedies are inadequate to address serious misconduct by a director and it is impracticable for shareholders to invoke the usual remedy of removal under section 8.08. In recognition that director election and removal are principal prerogatives of shareholders, section 8.09 authorizes judicial removal of a director who is found to have engaged in serious misconduct as described in subsection (a) (1) if the court also finds that, taking into consideration the director's course of conduct and the inadequacy of other available remedies, removal of the director would be in the best interest of the corporation. Misconduct serious enough to justify the extraordinary remedy of judicial removal does not involve any matter falling within an individual director's lawful exercise of business judgment, no matter how unpopular the director's views may be with the other members of the board. Policy and personal differences among the members of the board of directors should be left to be resolved by the shareholders.

Section 8.09(d) makes **it** clear that the court is not restricted to the removal remedy in actions under this section but may order any other equitable relief. Where, for example, the complaint concerns an ongoing course of conduct that is harmful to the corporation, the court may enjoin the director from continuing that conduct. In another instance, the court may determine that the director's continuation in office is inimical to the best interest of the corporation. Judicial removal might be the most appropriate remedy in that case if shareholder removal under section 8.08 is impracticable because of situations like the following:

(1) The director charged with serious misconduct personally owns or controls sufficient shares to block removal.

(2) The director was elected by voting group or cumulative voting, and the shareholders with voting power to prevent removal will exercise that power despite the director's serious misconduct and without regard to what the court deems to be the best interest of the corporation.

(3) A shareholders' meeting to consider removal under section 8.08 will entail considerable expense and a period of delay that will be contrary to the corporation's best interest.

A proceeding under this section may be brought by the board of directors or by a shareholder suing derivatively. If an action is brought derivatively, all of the provisions of subchapter 7D, including dismissal under section 7.44, are applicable to the action with the exception of the contemporaneous ownership requirement of section 7.41(1).

Section 8.09 is designed to interfere as little as possible with the usual mechanisms of corporate governance. Accordingly, except for limited circumstances such as those described above, where shareholders have reelected or declined to remove a director with full knowledge of the director's misbehavior, the court should decline to entertain an action for removal under section 8.09. It is not intended to permit judicial resolution of internal corporate disputes involving issues other than those specified in subsection (a)(1).

§ **8.10. VACANCY ON BOARD**

(a) Unless the articles of incorporation provide otherwise, if a vacancy occurs on a board of directors, including a vacancy resulting from an increase in the number of directors:

(1) the shareholders may fill the vacancy;

(2) the board of directors may fill the vacancy; or

(3) if the directors remaining in office constitute fewer than a quorum of the board, they may fill the vacancy by the affirmative vote of a majority of all the directors remaining in office.

(b) If the vacant office was held by a director elected by a voting group of shareholders, only the holders of shares of that voting group are entitled to vote to fill the vacancy if it is filled by the shareholders, and only the directors elected by that voting group are entitled to fill the vacancy if it is filled by the directors.

(c) A vacancy that will occur at a specific later date (by reason of a resignation effective at a later date under section 8.07(b) or otherwise) may be filled before the vacancy occurs but the new director may not take office until the vacancy occurs.

CROSS-REFERENCES

Election by voting group of shareholders, see § 8.04.
Number of directors, see § 8.03.
Quorum and voting of directors, see § 8.24.
Removal of directors, see § 8.08 & 8.09.
Resignation of directors, see § 8.07.
Shareholders' meetings, see § 7.0 1-7.03.
Terms of directors generally, see § 8.05.
Voting by voting group, see § 7.25 & 7.26.
"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Vacancies on the board of directors may be filled either by the shareholders or by the board of directors. In large corporations the cost of calling a special meeting of shareholders may be prohibitive so that in those corporations filling vacancies by the board of directors is the norm. On the other hand, in a closely held corporation the shareholders may fill vacancies as readily as the board.

Section 8.10(a)(3) allows the directors remaining in office to fill vacancies even though they are fewer than a quorum. The test for the exercise of this power is whether the directors remaining in office are fewer than a quorum, not whether the directors seeking to act are fewer than a quorum. For example, on a board of six directors where a quorum is four, if there are two vacancies, they may not be filled under section 8.10(a)(3) at a "meeting" attended by only three directors. Even though the three directors are fewer than a quorum, section 8.l0(a)(3) is not applicable because the number of directors remaining in office-four-is not fewer than a quorum.

Section 8.10(b) provides that if a voting group of shares is entitled to elect a director, only that voting group is entitled to fill a vacant office which was held by a director elected by that voting group, and only the directors elected by that voting group are entitled to fill the vacancy if it is filled by the directors. This section is part of the consistent treatment of directors elected by a voting group of shareholders. See sections 1.40, 7.25, 7.26, 7.28, 8.04 and 8.08(b).

Section 8.10(c) permits vacancies that wifi arise on a specific later date to be filled in advance of that date so long as the designee does not actually take office until the vacancy occurs. The director in the office that will become vacant may participate in the selection of a successor. A vacancy arising at a later date is most likely to arise because of a resignation effective at a later date; it may also arise in connection with retirements or with prospective amendments to bylaws. In a closely held corporation with a balance of power on the board of directors that was reached by agreement, a prospective resignation followed by the appointment of a successor under this section permits the board to act on the replacement before the change in balance caused by the resignation.

§ **8.11. COMPENSATION OF DIRECTORS**

Unless the articles of incorporation or bylaws provide otherwise, the board of directors may fix the compensation of directors.

CROSS-REFERENCES

Articles of incorporation, see § 2.02, ch. 10A.
Committees of board of directors, see § 8.25.
Director standards of conduct, see § 8.30.

OFFICIAL COMMENT

This section puts at rest the question whether the board of directors can fix the compensation of its members for serving as directors. The practice of compensating directors is now of long standing, and the establishment of a policy with respect to director compensation is an appropriate function of the board of directors.

In publicly held corporations, compensation is customarily provided to *non-management directors. As stated in The Corporate Director's Guidebook,"...* it is expected that a non-management director will devote substantial attention to the affairs of the corporation and will be compensated accordingly?' 33 Bus. LAW. 1591, 1622 (1978).

Subchapter B.

MEETINGS AND ACTION OF THE BOARD

§ 8.20. MEETINGS

(a) The board of directors may hold regular or special meetings in or out of this state.

(b) Unless the articles of incorporation or bylaws provide otherwise, the board of directors may permit any or all directors to participate in a regular or special meeting by, or conduct the meeting through the use of, any means of communication by which all directors participating may simultaneously hear each other during the meeting. A director participating in a meeting by this means is deemed to be present in person at the meeting.

CROSS-REFERENCES

Action without meeting, see § 8.21.
Articles of incorporation, see § 2.02, ch. 10A.
Bylaws, see § 2.06, ch. 10B.
Notice of meeting, see § 8.22.
Quorum and voting, see § 8.24.
Waiver of meeting notice, see § 8.23.

OFFICIAL COMMENT

This section authorizes meetings of directors anywhere. No distinction is made between meetings in-state and out-of-state. It also authorizes the board of directors to permit any or all directors to participate in a meeting by the use of any means of communication by which all directors participating may simultaneously hear each other. This decision is discretionary with the board of directors, and a person participating in this fashion is deemed to be present in person at the meeting for purposes of quorum and voting requirements.

With the development of modern electronic technology, it is possible that the advantages of the traditional meeting, at which all members are present at a single place, may be obtained even though the members are physically dispersed and no two directors are present at the same place. The advantage of the traditional meeting is the opportunity for interchange that is permitted by a meeting in a single room at which members are physically present. If this opportunity for interchange is thought to be available by the board of directors, a meeting may be conducted by electronic means although no two directors are physically present at the same place and no specific place for the meeting is designated.

§ **8.21. ACTION WITHOUT MEETING**

(a) Except to the extent that the articles of incorporation or bylaws require that action by the board of directors be taken at a meeting, action required or permitted by this Act to be taken by the board of directors may be taken without a meeting if each director signs a consent describing the action to be taken and delivers it to the corporation.

(b) Action taken under this section is the act of the board of directors when one or more consents signed by all the directors are delivered to the corporation. The consent may specify the time at which the action taken thereunder is to be effective. A director's consent may be withdrawn by a revocation signed by the director and delivered to the corporation prior to delivery to the corporation of unrevoked written consents signed by all the directors.

(c) A consent signed under this section has the effect of action taken at a meeting of the board of directors and may be described as such in any document.

CROSS-REFERENCES

Articles of incorporation, see § 2.02, ch. 10A.
Bylaws, see § 2.06, ch. 10B.
"Notice" defined, see § 1.41.
Notice of meeting, see § 8.22.
Waiver of meeting notice, see § 8.23.

OFFICIAL COMMENT

The power of the board of directors to act unanimously without a meeting is based on the pragmatic consideration that in many situations a formal meeting is a waste of time. For example, in a closely held corporation there will often be informal discussion by the manager-owners of the venture before a decision is made. And, of course, if there is only a single director (as is permitted by section 8.03), a written consent is the natural method of signifying director action. Consent may be signified on one or more documents if desirable. The consent document may specify the time at which the action is taken thereunder is to become effective.

In public held corporations, formal meetings of the board of directors may be appropriate for many actions. But there will always be situations where prompt action is necessary and the decision noncontroversial, so that approval without a formal meeting may be appropriate.

Under section 8.21 the requirement of unanimous consent precludes the possibility of stifling or ignoring opposing argument. A director opposed to an action that is proposed to be taken by unanimous written consent, or uncertain about the desirability of that action, may compel the holding of a directors' meeting to discuss the matter simply by withholding consent.

§ **8.22. NOTICE OF MEETING**

(a) Unless the articles of incorporation or bylaws provide otherwise, regular meetings of the board of directors may be held without notice of the date, time, place, or purpose of the meeting.

(b) Unless the articles of incorporation or bylaws provide for a longer or shorter period, special meetings of the board of directors must be preceded by at least two days' notice of the date, time, and place of the meeting. The notice need not describe the purpose of the special meeting unless required by the articles of incorporation or bylaws.

CROSS-REFERENCES

Action without meeting, see § 8.21.
Articles of incorporation, see § 2.02, ch. 10A.
Bylaws, see § 2.06, ch. 10B.
Effective date of notice, see § 1.41.
Meetings of board of directors, see § 8.20 & 8.21.
"Notice" defined, see § 1.41.
Waiver of notice, see § 8.23.

OFFICIAL COMMENT

Regular meetings of the board of directors may be held without notice and special meetings require only two days' notice unless other requirements are imposed by the articles of incorporation or bylaws. The notice may be written or oral. Also, no statement of the purpose of either a regular or special meeting is necessary unless required by the articles of incorporation or bylaws. These requirements differ from the requirements applicable to meetings of shareholders because of fundamental differences in their roles: directors are expected to be more closely involved in corporate affairs than shareholders, and meetings of directors are held more systematically and regularly than meetings of shareholders.

§ **8.23. WAIVER OF NOTICE**

(a) A director may waive any notice required by this Act, the articles of incorporation, or bylaws before or after the date and time stated in the notice. Except as provided by subsection (b), the waiver must be in writing, signed by the director entitled to the notice, and filed with the minutes or corporate records.

(b) A director's attendance at or participation in a meeting waives any required notice to the director of the meeting unless the director at the beginning of the meeting (or promptly upon arrival) objects to holding the meeting or transacting business at the meeting and does not thereafter vote for or assent to action taken at the meeting.

CROSS-REFERENCES

Action without meeting, see § 8.21.
Meetings of board of directors, see § 8.20.
"Notice" defined, see § 1.41.
Notice of meeting, see § 8.22.
"Secretary" defined, see § 1.40.

OFFICIAL COMMENT

Section 8.23(a) reverses the common law rule that invalidates waivers of notice by directors after the date and time of the meeting. In modern practice notice is often a technical requirement and waivers should be freely permitted.

Section 8.23(b) recognizes that the function of notice is to inform directors of a meeting. If a director actually appears at the meeting the director has probably had notice of **it** and generally should not be able to raise a technical objection that he or she was not given notice.

In cases where actual prejudice occurs because of the lack of notice, as may be indicated by the absence of one or more other directors, the director must call attention to the defect at the outset of the meeting or promptly upon arriving. That director, or a director who did not receive notice and was not present at the meeting, may then attack the validity of the action taken for want of notice. If a director properly objects to the meeting being held, the director is not presumed to have assented to actions taken thereafter, but waives the objection by thereafter voting for or assenting to action taken at the meeting. See section 8.24(d).

§ **8.24. QUORUM AND VOTING**

(a) Unless the articles of incorporation or bylaws require a greater number or unless otherwise specifically provided in this Act, a quorum of a board of directors consists of:

(1) a majority of the fixed number of directors if the corporation has a fixed board size; or

(2) a majority of the number of directors prescribed, or if no number is prescribed the number in office immediately before the meeting begins, if the corporation has a variable-range size board.

(b) The articles of incorporation or bylaws may authorize a quorum of a board of directors to consist of no fewer than 1/3 of the fixed or prescribed number of directors determined under subsection (a).

(c) If a quorum is present when a vote is taken, the affirmative vote of a majority of directors present is the act of the board of directors unless the articles of incorporation or bylaws require the vote of a greater number of directors.

(d) A director who is present at a meeting of the board of directors or a committee of the board of directors when corporate action is taken is deemed to have assented to the action taken unless: (1) the director objects at the beginning of the meeting (or promptly upon arrival) to holding it or transacting business at the meeting; (2) the dissent or abstention from the action taken is entered in the minutes of the meeting; or (3) the director delivers written notice of the director's dissent or abstention to the presiding officer of the meeting before its adjournment or to the corporation immediately after adjournment of the meeting. The right of dissent or abstention is not available to a director who votes in favor of the action taken.

CROSS-REFERENCES

Action without meeting, see § 8.21.

Articles of incorporation, see § 2.02, ch. 10A.

Bylaws, see § 2.06, ch. 10B.

Committees of board of directors, see § 8.25.

Director standards of conduct, see § 8.30.

Meetings of board of directors, see § 8.20.

"Notice" defined, see § 1.41.

Number of directors, see § 8.03.

Quorum for determination of advance for expenses, see § 8.53(c).

Quorum for determination and authorization of indemnification, see § 8.55(b).

"Secretary" defined, see § 1.40.

OFFICIAL COMMENT

In the absence of a provision in the articles of incorporation or bylaws, a quorum is determined as follows:

(1) If the board of directors consists of a fixed number-whether fixed by the board or shareholders under section 8.03(b)-a quorum is a majority of that number. Thus, if a board of directors has a fixed membership of 15, a quorum is 8. If the board of directors has exercised its power under section 8.03(b) to increase its size to 19, a quorum is 10; if it reduced its size to 12, a quorum is 7.

(2) If the board of directors is a variable size board, a quorum consists of a majority of the number of directors prescribed at that time by the board of directors or shareholders. If no number is prescribed, then a quorum consists of a majority of the directors in office immediately before the meeting begins.

Section 8.24(a) provides that the articles of incorporation or bylaws may provide for a greater number than specified in clauses (1) and (2) for a quorum of the board. Section 8.24(a) also recognizes that the Act itself may provide for a different quorum in certain specified situations. See sections 8.53(c)(1) and 8.55(b)(1).

Section 8.24(b) provides that the articles of incorporation or bylaws may decrease the size of the quorum to 1/3 of the number of directors determined under section 8.24(a).

Section 8.24(a) allows the articles of incorporation or bylaws to increase the quorum up to and including unanimity while section 8.24(c) allows these documents similarly to increase the vote necessary to take action. The articles of incorporation or bylaws may also establish quorum or voting requirements with respect to directors elected by voting groups of shareholders pursuant to section 8.04. The option to increase either or both the vote and quorum requirements most commonly is exercised in closely held corporations where a greater degree of participation is thought appropriate or where a minority participant in the venture seeks to obtain a veto power over corporate action.

The phrase "when the vote is taken" in section 8.24(c) is designed to make clear that the board of directors may act only when a quorum is present. If directors leave during the course of a meeting, the board of directors may not act after the number of directors present is reduced to less than a quorum.

Under section 8.24(d) directors, if they object or abstain with respect to action taken by the board of directors or a committee of the board of directors, must make their position clear in one of the ways described in this subsection. If objection is made in the form of a written dissent, it may be transmitted by wire, telecopier, or other medium of data transmission. This written objection serves the important purpose of forcefully bringing the position of the dissenting member to the attention of the balance of the board of directors. The requirement of a written objection also prevents a director from later seeking to avoid responsibility because of secret doubts about the wisdom of the action taken. The right of dissent or abstention is not available to a director who voted in favor of the action taken.

Section 8.24(d) applies only to directors who are present at the meeting. Directors who are not present are not deemed to have assented to any action taken at the meeting in their absence.

§ **8.25. COMMITTEES**

(a) Unless this Act, the articles of incorporation or the bylaws provide otherwise, a board of directors may create one or more committees and appoint one or more members of the board of directors to serve on any such committee.

(b) Unless this Act otherwise provides, the creation of a committee and appointment of members to it must be approved by the greater of (1) a majority of all the directors in office when the action is taken or (2) the number of directors required by the articles of incorporation or bylaws to take action under section 8.24.

(c) Sections 8.20 through 8.24 apply both to committees of the board and to their members.

(d) To the extent specified by the board of directors or in the articles of incorporation or bylaws, each committee may exercise the powers of the board of directors under section 8.01.

(e) A committee may not, however:

(1) authorize or approve distributions, except according to a formula or method, or within limits, prescribed by the board of directors;

(2) approve or propose to shareholders action that this Act requires be approved by shareholders;

(3) fill vacancies on the board of directors or, subject to subsection (g), on any of its committees; or

(4) adopt, amend, or repeal bylaws.

(f) The creation of, delegation of authority to, or action by a committee does not alone constitute compliance by a director with the standards of conduct described in section 8.30.

(g) The board of directors may appoint one or more directors as alternate members of any committee to replace any absent or disqualified member during the member's absence or disqualification. Unless the articles of incorporation or the bylaws or the resolution creating the committee provide otherwise, in the event of the absence or disqualification of a member of a committee, the member or members present at any meeting and not disqualified from voting, unanimously, may appoint another director to act in place of the absent or disqualified member.

CROSS-REFERENCES

Articles of incorporation, see § 2.02, ch. 10A.
Bylaws, see § 2.06, ch. 10B.
Derivative proceedings, see § 7.40-7.47.
Director standards of conduct, see § 8.30.
Dissolution, see ch. 14.
Distributions, see § 6.40.
Functions of board of directors, see § 8.01.
Indemnification determination, see § 8.55.
Issuance of shares, see § 6.01 & 6.02.

Mergers, see ch. 11.
Quorum and voting, see § 8.24.
Reacquisition of shares, see § 6.03 & 6.31.
Vacancies on board, see § 8.10.

OFFICIAL COMMENT

Section 8.25 makes explicit the common law power of a board of directors to act through committees of directors and specifies the powers of the board of directors that are non-delegable, that is, powers that only the full board of directors may exercise. Section 8.25 deals only with board committees exercising the powers or performing the functions of the board of directors; the board of directors or management, independently of section 8.25, may establish non-board committees composed of directors, employees, or others to exercise corporate powers not required to be exercised by the board of directors.

Section 8.25(b) states that, unless this Act otherwise provides, a committee of the board of directors may be created only by the affirmative vote of a majority of the board of directors then in office, or, if greater, by the number of directors required to take action by the articles of incorporation or the bylaws. This supermajority requirement reflects the importance of the decision to invest board committees with power to act under section 8.25.

Committees of the board of directors are assuming increasingly important roles in the governance of public corporations. *See* Committee on Corporate Laws, *Corporate Director's Guidebook,* (5th ed. 2007). Nominating and compensation committees, composed primarily or entirely of independent directors, are widely used by public corporations and may be required by listing standards adopted by public securities markets. Such standards, including those mandated by law, also require the appointment of audit committees, composed entirely of independent directors, to perform important functions including the selection and retention of the corporation's external auditors.

Section 8.25(a) permits a committee to consist of a single director. This accommodates situations in which only one director may be present or available to make a decision on short notice, as well as situations in which it is unnecessary or inconvenient to have more than one member on a committee. Committees also are often employed to decide matters in which other members of the board have a conflict of interest; in such a case, a court will typically scrutinize with care the committee's decision when it is the product of a lone director. *See, e.g.,* Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985). Additionally, various sections of the Model Act require the participation or approval of at least two qualified directors in order for the decision of the board or committee to have effect. (For the definition of "qualified director' see section 1.43). These include a determination that maintenance of a derivative suit is not in the corporation's best interests (section 7.44(b)(3)), a determination that indemnification is permissible (section 8.55(b)(1)), an approval of a director conflicting interest transaction (section 8.62(a), and disclaimer of the corporation's interest in a business opportunity (section 8.70(a)).

Section 8.25 limits the role of board committees in light of competing policies: on the one hand, it seems clear that appropriate committee action is not only desirable but is also likely to improve the functioning of larger and more diffuse boards of directors; on the other hand, wholesale delegation of authority to a board committee, to the point of abdication of director responsibility as a board of directors, is manifestly inappropriate and undesirable. Overbroad delegation also increases the potential, where the board of directors is divided, for usurpation of basic board functions by means of delegation to a committee dominated by one faction.

The statement of nondelegable functions set out in section 8.25(e) is based on the principle that prohibitions against delegation to board committees should be limited generally to actions that substantially affect the rights of shareholders or are fundamental to the governance of the corporation. As a result, delegation of authority to committees under section 8.25(e) may be broader than mere authority to act with respect to matters arising within the ordinary course of business.

Section 8.25(e) prohibits delegation of authority with respect to most mergers, sales of substantially all the assets, amendments to articles of incorporation and voluntary dissolution since these require shareholder action. In addition, section 8.25(e) prohibits delegation to a board committee of authority to fill board vacancies, subject to subsection (g), or to amend the bylaws. On the other hand, under section 8.25(e) many actions of a material nature, such as the authorization of long-term debt and capital investment or the issuance of shares, may properly be made the subject of committee delegation. In fact, the list of nondelegable powers has been reduced from the prior formulation of section 8.25(e).

Although section 8.25(e)(1) generally makes nondelegable the decision whether to authorize or approve distributions, including dividends, it does permit the delegation to a committee of power to approve a distribution pursuant to a formula or method or within limits prescribed by the board of directors. Therefore, the board could set a dollar range and timeframe for a prospective dividend and delegate to a committee the authority to determine the exact amount and record and payment dates of the dividend. The board also could establish certain conditions to the payment of a distribution and delegate to a committee the power to determine whether the conditions have been satisfied.

The statutes of several states make nondelegable certain powers not listed in section 8.25(e)-for example, the power to change the principal corporate office, to appoint or remove officers, to fix director compensation, or to remove agents. These are not prohibited by section 8.25(e) since the whole board of directors may reverse or rescind the committee action taken, if it should wish to do so, without undue risk that implementation of the committee action might be irrevocable or irreversible.

Section 8.25(f) makes clear that although the board of directors may delegate to a committee the authority to take action, the designation of the committee, the delegation of authority to it, and action by the committee does not alone constitute compliance by a noncommittee board member with the director's responsibility under section 8.30. On the other hand, a noncommittee director also does not automatically incur personal risk should the action of the particular committee fail to meet the standard of conduct set out in section 8.30. The noncommittee member's liability in these cases will depend upon whether the director's conduct was actionable under section 8.31. Factors to be considered in this regard will include the care used in the delegation to and supervision over the committee, the extent to which the delegation was required by applicable law or listing standards, and the amount of knowledge regarding the actions being taken by the committee which is available to the noncommittee director. Care in delegation and supervision may be facilitated, in the usual case, by review of minutes and receipt of other reports concerning committee activities. The enumeration of these factors is intended to emphasize that directors may not abdicate their responsibilities and avoid liability simply by delegating authority to board committees. Rather, a director against whom liability is asserted based upon acts of a committee of which the director is not a member avoids liability under section 8.31 by an appropriate measure of monitoring (particularly if the director met the standards contained in section 8.30) with respect to the creation and supervision of the committee.

Section 8.25(f) has no application to a member of the committee itself. The standards of conduct applicable to a committee member are set forth in section 8.30.

Section 8.25(g) is a rule of convenience that permits the board or the other committee members to replace an absent or disqualified member during the time that the member is absent or disqualified. Unless otherwise provided, replacement of an absent or disqualified member is not necessary to permit the other committee members to continue to perform their duties.

Subchapter C. DIRECTORS

§ 8.30. STANDARDS OF CONDUCT FOR DIRECTORS

(a) Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.

(b) The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.

(c) In discharging board or committee duties a director shall disclose, or cause to be disclosed, to the other board or committee members information not already known by them but known by the director to be material to the discharge of their decision-making or oversight functions, except that disclosure is not required to the extent that the director reasonably believes that doing so would violate a duty imposed under law, a legally enforceable obligation of confidentiality, or a professional ethics rule.

(d) In discharging board or committee duties a director who does not have knowledge that makes reliance unwarranted is entitled to rely on the performance by any of the persons specified in subsection (f) (1) or subsection (f)(3) to whom the board may have delegated, formally or informally by course of conduct, the authority or duty to perform one or more of the board's functions that are delegable under applicable law.

(e) In discharging board or committee duties a director who does not have knowledge that makes reliance unwarranted is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, prepared or presented by any of the persons specified in subsection (f).

(f) A director is entitled to rely, in accordance with subsection (d) or (e), on:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports or statements provided;

(2) legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence; or

(3) a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.

CROSS-REFERENCES

Committees of board of directors, see **§** 8.25.
Conflict of interest, see ch. 8F.
Derivative proceedings, see **§** 7.40-7.47.
Functions of board of directors, see **§** 8.01.
Indemnification, see **§** 8.50-8.59.
Meetings of board of directors, see **§** 8.20 & 8.21.
Officer standards of conduct, see **§** 8.42.
Officers, see **§** 8.40 & 8.41.
Quorum of directors, see **§** 8.24.
Removal of directors, see **§** 8.08 & 8.09.
Standards of liability for directors, see **§** 8.31.
Unlawful distributions, see **§** 8.33.

OFFICIAL COMMENT

Section 8.30 defines the general standards of conduct for directors. Under subsection (a), each board member must always perform a director's duties in good faith and in a manner reasonably believed to be in the best interests of the corporation. Although each director also has a duty to comply with its requirements, the focus of subsection (b) is on the discharge of those duties by the board as a collegial body. Under subsection (b), the members of the board or a board committee are to perform their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances. This standard of conduct is often characterized as a duty of care. Subsection (c) sets out the responsibility of each director, in discharging board or committee duties, to disclose or cause to be disclosed to the other members of the board or board committee information, of which they are unaware, known by the director to be material to their decision-making or oversight responsibilities, subject to countervailing confidentiality duties and appropriate action with respect thereto.

Section 8.30 sets forth the standards of conduct for directors by focusing on the manner in which directors perform their duties, not the correctness of the decisions made. These standards of conduct are based on former section 35 of the 1969 Model Act, a number of state statutes and on judicial formulations of the standards of conduct applicable to directors. Section 8.30 should be read in light of the basic role of directors set forth in section 8.0 1(b), which provides that the "business and affairs of a corporation shall be managed by or under the direction and subject to the oversight of" the board, as supplemented by various provisions of the Act assigning specific powers or responsibilities to the board. Relevant thereto, directors often act collegially in performing their functions and discharging their duties. If the observance of the directors' conduct is called into question, courts will typically evaluate the conduct of the entire board (or committee). Deficient performance of section 8.30 duties on the part of a particular director may be overcome, absent unusual circumstances, by acceptable conduct (meeting, for example, subsection (b)'s standard of care) on the part of other directors sufficient in number to perform the function or discharge the duty in question. While not thereby remedied, the deficient performance becomes irrelevant in any evaluation of the action taken. (This contrasts with a director's duties of loyalty, fair dealing and disclosure which will be evaluated on an individual basis and will also implicate discharge of the director's duties under subsection (a).) Further relevant thereto, the board may delegate or assign to appropriate officers, employees or agents of the corporation the authority or duty to exercise powers that the law does not require it to retain. Since the directors are entitled to rely thereon absent knowledge making reliance unwarranted, deficient performance of the directors' section 8.30 duties will not result from their delegatees' actions or omissions so long as the board acted in good faith and complied with the other standards of conduct set forth in section 8.30 in delegating responsibility and, where appropriate, monitoring performance of the duties delegated.

In earlier versions of the Model Act the duty of care element was included in subsection (a), with the text reading: "[a] director shall discharge his duties . with the care an ordinarily prudent person in a like position would exercise under similar circumstances' The use of the phrase "ordinarily prudent person" in a basic guideline for director conduct, suggesting caution or circumspection vis-à-vis danger or risk, has long been problematic given the fact that risk-taking decisions are central to the directors' role. When coupled with the exercise of "care" the prior text had a familiar resonance long associated with the field of tort law. See the Official Comment to section 8.31. The further coupling with the phrasal verb "shall discharge" added to the inference that former section 8.30(a)'s standard of conduct involved a negligence standard, with resultant confusion. In order to facilitate its understanding and analysis, independent of the other general standards of conduct for directors, the duty of care element has been set forth as a separate standard of conduct in subsection (b).

Long before statutory formulations of directors' standards of conduct, courts would invoke the business judgment rule in evaluating directors' conduct and determining whether to impose liability in a particular case. The elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts. Section 8.30 does not try to codify the business judgment rule or to delineate the differences between that defensive rule and the section's standards of director conduct. Section 8.30 deals only with standards of conduct-the level of performance expected of every director entering into the service of a corporation and undertaking the role and responsibilities of the office of director. The section does not deal directly with the liability of a director-although exposure to liability will usually result from a failure to honor the standards of conduct required to be observed by subsection (a). See section 8.31(a)(1) and clauses (i) and (ii)(A) of section 8.31(a)(2). The issue of directors' liability is addressed in sections 8.31 and 8.33 of this subchapter. Section 8.30 does, however, play an important role in evaluating a director's conduct and the effectiveness of board action. It has relevance in assessing, under section 8.31, the reasonableness of a director's belief. Similarly, **it** has relevance in assessing a director's timely attention to appropriate inquiry when particular facts and circumstances of significant concern materialize. It serves as a frame of reference for determining, under section 8.33(a), liability for an unlawful distribution. Finally, section 8.30 compliance may have a direct bearing on a court's analysis where transactional justification (e.g., a suit to enjoin a pending merger) is at issue.

A director complying with the standard of care expressed in subsection (b) is entitled to rely (under subsection (c)) upon board functions performed pursuant to delegated authority by, and to rely (under subsection (d)) upon information, opinions, reports or statements, including financial statements and other financial data, provided by, the persons or committees specified in the relevant parts of subsection (e). Within this authorization, the right to rely applies to the entire range of matters for which the board of directors is responsible. However, a director so relying must be without knowledge that would cause that reliance to be unwarranted. Section 8.30 expressly prevents a director from "hiding his or her head in the sand" and relying on the delegation of board functions, or on information, opinions reports or statements, when the director has actual knowledge that makes (or has a measure of knowledge that would cause a person, in a like position under similar circumstances, to undertake reasonable inquiry that would lead to information making) reliance unwarranted. Subsection (a)'s standards of good faith and reasonable belief in the best interests of the corporation also apply to a director's reliance under subsections (d), (e) and (f).

1. Section 8.30(a)

Section 8.30(a) establishes the basic standards of conduct for all directors. Its command is to be understood as peremptory-its obligations are to be observed by every director-and at the core of the subsection's mandate is the requirement that, when performing directors' duties, a director shall act in good faith coupled with conduct reasonably believed to be in the best interests of the corporation. This mandate governs all aspects of directors' duties: the duty of care, the duty to become informed, the duty of inquiry, the duty of informed judgment, the duty of attention, the duty of disclosure, the duty of loyalty, the duty of fair dealing and, finally, the broad concept of fiduciary duty that the courts often use as a frame of reference when evaluating a director's conduct. These duties do not necessarily compartmentalize and, in fact, tend to overlap. For example, the duties of care, inquiry, becoming informed, attention, disclosure and informed judgment all relate to the board's decision-making function, whereas the duties of attention, disclosure, becoming informed and inquiry relate to the board's oversight function.

Two of the phrases chosen to specify the manner in which a director's duties are to be discharged deserve further comment:

(1) The phrase "reasonably believes" is both subjective and objective in character. Its first level of analysis is geared to what the particular director, acting in good faith, actually believes-not what objective analysis would lead another director (in a like position and acting in similar circumstances) to conclude. The second level of analysis is focused specifically on "reasonably." 'While a director has wide discretion in marshalling the evidence and reaching conclusions, whether a director's belief is reasonable (i.e., could not would-a reasonable person in a like position and acting in similar circumstances have arrived at that belief) ultimately involves an overview that is objective in character.

(2) The phrase "best interests of the corporation" is key to an explication of a director's duties. The term "corporation" is a surrogate for the business enterprise as well as a frame of reference encompassing the shareholder body. In determining the corporation's "best interests," the director has wide discretion in deciding how to weigh near-term opportunities versus long-term benefits as well as in making judgments where the interests of various groups within the shareholder body or having other cognizable interests in the enterprise may differ.

As a generalization, section 8.30 operates as a "baseline" principle governing director conduct "when discharging the [ongoing] duties of a director" in circumstances uncomplicated by self-interest taint.

The Model Act recognizes, however, that directors' personal interests may not always align with the corporation's best interests and provides procedures by which interest-conflict transactions can be processed. See subchapter D (derivative proceedings) of chapter 7, subchapter E (indemnification), subchapter F (directors' conflicting interest transactions), and subchapter G (business opportunities) of this chapter 8. Those procedures generally contemplate that the interested director will not be involved in taking action on the interest-conflict transaction. And the common law has recognized that other interest-conflict situations may arise which do not entail a "transaction" by or with the corporation. See subchapter G of this chapter 8 (discussing the corporate opportunity doctrine). The interested director is relieved of the duty to act in connection with the matter on behalf of the corporation (specifically, the traditional mandate to act in the corporation's best interests), given the inherent conflict. However, the interested director is still expected to act in good faith, and that duty is normally discharged by observing the obligation of fair dealing. In the case of interest-conflict transactions, where there is a conflicting interest with respect to the corporation under section 8.60(1), the interested director's conduct is governed by subchapter F of this chapter 8. The duty of fair dealing is embedded in the subsection 8.60(4) provision calling for the interested director to make the required disclosure as to the conflicting interest and the transaction and, if one of the two safe harbor procedures is not properly observed, the interested director must prove the fairness (i.e., procedure, involving good faith among other aspects, as well as price) of the transaction to the corporation. In other cases, Section 8.30's standards of conduct are overlaid by various components of the duty to act fairly, the particular thrusts of which will depend upon the kind of interested director's conduct at issue and the circumstances of the case. As a general rule, the duty of fair dealing is normally discharged by the interested director through appropriate disclosure to the other directors considering the matter followed by abstention from participation in any decision-making relevant thereto. If and to the extent that the interested director's action respecting the matter goes further, the reasonableness of the director's belief as to the corporation's best interests, in respect of the action taken, should be evaluated on the basis of not only the director's honest and good faith belief but also on considerations bearing on the fairness of the transaction or conduct to the corporation.

2. *Section 8.30(b)*

Section 8.30(b) establishes a general standard of care for directors in the context of their dealing with the board's decision-making and oversight functions. 'While certain aspects will involve individual conduct (e.g., preparation for meetings), these functions are generally performed by the board through collegial action, as recognized by the reference in subsection (b) to board and committee "members" and "their duties." In contrast with subsection (a)'s individual conduct mandate, section 8.30(b) has a two-fold thrust: it provides a standard of conduct for individual action and, more broadly, **it** states a conduct obligation-"shall discharge their duties"-concerning the degree of care to be collegially used by the directors when performing those functions. It provides that directors have a duty to exercise "the care that a person in a like position would reasonably believe appropriate under similar circumstances'

The traditional formulation for a director's standard (or duty) of care has been geared to the "ordinarily prudent person." For example, the Model Act's prior formulation (in former section 8.30(a)(2)) referred to "the care an ordinarily prudent person in a like position would exercise under similar circumstances," and almost all state statutes that include a standard of care reflect parallel language. The phrase "ordinarily prudent person" constitutes a basic frame of reference grounded in the field of tort law and provides a primary benchmark for determining negligence. For this reason, its use in the standard of care for directors, suggesting that negligence is the proper determinant for measuring deficient (and thus actionable) conduct, has caused confusion and misunderstanding. Accordingly, the phrase "ordinarily prudent person" has been removed from the Model Act's standard of care and in its place "a person in a like position" has been substituted. The standard is not what care a particular director might believe appropriate in the circumstances but what a person-in a like position and acting under similar circumstances-would reasonably believe to be appropriate. Thus, the degree of care that directors should employ, under subsection (b), involves an objective standard.

Some state statutes have used the words "diligence," "care," and "skill" to define the duty of care. There is very little authority as to what "skill" and "diligence' as distinguished from "care," can be required or properly expected of corporate directors in the performance of their duties."Skill' in the sense of technical competence in a particular field, should not be a qualification for the office of director. The concept of "diligence" is sufficiently subsumed within the concept of "care." Accordingly, the words "diligence" and "skill" are not used in section 8.30's standard of care.

The process by which a director becomes informed, in carrying out the decision-making and oversight functions, will vary. Relevant thereto, the directors' decision-making function is established in large part by various sections of the Act: the issuance of shares (6.21); distributions (6.40); dismissal of derivative proceedings (7.44); indemnification (8.55); interested-transaction authorization (8.62); articles of incorporation amendments (10.02 and 10.03); bylaw amendments (10.20); mergers and share exchanges (11.04 2); asset dispositions (12.02); and dissolution (14.02). The directors' oversight function is established under section 8.01. In relying on the performance by management of delegated or assigned section 8.01 duties (including, for example, matters of law and legal compliance), as authorized by subsection (d), directors may depend upon the presumption of regularity absent knowledge or notice to the contrary. In discharging the section 8.01 duties associated with the board's oversight function, the standard of care entails primarily a duty of attention. In contrast with the board's decision-making function, which generally involves informed action at a point in time, the oversight function is concerned with a continuum and the duty of attention accordingly involves participatory performance over a period of time.

Several of the phrases chosen to define the standard of conduct in section 8.30(b) deserve specific mention:

(1) The phrase "becoming informed' in the context of the decision-making function, refers to the process of gaining sufficient familiarity with the background facts and circumstances in order to make an informed judgment. Unless the circumstances would permit a reasonable director to conclude that he or she is already sufficiently informed, the standard of care requires every director to take steps to become informed about the background facts and circumstances before taking action on the matter at hand. The process typically involves review of written materials provided before or at the meeting and attention to/participation in the deliberations leading up to a vote. It can involve consideration of information and data generated by persons other than legal counsel, public accountants, etc., retained by the corporation, as contemplated by subsection (e)(2); for example, review of industry studies or research articles prepared by unrelated parties could be very useful. It can also involve direct communications, outside of the boardroom, with members of management or other directors. There is no one way for "becoming informed," and both the method and measure "how to" and "how much"-are matters of reasonable judgment for the director to exercise.

(2) The phrase "devoting attention," in the context of the oversight function, refers to concern with the corporation's information and reporting systems and not to proactive inquiry searching out system inadequacies or noncompliance. While directors typically give attention to future plans and trends as well as current activities, they should not be expected to anticipate the problems which the corporation may face except in those circumstances where something has occurred to make it obvious to the board that the corporation should be addressing a particular problem. The standard of care associated with the oversight function involves gaining assurances from management and advisers that systems believed appropriate have been established coupled with ongoing monitoring of the systems in place, such as those concerned with legal compliance or internal controls-followed up with a proactive response when alerted to the need for inquiry.

(3) The reference to "person' without embellishment, is intended to avoid implying any qualifications, such as specialized expertise or experience requirements, beyond the basic director attributes of common sense, practical wisdom, and informed judgment.

(4) The phrase "reasonably believe appropriate" refers to the array of possible options that a person possessing the basic director attributes of common sense, practical wisdom and informed judgment would recognize to be available, in terms of the degree of care that

might be appropriate, and from which a choice by such person would be made. The measure of care that such person might determine to be appropriate, in a given instance, would normally involve a selection from the range of options and any choice within the realm of reason would be an appropriate decision under the standard of care called for under subsection (b). However, a decision that is so removed from the realm of reason, or is so unreasonable, that it falls outside the permissible bounds of sound discretion, and thus an abuse of discretion, will not satisfy the standard.

(5) The phrase "in a like position" recognizes that the "care" under consideration is that which would be used by the "person" if he or she were a director of the particular corporation.

(6) The combined phrase "in a like position. . . under similar circumstances" is intended to recognize that (a) the nature and extent of responsibilities will vary, depending upon such factors as the size, complexity, urgency, and location of activities carried on by the particular corporation, (b) decisions must be made on the basis of the information known to the directors without the benefit of hindsight, and (c) the special background, qualifications, and management responsibilities of a particular director may be relevant in evaluating that director's compliance with the standard of care. Even though the combined phrase is intended to take into account the special background, qualifications and management responsibilities of a particular director, it does not excuse a director lacking business experience or particular expertise from exercising the basic director attributes of common sense, practical wisdom, and informed judgment.

3. Section 8.30(c)

A duty to disclose information that a director knows to be material to the oversight or decision-making functions of the board or committee has always been embraced in the standards of conduct set forth in subsections (a) and (b). Subsection (c) makes explicit this existing duty of disclosure among directors. Thus, for example, when a member of the board knows information that the director recognizes is material to a decision by the board to approve financial statements of the corporation, the director is obligated to see to it that such information is provided to the other members of the board. So long as that disclosure is accomplished, the action required of the director can occur through direct statements in meetings of the board, or by any other timely means, including, for example, communicating the information to the chairman of the board or the chairman of a committee, or to the corporation's general counsel, and requesting that the recipient inform the other board or committee members of the disclosed information.

Subsection (c) recognizes that a duty of confidentiality can override a director's obligation to share with other directors information pertaining to a current corporate matter and that a director is not required to make such disclosure to the extent the director reasonably believes that such a duty of confidentiality prohibits it. In some circumstances, a duty of confidentiality may even prohibit disclosure of the nature or the existence of the duty itself. Ordinarily, however, a director who withholds material information based on a reasonable belief that a duty of confidentiality prohibits disclosure should advise the other directors of the existence and nature of that duty. Under the standards of conduct set forth in section 8.30(a), the director may also be required to take other action in light of the confidentiality restraint. The precise nature of that action must, of necessity, depend on the specific circumstances. Depending on the nature of the material information and of the matter before the board of directors or committee of the board, such action may include abstention or absence from all or a portion of the other directors' deliberation or vote on the matter to which the undisclosed information is material, or even resignation as a director. See Official Comment to section 8.62. Finally, a duty of confidentiality may not form the basis for the limitation on disclosure unless it is entered into and relied upon in good faith.

The required disclosure (as defined in section 8.60(7)) that must be made under section 8.62(a) in connection with a director's conflicting interest transaction, and the exceptions to the required disclosure in that context under section 8.62(b), have elements that parallel the disclosure obligation of directors under section 8.30(c). The demands of section 8.62, however, are more detailed and specific. They apply to just one situation-a director's conflict of interest transaction-while the requirements of section 8.30(c) apply generally to all other decision-making and oversight functions. For example, the specific requirements of section 8.62(a)(l) for a deliberation and vote outside the presence of the conflicted director are not imposed universally for all decision-making matters or for oversight matters that do not involve a decision. To the extent they may be different from the generally applicable provisions of section 8.30(c), the specific provisions of subchapter F control and are exclusive with respect to director conflicting interest transactions.

The duty of disclosure a director owes to other directors as contemplated by Section 8.30(c) is to be distinguished from a common law duty the board may have to cause the corporation to make disclosures to shareholders. For example, some courts have recognized and enforced such a duty in cases where shareholder action is being sought. *See, e.g., Weinberger v. UOP, Inc.,* 457 A.2d 701 (Del. 1983). The Act does not seek to codify such a duty, but leaves its existence and scope, the circumstances for its application, and the consequences of any failure to satisfy it, to be developed by courts on a case-by-case basis.

4. Section 8.30(d)

The delegation of authority and responsibility under subsection (d) may take the form of (i) formal action through a board resolution, (ii) implicit action through the election of corporate officers (e.g., chief financial officer or controller) or the appointment of corporate managers (e.g., credit manager), or (iii) informal action through a course of conduct (e.g., involvement through corporate officers and managers in the management of a significant 50%owned joint venture). A director may properly rely on those to whom authority has been delegated pursuant to subsection (d) respecting particular matters calling for specific action or attention in connection with the directors' decision-making function as well as matters on the board's continuing agenda, such as legal compliance and internal control, in connection with the directors' oversight function. Delegation should be carried out in accordance with the standard of care set forth in section 8.30(b).

By identifying those upon whom a director may rely in connection with the discharge of duties, section 8.30(d) does not limit the ability of directors to delegate their powers under section 8.01(b) except where delegation is expressly prohibited by the Act or otherwise by applicable law (see, e.g., section 8.25(e) and § 11 of the Securities Act of 1933). See section 8.25 and its Official Comment for detailed consideration of delegation to board committees of the authority of the board under section 8.01 and the duty to perform one or more of the board's functions. And by employing the concept of delegation, section 8.30(d) does not limit the ability of directors to establish baseline principles as to management responsibilities. Specifically, section 8.01(b) provides that "all corporate powers shall be exercised by or under the authority of" the board, and a basic board function involves the allocation of management responsibilities and the related assignment (or delegation) of corporate powers. For example, a board can properly decide to retain a third party to assume responsibility for the administration of designated aspects of risk management for the corporation (e.g., health insurance or disability claims). This would involve the directors in the exercise of judgment in connection with the decision-making function pursuant to subsection (b) (i.e., the assignment of authority to exercise corporate powers to an agent). See the Official Comment to section 8.01. It would not entail impermissible delegation-to a person specified in subsection (f)(2) pursuant to subsection (d) of a board function for which the directors by law have a duty to perform. They have the corporate power (under section 8.01(b)) to perform the task but administration of risk management is not a board function coming within the ambit of directors' duties; together with many similar management responsibilities, they may assign the task in the context of the allocation of corporate powers exercised under the authority of the board. This illustration highlights the distinction between delegation of a board function and assignment of authority to exercise corporate powers.

Although the board may delegate the authority or duty to perform one or more of its functions, reliance on delegation under subsection (d) may not alone constitute compliance with section 8.30 and reliance on the action taken by the delegatee may not alone constitute compliance by the directors or a noncommittee board member with section 8.01 responsibilities. On the other hand, should the board committee or the corporate officer or employee performing the function delegated fail to meet section

8.30's standard of care, noncompliance by the board with section 8.01 will not automatically result. Factors to be considered, in this regard, will include the care used in the delegation to and supervision over the delegatee, and the amount of knowledge regarding the particular matter which is available to the particular director. Care in delegation and supervision includes appraisal of the capabilities and diligence of the delegatee in light of the subject and its relative importance and may be facilitated, in the usual case, by receipt of reports concerning the delegatee's activities. The enumeration of these factors is intended to emphasize that directors may not abdicate their responsibilities and avoid accountability simply by delegating authority to others. Rather, a director charged with accountability based upon acts of others will fulfill the director's duties if the standards contained in section 8.30 are met.

5. Section 8.30(e)

Reliance under subsection (e) on a report, statement, opinion, or other information is permitted only if the director has read the information, opinion, report or statement in question, or was present at a meeting at which it was orally presented, or took other steps to become generally familiar with it. A director must comply with the general standard of care of section 8.30(b) in making a judgment as to the reliability and competence of the source of information upon which the director proposes to rely or, as appropriate, that it otherwise merits confidence.

6. Section8.30(f)

Reliance on one or more of the corporation's officers or employees, pursuant to the intracorporate frame of reference of subsection (f)(1), is conditioned upon a reasonable belief as to the reliability and competence of those who have undertaken the functions performed or who prepared or communicated the information, opinions, reports or statements presented. In determining whether a person is "re1iable' the director would typically consider (i) the individual's background experience and scope of responsibility within the corporation in gauging the individual's familiarity and knowledge respecting the subject matter and (ii) the individual's record and reputation for honesty, care and ability in discharging responsibilities which he or she undertakes. In determining whether a person is "competent' the director would normally take into account the same considerations and, if expertise should be relevant, the director would consider the individual's technical skills as well. Recognition in the statute of the right of one director to rely on the expertise and experience of another director, in the context of board or committee deliberations, is unnecessary, for the group's reliance on shared experience and wisdom is an implicit underpinning of director conduct. In relying on another member of the board, a director would quite properly take advantage of the colleague's knowledge and experience in becoming informed about the matter at hand before taking action; however, the director would be expected to exercise independent judgment when it comes time to vote.

Subsection (f)(2), which has an extracorporate frame of reference, permits reliance on outside advisers retained by the corporation, including persons specifically engaged to advise the board or a board committee. Possible advisers include not only those in the professional disciplines customarily supervised by state authorities, such as lawyers, accountants, and engineers, but also those in other fields involving special experience and skills, such as investment bankers, geologists, management consultants, actuaries, and real estate appraisers. The adviser could be an individual or an organization, such as a law firm. Reliance on a nonmanagement director, who is specifically engaged (and, normally, additionally compensated) to undertake a special assignment or a particular consulting role, would fall within this outside adviser frame of reference. The concept of "expert competence" embraces a wide variety of qualifications and is not limited to the more precise and narrower recognition of experts under the Securities Act of 1933. In this respect, subsection (f)(2) goes beyond the reliance provision found in many existing state business corporation acts. In addition, a director may also rely on outside advisers where skills or expertise of a technical nature is not a prerequisite, or where the person's professional or expert competence has not been established, so long as the director reasonably believes the person merits confidence. For example, a board might choose to assign to a private investigator the duty of inquiry (e.g., follow upon rumors about a senior executive's "grand lifestyle") and properly rely on the private investigator's report. And it would be entirely appropriate for a director to rely on advice concerning highly technical aspects of environmental compliance from a corporate lawyer in the corporation's outside law firm, without due inquiry concerning that particular lawyer's technical competence, where the director reasonably believes the lawyer giving the advice is appropriately informed (by reason of resources known to be available from that adviser's legal organization or through other means and therefore merits confidence.

Subsection (f) (3) permits reliance on a board committee when it is submitting recommendations for action by the full board of directors as well as when it is performing supervisory or other functions in instances where neither the full board of directors nor the committee takes dispositive action. For example, the compensation committee typically reviews proposals and makes recommendations for action by the full board of directors. In contrast, there may be reliance upon an investigation undertaken by a board committee and reported to the full board, which form the basis for a decision by the board of directors not to take dispositive action. Another example is reliance on a committee of the board of directors, such as a corporate audit committee with respect to the board's ongoing role of oversight of the accounting and auditing functions of the corporation. In addition where reliance on information or materials prepared or presented by a board committee is not involved, in connection with board action, a director may properly rely on oversight monitoring or dispositive action by a board committee (of which the director is not a member) empowered to act pursuant to authority delegated under section 8.25 or acting with the acquiescence of the board of directors. See the Official Comment to section 8.25. A director may similarly rely on committees not created under section 8.25 which have nondirector members. In parallel with subsection (f)(2)(ii), the concept of "confidence" is substituted for "competence" in order to avoid any inference that technical skills are a prerequisite. In the usual case, the appointment of committee members or the reconstitution of the membership of a standing committee (e.g., the audit committee), following an annual shareholders' meeting, would alone manifest the noncommittee members' belief that the committee "merits confidence." However, the reliance contemplated by subsection (f)(3) is geared to the point in time when the board takes action or the period of time over which a committee is engaged in an oversight function; consequently, the judgment to be made (i.e., whether a committee "merits confidence") will arise at varying points in time. After making an initial judgment that a committee (of which a director is not a member) merits confidence, the director may depend upon the presumption of regularity absent knowledge or notice to the contrary.

7. Application to Officers

Section 8.30 generally deals only with directors. Section 8.42 and its Official Comment explain the extent to which the provisions of section 8.30 apply to officers.

§ **8.31. STANDARDS OF LIABILITY FOR DIRECTORS**

(a) A director shall not be liable to the corporation or its shareholders for any decision to take or not to take action, or any failure to take any action, as a director, unless the party asserting liability in a proceeding establishes that:

(1) no defense interposed by the director based on (i) any provision in the articles of incorporation authorized by section 2.02(b)(4) or, (ii) the protection afforded by section 8.61 (for action taken in compliance with section 8.62 or section 8.63), or (iii) the protection afforded by section 8.70, precludes liability; and

(2) the challenged conduct consisted or was the result of:

(i) action not in good faith; or

(ii) a decision

(A) which the director did not reasonably believe to be in the best interests of the corporation, or

(B) as to which the director was not informed to an extent the director reasonably believed appropriate in the circumstances; or

(iii) a lack of objectivity due to the director's familial, financial or business relationship with, or a lack of independence due to the director's domination or control by, another person having a material interest in the challenged conduct

(A) which relationship or which domination or control could reasonably be expected to have affected the director's judgment respecting the challenged conduct in a manner adverse to the corporation, and

(B) after a reasonable expectation to such effect has been established, the director shall not have established that the challenged conduct was reasonably believed by the director to be in the best interests of the corporation; or

(iv) a sustained failure of the director to devote attention to ongoing oversight of the business and affairs of the corporation, or a failure to devote timely attention, by making (or causing to be made) appropriate inquiry, when particular facts and circumstances of significant concern materialize that would alert a reasonably attentive director to the need therefore; or

(v) receipt of a financial benefit to which the director was not entitled or any other breach of the director's duties to deal fairly with the corporation and its shareholders that is actionable under applicable law.

(b) The party seeking to hold the director liable:

(1) for money damages, shall also have the burden of establishing that:

(i) harm to the corporation or its shareholders has been suffered, and

(ii) the harm suffered was proximately caused by the director's challenged conduct; or

(2) for other money payment under a legal remedy, such as compensation for the unauthorized use of corporate assets, shall also have whatever persuasion burden may be called for to establish that the payment sought is appropriate in the circumstances; or

(3) for other money payment under an equitable remedy, such as profit recovery by or disgorgement to the corporation, shall also have whatever persuasion burden may be called for to establish that the equitable remedy sought is appropriate in the circumstances.

(c) Nothing contained in this section shall (1) in any instance where fairness is at issue, such as consideration of the fairness of a transaction to the corporation under section 8.61(b)(3), alter the burden of proving the fact or lack of fairness otherwise applicable, (2) alter the fact or lack of liability of a director under another section of this Act, such as the provisions governing the consequences of an unlawful distribution under section 8.33 or a transactional interest under section 8.61, or (3) affect any rights to which the corporation or a shareholder may be entitled under another statute of this state or the United States.

CROSS-REFERENCES

Article provision limiting or eliminating director liability, see **§** 2.02(b)(4).

Article provision permitting expanded indemnification, see § 2.02(b)(5).
Business opportunities, see ch. 8G.
Derivative proceedings, see § 7.40-7.47.
Director's conflicting interest transaction, see ch. 8F.
Functions of board of directors, see § 8.01.
Indemnification, see § § 8.50-8.59.
Judicial removal of directors, see § 8.09.
Standards of conduct for directors, see § 8.30.
Unlawful distributions, see § 8.33.

OFFICIAL COMMENT

Subsections (a) and (b) of section 8.30 establish standards of conduct that are central to the role of directors. Section 8.30(b)'s standard of conduct is frequently referred to as a director's duty of care. The employment of the concept of "care," if considered in the abstract, suggests a tort-law/negligence-based analysis looking toward a finding of fault and damage recovery where the duty of care has not been properly observed and loss has been suffered. But the Model Act's desired level of director performance, with its objectively-based standard of conduct ("the care that a person in a like position would reasonably believe appropriate under similar circumstances"), does not carry with it the same type of result-oriented liability analysis. The courts recognize that boards of directors and corporate managers make numerous decisions that involve the balancing of risks and benefits for the enterprise. Although some decisions turn out to be unwise or the result of a mistake of judgment, it is not reasonable to reexamine an unsuccessful decision with the benefit of hindsight. As observed in *Joy v.* North, 692 F.2d 880, 885 (2d Cir. 1982): “Whereas an automobile driver who makes a mistake in judgment as to speed or distance injuring a pedestrian will likely be called upon to respond in damages, a corporate [director or] officer who makes a mistake in judgment as to economic conditions, consumer tastes or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation." Therefore, as a general rule, a director is not exposed to personal liability for injury or damage caused by an unwise decision. While a director is not personally responsible for unwise decisions or mistakes of judgment-and conduct conforming with the standards of section 8.30 will almost always be protected-a director can be held liable for misfeasance or nonfeasance in performing the duties of a director. And while a director whose performance meets the standards of section 8.30 should have no liability, the fact that a director's performance fails to reach that level does not automatically establish personal liability for damages that the corporation may have suffered as a consequence.

Note on Directors' Liability

A director's financial risk exposure (e.g., in a lawsuit for money damages suffered by the corporation or its shareholders claimed to have resulted from misfeasance or nonfeasance in connection with the performance of the director's duties) can be analyzed as follows:

1. *Articles of incorporation limitation.* If the corporation's articles of incorporation contain a provision eliminating its directors' liability to the corporation or its shareholders for money damages, adopted pursuant to section 2.02(b)(4), there is no liability unless the director's conduct involves one of the prescribed exceptions that preclude the elimination of liability. See section 2.02 and its Official Comment.

2. *Director's conflicting interest transaction safe harbor. If the matter at issue* involves a director's conflicting interest transaction (as defined in section 8.60(2)) and a safe harbor procedure under section 8.61 involving action taken in compliance with section 8.62 or 8.63 *has been properly implemented, there is no liability for the interested director arising out of the transaction. See subchapter F of this chapter 8.*

3. *Business opportunities safe harbor. Similarly, if the matter involves a director's taking of a business opportunity and a safe harbor procedure under section 8.70 has been properly implemented, there is no liability for the director arising out of the taking of the business*

opportunity. See subchapter G of this chapter 8.

4. *Business judgment rule. If an articles of incorporation provision adopted pursuant to section 2.02 or a safe harbor procedure under section 8.61 does not shield the director's conduct from liability, this standard of judicial review for director conduct-deeply rooted in the case law presumes that, absent self-dealing or other breach of the duty of loyalty, directors' decision-making satisfies the applicable legal requirements. A plaintiff challenging the director's conduct in connection with a corporate decision, and asserting liability by reason thereof, encounters certain procedural barriers. In the first instance, many jurisdictions have* special pleading requirements that condition the ability to pursue the challenge on the plaintiff's bringing forward specific factual allegations that put in question the availability of the business judgment presumption. Assuming the suit survives a motion to dismiss for failure to state (in satisfaction of such a condition) an actionable claim, the plaintiff has the burden of overcoming that presumption of regularity.

5. *Damages and proximate cause.* If the business judgment rule does not shield the directors' decision-making from liability, as a general rule it must be established that money damages were suffered by the corporation or its shareholders and those damages resulted from and were *legally* caused by the challenged act or omission of the director.

6. *Other liability for money payment.* Aside from a claim for damages, the director may be liable to reimburse the corporation pursuant to a claim under *quantum meruit* (the reasonable value of services) or *quantum valebant* (the reasonable value of goods and materials) if corporate resources have been used without proper authorization. In addition, the corporation may be entitled to short-swing profit recovery, stemming from the director's trading in its securities, under § 16(b) of the Securities Exchange Act of 1934.

7. *Equitable profit recovery or disgorgement.* An equitable remedy compelling the disgorgement of the *director's* improper financial gain or entitling the corporation to profit recovery, where directors' duties have been breached, may require the payment of money by the director to the corporation.

8. *Corporate indemnification.* If the court determines that the director is liable, the director may be indemnified by the corporation for any payments made and expenses incurred, depending upon the circumstances, if a third-party suit is involved. If the proceeding is by or in the right of the corporation, the director may be reimbursed for reasonable expenses incurred in connection with the proceeding if ordered by a court under section 8.54(a)(3).

9. *Insurance.* To the extent that corporate indemnification is not available, the director may be reimbursed for *the* money damages for which the director is accountable, together with proceeding-related expenses, if the claim/ grounds for liability come within the coverage under directors' and officers' liability insurance that has been purchased by the corporation pursuant to section 8.57.

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Section 8.31 includes steps (1) through (6) in the analysis of a director's liability exposure set forth in the above Note. In establishing general standards of director liability under the Model Act, the section also serves the important purpose of providing clarification that the general standards of conduct set forth in section 8.30 are not intended to codify the business judgment rule-a point as to which there has been confusion on the part of some courts (notwithstanding a disclaimer of that purpose and effect in the prior Official Comment to section 8.30). For example, one court viewed the standard of care set forth in Washington's business corporation act (a provision based upon and almost identical to the prior section 8.30(a)-which read "A director shall discharge his duties as a director. ..: (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation") as having codified the business judgment rule. See *Seafirst Corp. v. Jenkins,* 644 F. Supp. 1152, 1159 (W.D. Wash. 1986). (A later court characterized this view as a mistaken assumption and recognized the disclaimer made in section 8.30's Official Comment. See *Shinn v. Thrust IV Inc.,* 786 P.2d 285, 290 n.1 (Wash. App. 1990).) Another court declared "Section 309 [a *standard of conduct almost iden*tical to the prior section 8.30(a)] codifies California's business judgment rule." See *Gaillard v. Natomas Co.,* 208 Cal. App. 3d 1250, 1264 (1989). The Court of Appeals of New York referred to that state's statutory standard of care for directors, a formulation set forth in NYBCL **§** 717 that is similar to the prior section 8.30(a), as "New York's business judgment rule." See *Lindner Fund, Inc. v. Waldbaum, Inc.*, 624 N.E.2d 160, 161 (1993). In contrast, another court considering New York's conduct standard observed:

> A board member's obligation to a corporation and its shareholders has two prongs, generally characterized as the duty of care and the duty of loyalty. The duty of care refers to the responsibility of a corporate fiduciary to exercise, in the performance of his or her tasks, the care that a reasonably prudent person in a similar position would use under similar circumstances. See NYBCL § 717. In evaluating a manager's compliance with the duty of care, New York courts adhere to the business judgment rule, which "bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes." *Norlin Corp. v. Rooney, Pace Inc.,* 744 F.2d 255, 264 (2d Cir. 1984) [quoting *Auerbach v. Bennett,* 47 N.Y.2d 619, 629 (1979)].

Sections 8.30 and 8.31 adopt the approach to director conduct and director liability taken in the *Norlin* decision. See section 8.30 and its Official Comment with respect to the standards of conduct for directors. For a detailed analysis of how and why standards of conduct and standards of liability diverge in corporate law, see Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law,* 62 Fordham L. REV. 437 (1993).

The Model Act does not undertake to prescribe detailed litigation procedures. However, it does deal with requirements applicable to shareholder derivative suits (see sections 7.40- 7.47) and section 8.31 builds on those requirements. If any of (i) a liability-eliminating provision included in the corporation's articles of incorporation, pursuant to section 2.02(b)(4), (ii) protection for a director's conflicting interest transaction afforded by section 8.61(b)(1) or section 8.61(b)(2), or (iii) protection for a disclaimer of the corporation's interest in a business opportunity afforded by section 8.70 is interposed by a defendant director as a bar to the challenge of his or her conduct, the plaintiff's role in satisfying the requirement of subsection (a)(1)-i.e., establishing that the articles of incorporation provision or the safe harbor provision interposed does not apply-would be governed by the court's procedural rules. Parenthetically, where fairness of a director's conflicting interest transaction can be established, protection from liability is also afforded by section 8.61(b)(3). If it is asserted by a defendant director as a defense, it is important to note that subsection (a)(2)(v) rather than subsection (a)(1) would be implicated and the burden of establishing that the transaction was fair to the corporation-and, therefore, no improper financial benefit was received-is placed on the interested director under section 8.61(b)(3). Similarly, the local pleading and other rules would govern the plaintiff's effort to satisfy subsection (a)(2)'s requirements. Consistent with the general rules of civil procedure, the plaintiff generally has the burden under subsection (b) of proving that the director's deficient conduct caused harm resulting in monetary damage or calls for monetary reimbursement; in the alternative, the circumstances may justify or require an equitable remedy.

1. Section8.31(a)

If a provision in the corporation's articles of incorporation (adopted pursuant to section 2.02(b)(4)) shelters the director from liability for money damages, or if a safe harbor provision, under subsection (b)(1) or (b)(2) of section 8.61 or section 8.70, shelters the director's conduct in connection with a conflicting interest transaction or the taking of a business opportunity, and such defense applies to all claims in plaintiff's complaint, there is no need to consider further the application of section 8.31's standards of liability. In that event, the court would presumably grant the defendant director's motion for dismissal or summary judgment (or the equivalent) and the proceeding would be ended. If the defense applies to some but not all of plaintiff's claims, defendant is entitled to dismissal or summary judgment with respect to those claims. Termination of the proceeding or dismissal of claims on the basis of an articles of incorporation provision or safe harbor will not automatically follow, however, if the party challenging the director's conduct can assert any of the valid bases for contesting the availability of the liability shelter. Absent such a challenge, the relevant shelter provision is self-executing and the individual director's exoneration from liability is automatic. Further, under both section 8.61 and section 8.70, the directors approving the conflicting interest transaction or the director's taking of the business opportunity will presumably be protected as well, for compliance with the relevant standards of conduct under section 8.30 is important for their action to be effective and, as noted above, conduct meeting section 8.30's standards will almost always be protected.

If a claim of liability arising out of a challenged act or omission of a director is not resolved and disposed of under subsection (a)(1), subsection (a)(2) provides the basis for evaluating whether the conduct in question can be challenged.

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Note on the Business Judgment Rule

Over the years, the courts have developed a broad common law concept geared to business judgment. In basic principle, a board of directors enjoys a presumption of sound business judgment and its decisions will not be disturbed (by a court substituting its own notions of what is or is not sound business judgment) if they can be attributed to any rational business purpose. See *Sinclair Oil Corp.* V. *Levien,* 280 A.2d 717, 720 (Del. 1971). Relatedly, it is presumed that, in making a business decision, directors act in good faith, on an informed basis, and in the honest belief that the action taken is in the best interests of the corporation. See *Aronson v. Lewis,* 473 A.2d 805, 812 (Del. 1983). \'\Then applied, this principle operates both as a procedural rule of evidence and a substantive rule of law, in that if the plaintiff fails to rebut the presumption that the directors acted in good faith, in the corporation's best interest and on an informed basis, the business judgment standard protects both the directors and the decisions they make. See *Citron v. Fairchild Camera* & *Instrument Corp.,* 569 A.2d 53, 64 (Del. 1989).

Some have suggested that, within the business judgment standard's broad ambit, a distinction might usefully be drawn between that part which protects directors from personal liability for the decision they make and the part which protects the decision itself from attack. See *Revlon, Inc. v. MacAndrews & Forbes* Holdings, Inc., 506 A.2d 173, 180 n.10 (Del. 1986). While these two objects of the business judgment standard's protection are different, and judicial review might result in the decision being enjoined but no personal liability (or vice versa), their operative elements are identical (i.e., good faith, disinterest, informed judgment and "best interests"). As a consequence, the courts have not observed any distinction in terminology and have generally followed the practice of referring only to the business judgment rule, whether dealing with personal liability issues or transactional justification matters.

While, in substance, the operative elements of the standard of judicial review commonly referred to as the business judgment rule have been widely recognized, courts have used a number of different word formulations to articulate the concept. The formulation adopted in § 4.01(c) of The American Law Institute's PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994) provides that a director who makes a business judgment in good faith (an obvious prerequisite) fulfills the duty of care standard if the director:

(1) is not interested *[as defined]* in the subject of the business judgment;

(2) is informed with respect to the subject of the business judgment to the extent the director . . . reasonably believes to be appropriate under the circumstances; and

(3) rationally believes that the business judgment is in the best interests of the corporation.

Referring to clause (2) above, the decision-making process is to be reviewed on a basis that is to a large extent individualized in nature ("informed . . . to the extent the director . . . reasonably believes to be appropriate under the circumstances")-as contrasted with the traditional objectively-based duty-of-care standard (e.g., the prior section 8.30(a)'s "care . . . an ordinarily prudent person would exercise"). An "ordinarily prudent person" might do more to become better informed, but if a director believes, in good faith, that the director can make a sufficiently informed business judgment, the director will be protected so long as that belief is within the bounds of reason. Referring to clause (3) above, the phrase "rationally believes" is stated in the PRINCIPLES to be a term having "both an objective and subjective content. A director . . . must actually believe that the business judgment is in the best interests of the corporation and that belief must be rational' 1 PRINCIPLES, at 179. Others see that aspect to be primarily geared to the process employed by a director in making the decision as opposed to the substantive content of the board decision made. See *Aronson* v. Lewis, supra, at 812 ("The business judgment rule is. . . a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. . . . Absent an abuse of discretion, that judgment will be respected by the courts.") In practical application, an irrational belief would in all likelihood constitute an abuse of discretion. *Compare In re Caremark International Inc. Derivative Litigation* (September 25, 1996) (1996 Del. Ch. LEXIS 125 at p. 27: "whether a judge or jury considering the matter after the fact. . . believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests the business judgment rule is process oriented and informed by a deep respect for all good faith board decisions.")

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Section 8.31 does not codify the business judgment rule as a whole. The section recognizes the common law doctrine and provides guidance as to its application in dealing with director liability claims. Because the elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts, it would not be desirable to freeze the concept in a statute. For example, in recent years the Delaware Supreme Court has established novel applications of the concept to various transactional justification matters, such as the role of special litigation committees and change of-control situations. See *Zapata Corporation v. Maldonado,* 430 A.2d 779 (1981), and *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946 (1985), respectively. Under *Zapata,* a rule that applies where there is no disinterested majority on the board appointing the special litigation committee, there is no presumption of regularity and the corporation must bear the burden of proving the independence of the committee, the reasonableness of its investigation, and the reasonableness of the bases of its determination that dismissal of the derivative litigation is in the best interests of the corporation. Under *Unocal,* the board must first establish reasonable grounds for believing an unsolicited takeover bid poses a danger to corporate policy and effectiveness, and a reasonable relationship of defensive measures taken to the threat posed, before the board's action will be entitled to the business judgment presumptions. The business judgment concept has been employed in countless legal decisions and is a topic that has received a great deal of scholarly attention. For an exhaustive treatment of the subject, see D. Block, N. Barton & S. Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* (4th ed. 1993 & Supp. 1995). 'While codification of the business judgment rule in section 8.31 is expressly disclaimed, its principal elements, relating to personal liability issues, are embedded in subsection (a)(2).

A. GOOD FAITH

The expectation that a director's conduct will be in good faith is an overarching element of his or her baseline duties. Relevant thereto, it has been stated that a lack of good faith is presented where a board "lacked an actual intention to advance corporate welfare" and "bad faith" is presented where "a transaction . . . is authorized for some purpose other than a genuine attempt to advance corporate welfare or is known to constitute a violation of applicable positive law." See *Gagliardi v. TriFoods Int'l Inc.,* 683 A.2d 1049 (Del. Ch. 1996). If a director's conduct can be successfully challenged pursuant to other clauses of subsection (a)(2), there is a substantial likelihood that the conduct in question will also present an issue of good faith implicating clause 2(i). Conduct involving knowingly illegal conduct that exposes the corporation to harm will constitute action not in good faith, and belief that decisions made (in connection with such conduct) were in the best interests of the corporation will be subject to challenge as well. If subsection (a)(2) included only clause 2(i), much of the conduct with which the other clauses are concerned could still be considered pursuant to the subsection, on the basis that such conduct evidenced the actor's lack of good faith. Accordingly, the canon of construction known as *ejusdem generis* has substantial relevance in understanding the broad overlap of the good faith element with the various other subsection (a)(2) clauses. Where conduct has not been found deficient on other grounds, decision-making outside the bounds of reasonable judgment-an abuse of discretion perhaps explicable on no other basis-can give rise to an inference of bad faith. That form of conduct (characterized by the court as "constructive fraud" or "reckless indifference" or "deliberate disregard" in the relatively few case precedents) giving rise to an inference of bad faith will also raise a serious question whether the director could have reasonably believed that the best interests of the corporation would be served. If a director's conflicting interest transaction is determined to be manifestly unfavorable to the corporation, giving rise to an inference of bad faith tainting the directors' action approving the transaction under section 8.62, the safe harbor protection afforded by section 8.61 for both the transaction and the conflicted director would be in jeopardy. See the Official Comment to section 8.61. Depending on the facts and circumstances, the directors who approve a director's conflicting interest transaction that is manifestly unfavorable to the corporation may be at risk under clause (2)(i).

B. REASONABLE BELIEF

A director should reasonably believe that his or her decision will be in the best interests of the corporation and a director should become sufficiently informed, with respect to any action taken or not taken, to the extent he or she reasonably believes appropriate in the circumstances. In each case, the director's reasonable belief calls for a subjective belief and, so long as it is his or her honest and good faith belief, a director has wide discretion. However, in the rare case where a decision respecting the corporation's best interests is so removed from the realm of reason (e.g., corporate waste), or a belief as to the sufficiency of the director's preparation to make an informed judgment is so unreasonable as to fall outside the permissible bounds of sound discretion (e.g., a clear case is presented if the director has undertaken no preparation and is woefully uninformed), the director's judgment will not be sustained.

C. LACK OF OBJECTIVITY OR INDEPENDENCE

If a director has a familial, financial or business relationship with another person having a material interest in a transaction or other conduct involving the corporation, or if the director is dominated or controlled by another person having such a material interest, there is a potential for that conflicted interest or divided loyalty to affect the director's judgment. If the matter at issue involves a director's transactional interest, such as a "director's conflicting interest transaction" (see section 8.60 (1)) in which a "related person" (see section 8.60 (5)) is involved, it will be governed by section 8.61; otherwise, the lack of objectivity due to a relationship's influence on the director's judgment will be evaluated, in the context of the pending conduct challenge, under section 8.31. If the matter at issue involves lack of independence, the proof of domination or control and its influence on the director's judgment will typically entail different (and perhaps more convincing) evidence than what may be involved in a lack of objectivity case. The variables are manifold, and the facts must be sorted out and weighed on a case-by-case basis. If that other person is the director's spouse or employer, the concern that the director's judgment might be improperly influenced would be substantially greater than if that person is the spouse of the director's step-grandchild or the director's partner in a vacation time-share. When the party challenging the director's conduct can establish that the relationship or the domination or control in question could reasonably be expected to affect the director's judgment respecting the matter at issue in a manner adverse to the corporation, the director will then have the opportunity to establish that the action taken by him or her was reasonably believed to be in the best interests of the corporation. The reasonableness of the director's belief as to the corporation's best interests, in respect of the action taken, should be evaluated on the basis of not only the director's honest and good faith belief but also on considerations bearing on the fairness to the corporation of the transaction or other conduct involving the corporation that is at issue.

D. IMPROPER FINANCIAL BENEFIT

Subchapter F of chapter 8 of the Model Act deals in detail with directors' transactional interests. Its coverage of those interests is exclusive and its safe harbor procedures for directors' conflicting interest transactions (as defined)providing shelter from legal challenges based on interest conflicts, when properly observed-will establish a director's entitlement to any financial benefit gained from the transactional event. A director's conflicting interest transaction that is not protected by the fairness standard set forth in section 8.61(b)(3), pursuant to which the conflicted director may establish the transaction to have been fair to the corporation, would often involve receipt of a financial benefit to which the director was not entitled (i.e., the transaction was not "fair" to the corporation). Unauthorized use of corporate assets, such as aircraft or hotel suites, would also provide a basis for the proper challenge of a director's conduct. There can be other forms of improper financial benefit not involving a transaction with the corporation or use of its facilities, such as where a director profits from unauthorized use of proprietary information.

E. FINANCIAL BENEFIT/MATERIAL INTEREST

A director is expected to observe an obligation of undivided loyalty to the corporation and, while the law will not concern itself with trifling deviations *(de minimis non curat lex),* there is no materiality threshold that applies to a financial benefit to which a director is not properly entitled. The Model Act observes this principle in several places (e.g., the exception to liability elimination prescribed in section 2.02(b)(4)(A) and the indemnification restriction in section 8.51(d)(2), as well as the liability standard in subsection (a)(2)(v)). In contrast, there is a materiality threshold for the interest of another in a transaction or conduct where a director's lack of objectivity or lack of independence has been asserted under subsection (a)(2)(iii). In the typical case, analysis of another's interest would first consider the materiality of the transaction or conduct at issue-in most cases, any transaction or other action involving the attention of the board or one of its committees will cross the materiality threshold, but not always and would then consider the materiality of that person's interest therein. The possibility that another's interest in a transaction or conduct that is not material, or that an immaterial interest of another in a transaction or conduct, would adversely affect a director's judgment is sufficiently remote that it should not be made subject to judicial review.

F. SUSTAINED INATTENTION

The director's role involves two fundamental components: the decision making function and the oversight function. In contrast with the decision making function, which generally involves action taken at a point in time, the oversight function under section 8.01(b) involves ongoing monitoring of the corporation's business and affairs over a period of time. This involves the duty of ongoing attention, when actual knowledge of particular facts and circumstances arouse suspicions which indicate a need to make inquiry. As observed by the Supreme Court of New Jersey in *Francis v. United Jersey Bank,* 432 A.2d 814, 822 (Sup. Ct. 1981):

> Directors are under a continuing obligation to keep informed about the activities of the corporation. . . . Directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look. The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect. . . . Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies.

While the facts will be outcome-determinative, deficient conduct involving a sustained failure to exercise oversight-where found actionable-has typically been characterized by the courts in terms of abdication and continued neglect of a director's duty of attention, not a brief distraction or temporary interruption. However, embedded in the oversight function is the need to inquire when suspicions are aroused. This duty is not a component of ongoing oversight, and does not entail proactive vigilance, but arises when, and only when, particular facts and circumstances of material concern (e.g., evidence of embezzlement at a high level or the discovery of significant inventory shortages) suddenly surface.

G. OTHER BREACHES OF A DIRECTOR'S DUTIES

Subsection (a)(2)(v) is, in part, a catchall provision that implements the intention to make section 8.31 a generally inclusive provision but, at the same time, to recognize the existence of other breaches of common-law duties that can give rise to liability for directors. As developed in the case law, these actionable breaches include unauthorized use of corporate property or information, unfair competition with the corporation and taking of a corporate opportunity. In the latter case, the director is alleged to have wrongfully diverted a business opportunity as to which the corporation had a prior right. Section 8.70 provides a safe harbor mechanism for a director who wishes to take advantage of a business opportunity, regardless of whether such opportunity would be characterized as a "corporate opportunity" under existing case law. Note that section 8.70(b) provides that the fact that a director did not employ the safe harbor provisions of section 8.70 does not create an inference that the opportunity should have first been presented to the corporation or alter the burden of proof otherwise applicable to establish a breach of the director's duty to the corporation.

H. FAIRNESS

Pursuant to section 8.61(b)(3), an interested director (or the corporation, if it chooses) can gain protection for a director's conflicting interest transaction by establishing that it was fair to the corporation. (The concept of "fair" and "fairness," in this and various other contexts, can take into account both fair price and fair dealing on the part of the interested director. See the Official Comment to section 8.61.) Under case law, personal liability as well as transactional justification issues will be subject to a fairness standard of judicial review if the plaintiff makes out a credible claim of breach of the duty of loyalty or if the presumptions of the business judgment standard (e.g., an informed judgment) are overcome, with the burden of proof shifting from the plaintiff to the defendant. In this respect, the issue of fairness is relevant to both subsection (a) and subsection (b). Within the ambit of subsection (a)(2), a director can often respond to the challenge that his or her conduct was deficient by establishing that the transaction or conduct at issue was fair to the *corporation. See Kahn v. Lynch Communications Systems, Inc. 669* A.2d 79 (Del. 1995). *Cf Cede & Co. v. Technicolor Inc.,* 634 A.2d 345 (Del. 1993) (when the business judgment rule is rebutted-procedurally-the burden shifts to the defendant directors to prove the "entire fairness" of the challenged transaction). It is to be noted, however, that fairness may not be relevant to the matter at issue (see, e.g., clause (iv) of subsection (a)(2)). If the director is successful in establishing fairness, where the issue of fairness is relevant, then it is unlikely that the complainant can establish legal liability or the appropriateness of an equitable remedy under subsection (b).

I. DIRECTOR CONDUCT

Subsection (a)(2) deals, throughout, with a director's action that is taken or not taken. To the extent that the director's conduct involves a breach of his or her duty of care or duty of attention within the context of collegial action by the board or one of its committees, proper performance of the relevant duty through the action taken by the director's colleagues can overcome the consequences of his or her deficient conduct. For example, where a director's conduct can be challenged under subsection (a)(2)(ii)(B) by reason of having been uninformed about the decision-he or she did not read the merger materials distributed prior to the meeting, arrived late at the board meeting just in time for the vote but, nonetheless, voted for the merger solely because the others were in favor-the favorable action by a quorum of properly informed directors would ordinarily protect the director against liability. When the director's conduct involves the duty of fair dealing within the context of action taken by the board or one of its committees, the wiser choice will usually be for the director not to participate in the collegial action. That is to say, where a director may have a conflicting interest or a divided loyalty, or even where there may be grounds for the issue to be raised, the better course to follow is usually for the director to disclose the conduct-related facts and circumstances posing the possible compromise of his or her independence or objectivity, and then to withdraw from the meeting (or, in the alternative, to abstain from the deliberations and voting). The board members free of any possible taint can then take appropriate action as contemplated by section 8.30. (If a director's conflicting interest transaction is involved, it will be governed by subchapter F of this chapter and the directors' action will be taken pursuant to section 8.62 (or the board can refer the matter for shareholder's action respecting the transaction under section 8.63). In this connection, particular reference is made to the definition of "qualified director" in section 1.43.) If this course is followed, the director's conduct respecting the matter in question will in all likelihood be beyond challenge.

2. Section 8.31(b)

After satisfying the burden of establishing that the conduct of the director is challengeable under subsection (a), the plaintiff, in order to hold the director liable for money damages under clause (b)(1), has the further burden of establishing that: (i) harm (measurable in money damages) has been suffered by the corporation or its shareholders and (ii) the director's challenged conduct was the proximate cause of that harm. The concept of "proximate cause" is a term of art that is basic to tort law, and the cases providing content to the phrase represent well-developed authority to which a court will undoubtedly refer. A useful approach for the concept's application, for purposes of subsection (b)(1), would be that the challenged conduct must have been a "substantial factor in producing the harm." See *Francis v. United Jersey Bank,* supra, 432 A.2d at 829. Similarly, the plaintiff has the burden of establishing money payment is due from the director pursuant to clause (b)(2). If, while challengeable, the conduct at issue caused no harm under clause (b)(1) or does not provide the basis for other legal remedy under clause (b)(2), but may provide the basis for an equitable remedy under clause (b)(3), the plaintiff must satisfy whatever further burden of persuasion may be indicated to establish that imposition of the remedy sought is appropriate in the circumstances. In *Brophy v. Cities Service Co,* 70 A.2d 5, 8 (Del. Ch. 1949), an employee was required to account for profits derived from the use of the corporation's confidential plans to reacquire its securities through open-market purchases. Notwithstanding the fact that harm to the corporation had not been established, the Chancellor observed: "[p]ublic policy will not permit an employee occupying a position of trust and confidence toward his employer to abuse that relation to his own profit, regardless of whether his employer suffers a loss' Once actionable conduct that provides the basis for an equitable remedy under clause (b)(3) has been established, its appropriateness will often be clear and, if so, no further advocacy on the part of the plaintiff will be required.

3. Section 8.31(c)

While section 8.31 addresses director liability to the corporation or its shareholders under the Model Act-and related case law dealing with interpretation by the courts of their states' business corporation acts or dealing with corporate governance concepts coming within the common law's ambit-it does not limit any liabilities or foreclose any rights expressly provided for under other law. For example, directors can have liability (i) to shareholders (as well as former shareholders), who purchased their shares in a registered public offering, under section 11 of the Securities Act of 1933 and (ii) to the corporation, for short-swing profit recovery, under section 16(b) of the Securities Exchange Act of 1934. Subsection (c) merely acknowledges that those rights are unaffected by section 8.31. And directors can have liability to persons other than the corporation and its shareholders, such as (i) employee benefit plan participants and beneficiaries (who may or may not be shareholders), if the directors are determined to be fiduciaries under the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001-1461 (1988 & Supp. IV 1992), (ii) government agencies for regulatory violations or (iii) individuals claiming damages for injury governed by tort-law concepts (e.g., libel or slander).

As discussed above in the Official Comment to section 8.3 1(a), the concept of "fairness" is often relevant to whether a director will have liability if his or her conduct is challenged. Specifically, a director can successfully defend a financial interest in a transaction with the corporation by establishing that it was fair to the corporation. See section 8.61 and its Official Comment. More generally, the courts have resorted to a fairness standard of review where the business judgment rule has been inapplicable. See *Weinberger v. UOP, Inc.,* 457 A.2d 701 (Del. 1983). In the usual case, the defendant seeking to justify challenged conduct, on the basis of fairness, has the burden of proving that it was fair to the corporation. Subsection (c) expressly disclaims any intention to shift the burden of proof otherwise applicable where the question of the fairness of a transaction or other challenged conduct is at issue.

Finally, the *Model* Act deals expressly with certain aspects of director liability in other sections. For example, a director has a duty to observe the limitations on shareholder distributions set forth in section 6.40 and, if a director votes for or assents to a distribution in violation thereof, the director has personal liability as provided in section 8.33. And section 8.61 channels all directors' transactional interests into the exclusive treatment for directors' conflicting interest transactions that is therein provided, rejecting an award of damages or other sanctions for interests that do not come within its conceptual framework. Subsection (c) expressly acknowledges that the liability standard provided in section 8.33 and the exclusive treatment for directors' transactional interests provided in section 8.61 are unaffected by section 8.31.

§ **832. [RESERVED]**

§ **8.33. DIRECTORS' LIABILITY FOR UNLAWFUL DISTRIBUTIONS**

(a) A director who votes for or assents to a distribution in excess of what maybe authorized and made pursuant to section 6.40(a) or 14.09(a) is personally liable to the corporation for the amount of the distribution that exceeds what could have been distributed without violating section 6.40(a) or 14.09(a) if the party asserting liability establishes that when taking the action the director did not comply with section 8.30.

(b) A director held liable under subsection (a) for an unlawful distribution is entitled to:

(1) contribution from every other director who could be held liable under subsection (a) for the unlawful distribution; and

(2) recoupment from each shareholder of the pro-rata portion of the amount of the unlawful distribution the shareholder accepted, knowing the distribution was made in violation of section 6.40(a) or 14.09(a).

(c) A proceeding to enforce:

(1) the liability of a director under subsection (a) is barred unless it is commenced within two years after the date (i) on which the effect of the distribution was measured under section 6.40(e) or (g), (ii) as of which the violation of section 6.40(a) occurred as the consequence of disregard of a restriction in the articles of incorporation or (iii) on which the distribution of assets to Shareholders under section 14.09(a) was made; or

(2) contribution or recoupment under subsection (b) is barred unless it is commenced within one year after the liability of the claimant has been finally adjudicated under subsection (a).

CROSS-REFERENCES

Article provision limiting liability, see **§** 2.02(b)(4).
Director duties in dissolution, see **§** 14.09.
Director standards of conduct, see **§** 8.30.
"Distribution" defined, see **§** 1.40.
Distributions generally, see **§** 6.40.
Indemnification, see **§** 2.02(b) (5), 8.50-8.59.

OFFICIAL COMMENT

Although the revisions to the financial provisions of the Model Act have simplified and rationalized the rules for determining the validity of distributions (see sections 6.40 and 14.09), the possibility remains that a distribution may be made in violation of these rules. Section 8.33 provides that if it is established a director failed to meet the relevant standards of conduct of section 8.30 (e.g., good faith, reasonable care, warranted reliance) and voted for or assented to an unlawful distribution, the director is personally liable for the portion of the distribution that exceeds the maximum amount that could have been lawfully distributed.

A director whose conduct, in voting for or assenting to a distribution, is challenged under section 8.33 will have all defenses which would ordinarily be available, including the common law business judgment rule. Relevant thereto, however, there would be common issues posed by (i) a defense geared to compliance with section 8.30 (e.g., reasonable care under subsection (b) and warranted reliance under subsections (d) and (e)) and, in the alternative, (ii) a defense relying on the business judgment rule's shield (e.g., informed judgment). Thus, section 8.30 compliance will in most cases make resort to the business judgment rule's shield unnecessary.

A director who is compelled to restore the amount of an unlawful distribution to the corporation is entitled to contribution from every other director who could have been held liable for the unlawful distribution. The director may also recover the pro-rata portion of the amount of the unlawful distribution from any shareholder who accepted the distribution knowing that its payment was in violation of the statute. A shareholder (other than a director) who receives a payment not knowing of its invalidity is not subject to recoupment under subsection (b)(2). Although no attempt has been made in the Model Act to work out in detail the relationship between the right of recoupment from shareholders and the right of contribution from directors, it is expected that a court will equitably apportion the obligations and benefits arising from the application of the principles set forth in this section.

Section 8.33(c) limits the time within which a proceeding may be commenced against a director for an unlawful distribution to two years after the date on which the effect of the distribution was measured or breach of a restriction in the articles of incorporation occurred. Although a statute of limitations provision is a novel concept for the Model Act, a substantial minority of jurisdictions have provisions limiting the time within which an action may be brought on account of an unlawful distribution. Section 8.33(c) also limits the time within which a proceeding for contribution or recoupment may be made to one year after the date on which the liability of the claimant has been finally determined and adjudicated. This one-year period specified in clause (2) may end within or extend beyond the two-year period specified in clause (1).

Subchapter D. OFFICERS

§ 8.40. OFFICERS

(a) A corporation has the officers described in its bylaws or appointed by the board of directors in accordance with the bylaws.

(b) The board of directors may elect individuals to fill one or more offices of the corporation. An officer may appoint one or more officers if authorized by the bylaws or the board of directors.

(c) The bylaws or the board of directors shall assign to one of the officers responsibility for preparing the minutes of the directors' and shareholders' meetings and for maintaining and authenticating the records of the corporation required to be kept under sections 16.01(a) and 16.01(e).

(d) The same individual may simultaneously hold more than one office in a corporation.

CROSS-REFERENCES

Agents of corporation, see § 3.02.
Bylaws, see § 2.06, ch. 10B.
Contract rights of officers, see § 8.44.
Functions of officers, see § 8.41.
Officer as employee of corporation, see § 1.40.
Officer standards of conduct, see § 8.42.
Removal of officers, see § 8.43.
"Secretary" defined, see § 1.40.
Tenure of officers, see § 8.44.

OFFICIAL COMMENT

Section 8.40 permits every corporation to designate the offices it wants. The designation may be made in the bylaws or by the board of directors consistently with the bylaws. This is a departure from earlier versions of the Model Act and most state corporation acts, which require certain offices, usually the president, the secretary, and the treasurer, and generally authorize the corporation to designate additional offices. Experience has shown, however, that little purpose is served by a statutory requirement that there be certain offices, and statutory requirements may sometimes create problems of apparent authority or confusion with nonstatutory offices the corporation desires to create.

Section 8.40(b) indicates that, while it is generally the responsibility of the board of directors to elect officers, an officer may appoint one or more officers if authorized by the bylaws or the board of directors.

The board of directors, as well as duly authorized officers, employees or agents, may also appoint other agents for the corporation. Nothing in this section is intended to limit the authority of a board of directors to organize its own internal affairs, including designating officers of the board.

The bylaws or the board of directors must assign to an officer the responsibility to prepare minutes and authenticate the corporate records referred to in sections 16.01(a) and (e); the person performing this function is referred to as the "secretary" of the corporation throughout the Model Act. See section 1.40. Under the Act, a corporation may have this and all other corporate functions performed by a single individual.

The person who is designated by the bylaws or the board to have responsibility for preparing minutes of meetings and maintaining the corporate records has authority to bind the corporation by that officer's authentication under this section. This assignment of authority, traditionally vested in the corporate "secretary' allows third persons to rely on authenticated records without inquiry as to their truth or accuracy.

§ **8.41. FUNCTIONS OF OFFICERS**

Each officer has the authority and shall perform the functions set forth in the bylaws or, to the extent consistent with the bylaws, the functions prescribed by the board of directors or by direction of an officer authorized by the board of directors to prescribe the functions of other officers.

CROSS-REFERENCES

Assistant officers, see § 8.40.
Bylaws, see § 2.06, ch. 10B.
Officer as employee, see § 1.40.
Secretary, see § 1.40.
Standards of conduct:
Directors, see § 8.30.
Officers, see § 8.42.

OFFICIAL COMMENT

Section 8.41 recognizes that persons designated as officers have the formal authority set forth for that position (1) by its description in the bylaws, (2) by specific resolution of the board of directors, or (3) by direction of another officer authorized by the board of directors to prescribe the functions of other officers.

These methods of investing officers with formal authority do not exhaust the sources of an officer's actual or apparent authority. Many cases state that specific corporate officers, particularly the chief executive officer, may have implied authority merely by virtue of their positions. This authority, which may overlap the express authority granted by the bylaws, generally has been viewed as extending only to ordinary business transactions, though some cases have recognized unusually broad implied authority of the chief executive officer or have created a presumption that corporate officers have broad authority, thereby placing on the corporation the burden of showing lack of authority Corporate officers may also be vested with apparent (or ostensible) authority by reason of corporate conduct on which third persons reasonably rely.

In addition to express, implied, or apparent authority, a corporation is normally bound by unauthorized acts of officers if they are ratified by the board of directors. Generally, ratification extends only to acts that could have been authorized as an original matter. Ratification may itself be express or implied and may in some cases serve as the basis of apparent (or ostensible) authority.

§ 8.42. STANDARDS OF CONDUCT FOR OFFICERS

(a) An officer, when performing in such capacity, has the duty to act:

(1) in good faith;

(2) with the care that a person in a like position would reasonably exercise under similar circumstances; and

(3) in a manner the officer reasonably believes to be in the best interests of the corporation.

(b) The duty of an officer includes the obligation:

(1) to inform the superior officer to whom, or the board of directors or the committee thereof to which, the officer reports of information about the affairs of the corporation known to the officer, within the scope of the officer's functions, and known to the officer to be material to such superior officer, board or committee; and

(2) to inform his or her superior officer, or another appropriate person within the corporation, or the board of directors, or a committee thereof, of any actual or probable material violation of law involving the corporation or material breach of duty to the corporation by an officer, employee, or agent of the corporation, that the officer believes has occurred or is likely to occur.

(c) In discharging his or her duties, an officer who does not have knowledge that makes reliance unwarranted is entitled to rely on:

(1) the performance of properly delegated responsibilities by one or more employees of the corporation whom the officer reasonably believes to be reliable and competent in performing the responsibilities delegated; or

(2) information, opinions, reports or statements, including financial statements and other financial data, prepared or presented by one or more employees of the corporation whom the officer reasonably believes to be reliable and competent in the matters presented or by legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the officer reasonably believes are matters (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence.

(d) An officer shall not be liable to the corporation or its shareholders for any decision to take or not to take action, or any failure to take any action, as an officer, if the duties of the office are performed in compliance with this section. Whether an officer who does not comply with this section shall have liability will depend in such instance on applicable law, including those principles of section 8.31 that have relevance.

CROSS-REFERENCES

Appointment of officers, see § 8.40.
Functions of officers, see § 8.41.
Indemnification, see § 8.50-8.59.
Removal of officers, see § 8.43.
Standards of liability for directors, see § 8.31.

OFFICIAL COMMENT

Subsection (a) provides that an officer, when performing in such officer's official capacity, shall meet standards of conduct generally similar to those expected of directors under section 8.30. Consistent with the principles of agency, which generally govern the conduct of corporate employees, an officer is expected to observe the duties of obedience and loyalty and to act with the care that a person in a like position would reasonably exercise under similar circumstances. *See* RESTATEMENT (SECOND) OF AGENCY (379(1) (1958) ("Unless otherwise agreed, a paid agent is subject to a duty to the principal to act with standard care and with the skill which is standard in the locality for the kind of work which he is employed to perform and, in addition, to exercise any special skill that he has"). This section is not intended to modify, diminish or qualify the duties or standards of conduct that may be imposed upon specific officers by other law or regulation.

The common law, including the law of agency, has recognized a duty on the part of officers and key employees to disclose to their superiors material information relevant to the affairs of the agency entrusted to them. *See* RESTATEMENT (SECOND) OF AGENCY 381; A. Gilchrist Sparks, III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers,* 48 Bus. LAW. 215, 226-29 (1992). This duty is implicit in, and embraced under, the broader standard of subsection (a). New subsection (b) sets forth explicitly this disclosure obligation by confirming that the officer's duty includes the obligation (i) to keep superior corporate authorities informed of material information within the officer's sphere of functional responsibilities, and (ii) to inform the relevant superior authority, or other appropriate person within the corporation, of violations of law or breaches of duty that the officer believes have occurred or are about to occur (i.e., more likely than not to occur) and are or would be material to the corporation. Subsection (b)(1) specifies that business information shall be transmitted through the officer's regular reporting channels. Subsection (b)(2) specifies the reporting responsibility differently with respect to actual or probable material violations of law or material breaches of duty. The use of the term "appropriate" in subsection (b)(2) is intended to accommodate both the normative standard that may have been set up by the corporation for reporting potential violations of law or duty to a specified person, such as an ombudsperson, ethics officer, internal auditor, general counsel or the like, and situations where there is no designated person but the officer's immediate superior is not appropriate (for example, because the officer believes that individual is complicit in the unlawful activity or breach of duty).

Subsection (b) (1) should not be interpreted so broadly as to discourage efficient delegation of functions. It addresses the flow of information to the board of directors and to superior officers necessary to enable them to perform their decision-making and oversight functions. See the Official Comment to section 8.31. The officer's duties under subsection (b) may not be negated by agreement; however, their scope under subsection (b)(1) may be shaped by prescribing the scope of an officer's functional responsibilities.

With respect to the duties under subsection (b)(2), codes of conduct or codes of ethics, such as those adopted by many large corporations, may prescribe the circumstances in which and mechanisms by which officers and employees may discharge their duty to report material information to superior officers or the board of directors, or to other designated persons.

The term "material" modifying violations of law or breaches of duty in subsection (b)(2) denotes a qualitative as well as quantitative standard. It relates not only to the potential direct financial impact on the corporation, but also to the nature of the violation or breach. For example, an embezzlement of $10,000, or even less, would be material because of the seriousness of the offense, even though the amount involved would not be material to the financial position or results of operations of the corporation.

The duty under subsection (b)(2) is triggered by an officer's subjective belief that a material violation of law or breach of duty actually or probably has occurred or is likely to occur. This duty is not triggered by objective knowledge concepts, such as whether the officer should have concluded that such misconduct was occurring. The subjectivity of the trigger under subsection (b)(2), however, does not excuse officers from their obligations under subsection (a) to act in good faith and with due care in the performance of the functions assigned to them, including oversight duties within their respective areas of responsibility. There may be occasions when the principles applicable under section 8.30(c) limiting the duty of disclosure by directors where a duty of confidentiality is overriding may also apply to officers. See the Official Comment to section 8.30(c).

An officer's ability to rely on others in meeting the standards prescribed in section 8.42 may be more limited, depending upon the circumstances of the particular case, than the measure and scope of reliance permitted a director under section 8.30, in view of the greater obligation the officer may have to be familiar with the affairs of the corporation. The proper delegation of responsibilities by an officer, separate and apart from the exercise of judgment as to the delegatee's reliability and competence, is concerned with the procedure employed. This will involve, in the usual case, sufficient communication to the end that the delegatee understands the scope of the assignment and, in turn, manifests to the officer a willingness and commitment to undertake its performance. The entitlement to rely upon employees assumes that a delegating officer will maintain a sufficient level of communication with the officer's subordinates to fulfill his or her supervisory responsibilities. The definition of "employee" in section 1.40(8) includes an officer; accordingly, section 8.42 contemplates the delegation of responsibilities to other officers as well as to nonofficer employees.

It is made clear, in subsection (d), that performance meeting the section's standards of conduct will eliminate an officer's exposure to any liability to the corporation or its shareholders. In contrast, an officer failing to meet its standards will not automatically face liability. Deficient performance of duties by an officer, depending upon the facts and circumstances, will normally be dealt with through intracorporate disciplinary procedures, such as reprimand, compensation adjustment, delayed promotion, demotion or discharge. These procedures may be subject to (and limited by) the terms of an officer's employment agreement. See section 8.44.

In some cases, failure to observe relevant standards of conduct can give rise to an officer's liability to the corporation or its shareholders. A court review of challenged conduct will involve an evaluation of the particular facts and circumstances in light of applicable law. In this connection, subsection (d) recognizes that relevant principles of section 8.31, such as duties to deal fairly with the corporation and its shareholders and the challenger's burden of establishing proximately caused harm, should be taken into account. In addition, the business judgment rule will normally apply to decisions within an officer's discretionary authority. Liability to others can also arise from an officer's own acts or omissions (e.g., violations of law or tort claims) and, in some cases, an *offi*cer with supervisory responsibilities can have risk exposure in connection with the acts or omissions of others.

The Official Comment to section 8.30 supplements this Official Comment to the extent that it can be appropriately viewed as generally applicable to officers as well as directors.

§ 8.43. RESIGNATION AND REMOVAL OF OFFICERS

(a) An officer may resign at any time by delivering notice to the corporation. A resignation is effective when the notice is delivered unless the notice specifies a later effective time. If a resignation is made effective at a later time and the board or the appointing officer accepts the future effective time, the board or the appointing officer may fill the pending vacancy before the effective time if the board or the appointing officer provides that the successor does not take office until the effective time.

(b) An officer may be removed at any time with or without cause by: (i) the board of directors; (ii) the officer who appointed such officer, unless the bylaws or the board of directors provide otherwise; or (iii) any other officer if authorized by the bylaws or the board of directors.

(c) In this section, "appointing officer" means the officer (including any successor to that officer) who appointed the officer resigning or being removed.

CROSS-REFERENCES

Contract rights of officers, see § 8.44.
"Deliver' see § 1.40.
Effective date of notice, see § 1.41.
Notice to the corporation, see § 1.41.

OFFICIAL COMMENT

Section 8.43(a) is consistent with current practice and declaratory of current law. It recognizes: that corporate officers may resign; that, with the consent of the board of directors or the appointing officer, they may resign effective at a later date; and that a future vacancy may be filled to become effective as of the effective date of the resignation.

In part because of the unlimited power of removal confirmed by section 8.43(b), a board of directors may enter into an employment agreement with the holder of an office that extends beyond the term of the board of directors. This type of contract is binding on the corporation even if the articles of incorporation or bylaws provide that officers are elected for a term shorter than the period of the employment contract. If a later board of directors refuses to reelect that person as an officer, the person has the right to sue for damages but not for specific performance of the contract.

Section 8.43(b) is consistent with current practice and declaratory of current law. It recognizes that the officers of the corporation are subject to removal by the board of directors and, in certain instances, by other officers. It provides the corporation with the flexibility to determine when, if ever, an officer will be permitted to remove another officer. To the extent that the corporation wishes to permit an officer, other than the appointing officer, to remove another officer, the bylaws or a board resolution should set forth clearly the persons having removal authority.

A person may be removed from office irrespective of contract rights or the presence or absence of "cause" in a legal sense. Section 8.44 provides that removal from office of a holder who has contract rights is without prejudice to whatever rights the former officer may assert in a suit for damages for breach of contract.

§ **8.44. CONTRACT RIGHTS OF OFFICERS**

(a) The appointment of an officer does not itself create contract rights.

(b) An officer's removal does not affect the officer's contract rights, if any, with the corporation. An officer's resignation does not affect the corporation's contract rights, if any, with the officer.

CROSS-REFERENCES

Appointment of officers and assistant officers, see § 8.40.
Resignation or removal of officers, see § 8.43.

OFFICIAL COMMENT

Section 8.43 makes clear that the appointment of an officer does not itself create contract rights in the officer. The removal of an officer with contract rights is without prejudice to later enforcement of the officer's contract rights in a suit for damages for breach of contract. See the Official Comment to section 8.43. Similarly, an officer with an employment contract who prematurely resigns may be in breach of his or her employment contract. The mere appointment of an officer for a term does not create a contractual obligation on the officer's part to complete the term.

Subchapter E.
INDEMNIFICATION AND ADVANCE FOR EXPENSES

INTRODUCTORY COMMENT

The provisions for indemnification and advance for expenses of the Model Act are among the most complex and important in the entire Act. Subchapter E of chapter 8 is an integrated treatment of this subject and strikes a balance among important social policies. Its substance is based almost entirely on an amendment to the 1969 Model Act adopted in 1980 and substantially revised in 1994.

1. Policy Issues Raised by Indemnification and Advance for Expenses

Indemnification (including advance for expenses) provides financial protection by the corporation for its directors against exposure to expenses and liabilities that may be incurred by them in connection with legal proceedings based on an alleged breach of duty in their service to or on behalf of the corporation. Today, when both the volume and the cost of litigation have increased dramatically, it would be difficult to persuade responsible persons to serve as directors if they were compelled to bear personally the cost of vindicating the propriety of their conduct in every instance in which it might be challenged. While reasonable people may differ as to what constitutes a meritorious case, almost all would agree that corporate directors should have appropriate protection against personal risk and that the rule of *New York Dock Co. v. McCollom,* 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939), which denied reimbursement to directors who successfully defended their case on the merits, should as a matter of policy be overruled by statute.

The concept of indemnification recognizes that there will be situations in which the director does not satisfy all of the elements of the standard of conduct set forth in section 8.30(a) or the requirements of some other applicable law but where the corporation should nevertheless be permitted (or required) to absorb the economic costs of any ensuing litigation. A carefully constructed indemnification statute should identify these situations.

If permitted too broadly, however, indemnification may violate equally basic tenets of public policy. It is inappropriate to permit management to use corporate funds to avoid the consequences of certain conduct. For example, a director who intentionally inflicts harm on the corporation should not expect to receive assistance from the corporation for legal or other expenses and should be required to satisfy from his or her personal assets not only any adverse judgment but also expenses incurred in connection with the proceeding. Any other rule would tend to encourage socially undesirable conduct.

A further policy issue is raised in connection with indemnification against liabilities or sanctions imposed under state or federal civil or criminal statutes.

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A shift of the economic cost of these liabilities from the individual director to the corporation by way of indemnification may in some instances frustrate the public policy of those statutes.

The fundamental issue that must be addressed by an indemnification statute is the establishment of policies consistent with these broad principles: to ensure that indemnification is permitted only where it will further sound corporate policies and to prohibit indemnification where it might protect or encourage wrongful or improper conduct. As phrased by one commentator, the goal of indemnification is to "seek the middle ground between encouraging fiduciaries to violate their trust, and discouraging them from serving at all." Johnston, "Corporate Indemnification and Liability Insurance for Directors and Officers" 33 Bus. LAW. 1993, 1994 (1978). The increasing number of suits against directors, the increasing cost of defense, and the increasing emphasis on diversifying the membership of boards of directors all militate in favor of workable arrangements to protect directors against liability to the extent consistent with established principles.

Some of the same policy considerations apply to the indemnification of officers and, in many cases, employees and agents. The indemnification of officers, whose duties are specified in section 8.42, is dealt with separately in section 8.56. However, other considerations apply to employees and agents, who have significantly different roles and responsibilities and as to whom the spectre of structural bias (sympathetic directors approving indemnification for themselves or for colleagues on the board or for officers, who may work closely with board members) is not present. The indemnification of employees and agents, whose duties are prescribed by sources of law other than corporation law (e.g., contract and agency law), is beyond the scope of this subchapter. Section 8.58(d), however, makes clear that the absence in subchapter E of provisions concerning employees and agents is not intended to limit a corporation's power to indemnify or advance expenses to them in accordance with applicable law.

2. Relationship of Indemnification to Other Policies Established in the Model Act

Indemnification is closely related to the standards of conduct for directors and officers established elsewhere in chapter 8. The structure of the Model Act is based on the assumption that if a director acts consistently with the standards of conduct described in section 8.30 or with the standards of a liability-limitation provision in the articles of incorporation (as authorized by section 2.02(b)(4)), the director will not have exposure to liability to the corporation or to shareholders and any expenses necessary to establish a defense will be borne by the corporation (under section 8.52). But the converse is not necessarily true. The basic standards for indemnification set forth in this subchapter for a civil action, in the absence of an indemnification provision in the corporation's articles (as authorized by section 2.02(b)(5)), are good faith and reasonable belief that the conduct was in or not opposed to the best interests of the corporation. See section 8.51. In some circumstances, a director or officer may be found to have violated a statutory or common law duty and yet be able to establish eligibility for indemnification under these standards of conduct. In addition, this subchapter permits a director or officer who is held liable for violating a statutory or common law duty, but who does not meet the relevant standard of conduct, to petition a court to order indemnification under section 8.54(a)(3) on the ground that it would be fair and reasonable to do so.

3. Application of Amendments to Prior Conduct

Each jurisdiction adopting amendments to its indemnification statutes should consider the extent to which the statutes, as amended, should apply to conduct occurring prior to the effective time of the amendments. Absent constitutional or statutory provisions dealing generally with retroactivity of statutory amendments, resolution of this issue may be made to depend upon whether a claim for indemnification was made prior to (and was pending at) the effective time of the amendment. Alternatively, the amended statute can specifically provide that it applies to conduct occurring before or after the effective time.

§ 8.50. SUBCHAPTER DEFINITIONS

In this subchapter:

(1) "Corporation" includes any domestic or foreign predecessor entity of a corporation in a merger.

(2) "Director" or "officer" means an individual who is or was a director or officer, respectively, of a corporation or who, while a director or officer of the corporation, is or was serving at the corporation's request as a director, officer, manager, partner, trustee, employee, or agent of another entity or employee benefit plan. A director or officer is considered to be serving an employee benefit plan at the corporation's request if the individual's duties to the corporation also impose duties on, or otherwise involve services by, the individual to the plan or to participants in or beneficiaries of the plan. "Director" or "officer" includes, unless the context requires otherwise, the estate or personal representative of a director or officer.

(3) "Liability" means the obligation to pay a judgment, settlement, penalty, fine (including an excise tax assessed with respect to an employee benefit plan), or reasonable expenses incurred with respect to a proceeding.

(4) "Official capacity" means: (i) when used with respect to a director, the office of director in a corporation; and (ii) when used with respect to an officer, as contemplated in section 8.56, the office in a corporation held by the officer. "Official capacity" does not include service for any other domestic or foreign corporation or any partnership, joint venture, trust, employee benefit plan, or other entity.

(5) "Party" means an individual who was, is, or is threatened to be made, a defendant or respondent in a proceeding.

(6) "Proceeding" means any threatened, pending, or completed action, suit, or proceeding, whether civil, criminal, administrative, arbitrative, or investigative and whether formal or informal.

CROSS-REFERENCES

Act definitions, see § 1.40.
Effect of merger, see § 11.07(a).
"Entity" defined, see § 1.40.
"Expenses" defined, see § 1.40 (9AA).
Officers, see § 8.40(a).
Witness indemnification, see § 8.58(d).

OFFICIAL COMMENT

The definitions set forth in section 8.50 apply only to subchapter E and have no application elsewhere in the Model Act (except as set forth in section 2.02(b)(5)). The term "qualified director' which is used in section 8.53 and 8.55, is defined in section 1.43.

1. Corporation

A special definition of "corporation" is included in subchapter E to make it clear that predecessor entities that have been absorbed in mergers are included within the definition. It is probable that the same result would be reached for many transactions under section 11.07(a) (effect of merger), which provides for the assumption of liabilities by operation of law upon a merger. The express responsibility of successor entities for the liabilities of their predecessors under this subchapter is broader than under section 11.07(a) and may impose liability on a successor although section 11.07(a) does not. Section 8.50(1) is thus an essential aspect of the protection provided by this subchapter for persons eligible for indemnification.

2. Director and Officer

A special definition of "director" and "officer" is included in subchapter E to cover individuals who are made parties to proceedings because they are or were directors or officers or, while serving as directors or officers, also serve or served at the corporation's request in another capacity for another entity. The purpose of the latter part of this definition is to give directors and officers the benefits of the protection of this subchapter while serving at the corporation's request in a responsible position for employee benefit plans, trade associations, nonprofit or charitable entities, domestic or foreign entities, or other kinds of profit or nonprofit ventures. To avoid misunderstanding, it is good practice from both the corporation's and director's or officer's viewpoint for this type of request to be evidenced by resolution, memorandum or other writing. The definition covers an individual who is or was either a director or officer so that further references in the remainder of subchapter E to an individual who is a director or officer necessarily include former directors or officers.

The second sentence of section 8.50(2) addresses the question of liabilities arising under the Employee Retirement Income Security Act of 1974 (ERISA). It makes clear that a director or officer who is serving as a fiduciary of an employee benefit plan is automatically viewed for purposes of this subchapter as having been requested by the corporation to act in that capacity. Special treatment is believed necessary because of the broad definition of "fiduciary" and the requirement that a "fiduciary" must discharge his or her duties "solely in the interest" of the participants and beneficiaries of the employee benefit plan. Decisions by a director or officer, who is serving as a fiduciary under the plan on questions regarding (a) eligibility for benefits, (b) investment decisions, or (c) interpretation of plan provisions respecting (i) qualifying service, (ii) years of service, or (iii) retroactivity, are all subject to the protections of this subchapter. See also sections 8.50(4) and 8.5 1(b) of this subchapter.

The last sentence of section 8.50(2) provides that the estate or personal representative of a director or officer is entitled to the rights of indemnification possessed by that director or officer. The phrase "unless the context requires otherwise" was added to make clear that the estate or personal representative does not have the right to participate in directorial decisions authorized in this subchapter.

3. Liability

"Liability" is defined for convenience in order to avoid repeated references to recoverable items throughout the subchapter. Even though the definition of "liability" includes amounts paid in settlement or to satisfy a judgment, indemnification against certain types of settlements and judgments is not allowed under several provisions of subchapter E. For example, indemnification in suits brought by or in the right of the corporation is limited to expenses (see section 8.51(d)(1)), unless indemnification for a settlement is ordered by a court under section 8.54(a)(3).

The definition of "liability" permits the indemnification only of expenses." The definition of "expenses" in section 1.40(9AA) limits expenses to those that are reasonable. The result is that any portion of expenses falling outside the perimeter of reasonableness should not be advanced or indemnified. In contrast, unlike earlier versions of the Model Act and statutes of many states, section 8.50(4) provides that amounts paid to settle or satisfy substantive claims are not subject to a reasonableness test. Since payment of these amounts is permissive-mandatory indemnification is available under section 8.52 only where the defendant is "wholly successful"-a special limitation of "reasonableness" for settlements is inappropriate.

"Penalties" and "fines" are expressly included within the definition of "liability" so that, in appropriate cases, these items may also be indemnified. The purpose of this definition is to cover every type of monetary obligation that may be imposed upon a director, including civil penalties, restitution, and obligations to give notice. This definition also expressly includes as a "fine" the levy of excise taxes under the Internal Revenue Code pursuant to ERISA.

4. Official Capacity

The definition of "official capacity" is necessary because the term determines which of the two alternative standards of conduct set forth in section 8.51(a)(1)(ii) applies: If the action was taken in an "official capacity," the individual to be indemnified must have reasonably believed that he or she was acting in the best interests of the corporation. In contrast, if the action in question was not taken in an "official capacity' the individual need only have reasonably believed that the conduct was not opposed to the best interests of the corporation. See also the Official Comment to section 8.5 1(a).

5. Party

The definition of "party" includes every "individual who was, is, or is threatened to be made, a defendant or respondent in a proceeding." Thus, the definition includes present and former parties in addition to individuals currently or formerly threatened with being made a party. An individual who is only called as a witness is not a "party" within this definition and, as specifically provided in section 8.58(d), payment or reimbursement of his expenses is not limited by this subchapter.

6. Proceeding

The broad definition of "proceeding" ensures that the benefits of this subchapter will be available to directors in new and unexpected, as well as traditional, types of litigation or other adversarial matters, whether civil, criminal, administrative, or investigative. It also includes arbitration and other dispute resolution proceedings, lawsuit appeals and petitions to review administrative actions.

§ 8.51. PERMISSIBLE INDEMNIFICATION

(a) Except as otherwise provided in this section, a corporation may indemnify an individual who is a party to a proceeding because the individual is a director against liability incurred in the proceeding if:

(1)

(i) the director conducted himself or herself in good faith; and

(ii) reasonably believed:

(A) in the case of conduct in an official capacity, that his or her conduct was in the best interests of the corporation; and

(B) in all other cases, that the director's conduct was at least not opposed to the best interests of the corporation; and

(iii) in the case of any criminal proceeding, the director had no reasonable cause to believe his or her conduct was unlawful; or

(2) the director engaged in conduct for which broader indemnification has been made permissible or obligatory under a provision of the articles of incorporation (as authorized by section 2.02(b)(5)).

(b) A director's conduct with respect to an employee benefit plan for a purpose the director reasonably believed to be in the interests of the participants in, and the beneficiaries of, the plan is conduct that satisfies the requirement of subsection (a)(1)(ii)(B).

(c) The termination of a proceeding by judgment, order, settlement, or conviction, or upon a plea of nolo contendere or its equivalent, is not, of itself, determinative that the director did not meet the relevant standard of conduct described in this section.

(d) Unless ordered by a court under section 8.54(a)(3), a corporation may not indemnify a director:

(1) in connection with a proceeding by or in the right of the corporation, except for expenses incurred in connection with the proceeding if it is determined that the director has met the relevant standard of conduct under subsection (a); or

(2) in connection with any proceeding with respect to conduct for which the director was adjudged liable on the basis of receiving a financial benefit to which he or she was not entitled, whether or not involving action in the director's official capacity.

CROSS-REFERENCES

Advance for expenses, see § 8.53.

Articles of incorporation, see § 2.02(b)(5).
"Corporation" defined, see § 8.50(1).
Court-ordered indemnification, see § 8.54.
Derivative proceedings, see § 7.40-7.47.
Determination of indemnification, see § 8.55.
"Director" defined, see § 8.50(2).
Director's conflicting interest transaction, see § 8.60-8.63.
Exclusivity of subchapter, see § 8.59.
"Expenses" defined, see § 1.40.
"Liability" defined, see § 8.50(3).
Liability-limitation provisions, see § 2.02(b)(4).
Limits on indemnification, see § 8.58(c).
Mandatory indemnification, see § 8.52.
Obligatory indemnification, see § § 2.02(b) (5), 8.58(a).
Officer indemnification, see § 8.56.
"Official capacity" defined, see § 8.50(4).
"Party" defined, see § 8.50(5).
"Proceeding" defined, see § 8.50(6).
Standards of conduct for directors, see § 8.30.
Standards of liability for directors, see § 8.31.

OFFICIAL COMMENT

1. Section 8.51(a)

Subsection 8.5 1(a) permits, but does not require, a corporation to indemnify directors if the standards of subsection (a)(1) or of a provision of the articles referred to in subsection (a)(2) are met. This authorization is subject to any limitations set forth in the articles of incorporation pursuant to section 8.58(c). Absent any such limitation, the standards for indemnification of directors contained in this subsection define the outer limits for which discretionary indemnification is permitted under the Model Act. Conduct which does not meet one of these standards is not eligible for permissible indemnification under the Model Act, although court-ordered indemnification may be available under section 8.54(a)(3). Conduct that falls within these outer limits does not automatically entitle directors to indemnification, although a corporation may obligate itself to indemnify directors to the maximum extent permitted by applicable law. See section 8.58(a). No such obligation, however, may exceed these outer limits. Absent such an obligatory provision, section 8.52 defines much narrower circumstances in which directors are entitled as a matter of right to indemnification.

Some state statutes provide separate, but usually similarly worded, standards for indemnification in third-party suits and indemnification in suits brought by or in the right of the corporation. Section 8.51 makes clear that the outer limits of conduct for which indemnification is permitted should not be dependent on the type of proceeding in which the claim arises. To prevent circularity in recovery, however, section 8.51(d) (1) limits indemnification in connection with suits brought by or in the right of the corporation to expenses incurred and excludes amounts paid to settle such suits or to satisfy judgments. In addition, to discourage wrongdoing, section 8.51(d) (2) bars indemnification where the director has been adjudged to have received a financial benefit to which the director is not entitled. Nevertheless, a court may order certain relief from these limitations under section 8.54(a)(3).

The standards of conduct described in subsections (a)(1)(i) and (a) (1) (ii) (A) that must be met in order to permit the corporation to indemnify a director are closely related, but not identical, to the standards of conduct imposed by section 8.30 on members of the board of directors when discharging the duties of a director: good faith, reasonable belief that the best interests of the corporation are being served, and appropriate care (i.e., that which a person in a like position would reasonably believe appropriate under similar circumstances). Unless authorized by a charter provision adopted pursuant to subsection (a)(2), it would be difficult to justify indemnifying a director who has not met any of these standards. It would not, however, make sense to require a director to meet all these standards in order to be indemnified because a director who does so would normally have no liability, at least to the corporation or its shareholders, under the terms of section 8.31.

Section 8.5 1(a) adopts a middle ground by authorizing discretionary indemnification in the case of a failure to meet the appropriate care standard of section 8.30(b) because public policy would not be well served by an absolute bar. A director's potential liability for conduct which does not on each and every occasion satisfy the appropriate care requirement of section 8.30(b), or which with the benefit of hindsight could be so viewed, would in all likelihood deter qualified individuals from serving as directors and inhibit some who serve from taking risks. Permitting indemnification against such liability tends to counter these undesirable consequences. Accordingly, section 8.5 1(a) authorizes indemnification at the corporation's option even though section 8.30's appropriate care requirement is not met, but only if the director satisfies the "good faith" and "corporation's best interests" standards. This reflects a judgment that, balancing public policy considerations, the corporation may indemnify a director who does not satisfy the appropriate care test but not one who fails either of the other two standards.

As in the case of section 8.30, where the concept of good faith is also used, no attempt is made in section 8.51 to provide a definition. The concept involves a subjective test, which would permit indemnification for "a mistake of judgment," in the words of the Official Comment to section 8.31, even though made unwisely or negligently by objective standards. Section 8.51 also requires, as does section 8.30, a "reasonable" belief that conduct when acting in the director's official capacity was in the corporation's best interests. It then adds a provision, not found in section 8.30, relating to criminal proceedings that requires the director to have had no "reasonable cause" to believe that the conduct was unlawful. These both involve objective standards applicable to the director's belief concerning the effect of the conduct in question. Conduct includes both acts and omissions.

Section 8.51(a)(1)(ii)(B) requires, if not acting in the director's official capacity, that the action be "at least not opposed to" the corporation's best interests. This standard is applicable to the director when serving another entity at the request of the corporation or when sued simply because of the director's status. The words "at least" qualify "not opposed to" in order to make it clear that this standard is an outer limit for conduct other than in an official capacity. 'While this subsection is directed at the interests of the indemnifying (i.e., the requesting) corporation, a director serving another entity by request remains subject to the provisions of the law governing service to that entity, including provisions dealing with conflicts of interest. Compare sections 8.60-8.63. Should indemnification from the requesting corporation be sought by a director for acts done while serving another entity, which acts involved breach of the duty of loyalty owed to that entity, nothing in section 8.51(a)(1)(ii)(B) would preclude the requesting corporation from considering, in assessing its own best interests, whether the fact that its director had engaged in a violation of the duty owed to the other entity was in fact "opposed to" the interests of the indemnifying corporation. Receipt of an improper financial benefit from a subsidiary would normally be opposed to the best interests of the parent.

Section 8.51 also permits indemnification in connection with a proceeding involving an alleged failure to satisfy legal standards other than the standards of conduct in section 8.30, e.g., violations of federal securities laws and environmental laws. It should be noted, however, that the Securities and Exchange Commission takes the position that indemnification against liabilities under the Securities Act of 1933 is against public policy and requires that, as a condition for accelerating the effectiveness of a registration statement under the Act, the issuer must undertake that, unless in the opinion of its counsel the matter has been settled by controlling precedent, it will submit to a court the question whether such indemnification is against public policy as expressed in the Act. 17 C.F.R. § 229.5 12(h) (1993).

In addition to indemnification under section 8.51(a)(1), section 8.51(a)(2) permits indemnification under the standard of conduct set forth in a charter provision adopted pursuant to section 2.02(b)(5). Based on such a charter provision, section 8.51(a)(2) permits indemnification in connection with claims by third parties and, through section 8.56, applies to officers as well as directors. (This goes beyond the scope of a charter provision adopted pursuant to section 2.02(b)(4), which can only limit liability of directors against claims by the corporation or its shareholders.) Section 8.51(a)(2) is subject to the prohibition of subsection (d)(1) against indemnification of settlements and judgments in derivative suits. It is also subject to the prohibition of subsection (d)(2) against indemnification for receipt of an improper financial benefit; however, this prohibition is already subsumed in the exception contained in section 2.02(b) (5) (A).

2. Section 8.51(b)

As discussed in the Official Comment to Section 8.50(2), ERISA requires that a "fiduciary" (as defined in ERISA) discharge the fiduciary's duties "solely in the interest" of the participants in and beneficiaries of an employee benefit plan. Section 8.51(b) makes clear that a director who is serving as a trustee or fiduciary for an employee benefit plan under ERISA meets the standard for indemnification under section 8.51(a) if the director reasonably believes the conduct while serving in that capacity was in the best interests of the participants in and beneficiaries of the plan.

This standard is arguably an exception to the more general standard that conduct not in an official corporate capacity is indemnifiable if it is "at least not opposed to" the best interests of the corporation. However, a corporation that causes a director to undertake fiduciary duties in connection with an employee benefit plan should expect the director to act in the best interests of the plan's beneficiaries or participants. Thus, subsection (b) establishes and provides a standard for indemnification that is consistent with the statutory policies embodied in ERISA. See Official Comment to section 8.50(2).

3. Section 8.51(c)

The purpose of section 8.51(c) is to reject the argument that indemnification is automatically improper whenever a proceeding has been concluded on a basis that does not exonerate the director claiming indemnification. Even though a final judgment or conviction is not automatically determinative of the issue of whether the minimum standard of conduct was met, any judicial determination of substantive liability would in most instances be entitled to considerable weight. By the same token, it is clear that the termination of a proceeding by settlement or plea of *nolo contendere* should not of itself create a presumption either that conduct met or did not meet the relevant standard of subsection (a) since a settlement or *nolo* plea may be agreed to for many reasons unrelated to the merits of the claim. On the other hand, a final determination of non-liability (including one based on a liability-limitation provision adopted under section 2.02(b)(4)) or an acquittal in a criminal case automatically entities the director to indemnification of expenses under section 8.52.

Section 8.51(c) applies to the indemnification of expenses in derivative proceedings (as well as to indemnification in third party suits). The most likely application of this subsection in connection with a derivative proceeding will be to a settlement since a judgment or order would normally result in liability to the corporation and thereby preclude indemnification for expenses under section 8.51(d)(1), unless ordered by a court under section 8.54(a)(3). In the rare event that a judgment or order entered against the director did not include a determination of liability to the corporation, the entry of the judgment or order would not be determinative that the director failed to meet the relevant standard of conduct.

4. Section 8.51(d)

This subsection makes clear that indemnification is not permissible under section 8.51 in two situations: (i) a proceeding brought by or in the right of a corporation that results in a settlement or a judgment against the director and (ii) a proceeding that results in a judgment that an improper financial benefit was received as a result of the director's conduct.

Permitting indemnification of settlements and judgments in derivative proceedings would give rise to a circularity in which the corporation receiving payment of damages by the director in the settlement or judgment (less attorneys' fees) would then immediately return the same amount to the director (including attorneys' fees) as indemnification. Thus, the corporation would be in a poorer economic position than if there had been no proceeding. This situation is most egregious in the case of a judgment against the director. Even in the case of a settlement, however, prohibiting indemnification is not unfair. Under the revised procedures of section 7.44, upon motion by the corporation, the court must dismiss any derivative proceeding which independent directors (or a court-appointed panel) determine in good faith, after a reasonable inquiry, is not in the best interests of the corporation. Furthermore, under section 2.02(b)(4), the directors have the opportunity to propose to shareholders adoption of a provision limiting the liability of directors in derivative proceedings. In view of these considerations, it is unlikely that directors will be unnecessarily exposed to meritless actions. In addition, if directors were to be indemnified for amounts paid in settlement, the dismissal procedures in section 7.44 might not be fully employed since it could be less expensive for the corporation to indemnify the directors immediately for the amount of the claimed damages rather than bear the expense of the inquiry required by section 7.44. The result could increase the filing of meritless derivative proceedings in order to generate small but immediately paid attorneys' fees. Despite the prohibition on indemnification of a settlement or a judgment in a derivative proceeding, subsection (d)(1) permits indemnification of the related reasonable expenses incurred in the proceeding so long as the director meets the relevant standard of conduct set forth in section 8.51(a). In addition, indemnification of derivative proceeding expenses and amounts paid in settlement where the relevant standard was not met maybe ordered by a court under section 8.54(a)(3).

Indemnification under section 8.51 is also prohibited if there has been an adjudication that a director received an improper financial benefit (i.e., a benefit to which the director is not entitled), even if, for example, the director acted in a manner not opposed to the best interests of the corporation. For example, improper use of inside information for financial benefit should not be an action for which the corporation may elect to provide indemnification, even if the corporation was not thereby harmed. Given the express language of section 2.02(b)(5) establishing the outer limit of an indemnification provision contained in the articles of incorporation, a director found to have received an improper financial benefit would not be permitted indemnification under subsection (a)(2). Although it is unlikely that a director found to have received an improper financial benefit could meet the standard in subsection (a)(1)(ii)(B), this limitation is made explicit in section 8.51(d)(2). Section 8.54(a)(3) permits a director found liable in a proceeding referred to in subsection (d)(2) to petition a court for a judicial determination of entitlement to indemnification for reasonable expenses. The language of section 8.51(d)(2) is based on section 2.02(b)(4)(A) and, thus, the same standards should be used in interpreting the application of both provisions. Although a settlement may create an obligation to pay money, it should not be construed for purposes of this subchapter as an adjudication of liability.

§ 8.52. MANDATORY INDEMNIFICATION

A corporation shall indemnify a director who was wholly successful, on the merits or otherwise, in the defense of any proceeding to which the director was a party because he or she was a director of the corporation against expenses incurred by the director in connection with the proceeding.

CROSS-REFERENCES

"Corporation" defined, see § 8.50(1).
Court-ordered indemnification, see § 8.54.
"Director" defined, see § 8.50(2).
"Expenses" defined, see § 1.40(9AA).
Limits on indemnification, see § 8.58(c).
"Party" defined, see § 8.50(5).
Permissible indemnification, see § 8.51.
"Proceeding" defined, see § 8.50(6).

OFFICIAL COMMENT

Section 8.51 determines whether indemnification may be made voluntarily by a corporation if it elects to do so. Section 8.52 determines whether a corporation must indemnify a director for his or her expenses; in other words, section 8.52 creates a statutory right of indemnification in favor of the director who meets the requirements of that section. Enforcement of this right by judicial proceeding is specifically contemplated by section 8.54(a)(1). Section 8.54(b) gives the director a statutory right to recover expenses incurred in enforcing the director's statutory right to indemnification under section 8.52.

The basic standard for mandatory indemnification is that the director has been "wholly successful, on the merits or otherwise' in the defense of the proceeding. The word "wholly" is added to avoid the argument accepted in *Merritt Chapman* & *Scott Corp. v. Wolfson,* 321 A.2d 138 (Del. 1974), that a defendant may be entitled to partial mandatory indemnification if, by plea bargaining or otherwise, the director was able to obtain the dismissal of some but not all counts, of an indictment. A defendant is "wholly successful" only if the entire proceeding is disposed of on a basis which does not involve a finding of liability. A director who is precluded from mandatory indemnification by this requirement may still be entitled to permissible indemnification under section 8.51(a) or court-ordered indemnification under section 8.54(a) (3).

The language in earlier versions of the Model Act and in many other state statutes that the basis of success may be "on the merits or otherwise" is retained. 'While this standard may result in an occasional defendant becoming entitled to indemnification because of procedural defenses not related to the merits, e.g., the statute of limitations or disqualification of the plaintiff, it is unreasonable to require a defendant with a valid procedural defense to undergo a possibly prolonged and expensive trial on the merits in order to establish eligibility for mandatory indemnification.

§ **8.53. ADVANCE FOR EXPENSES**

(a) A corporation may, before final disposition of a proceeding, advance funds to pay for or reimburse expenses incurred in connection with the proceeding by an individual who is a party to the proceeding because that individual is a member of the board of directors if the director delivers to the corporation:

(1) a written affirmation of the director's good faith belief that the relevant standard of conduct described in section 8.51 has been met by the director or that the proceeding involves conduct for which liability has been eliminated under a provision of the articles of incorporation as authorized by section 2.02(b)(4); and

(2) a written undertaking of the director to repay any funds advanced if the director is not entitled to mandatory indemnification under section 8.52 and it is ultimately determined under section 8.54 or section 8.55 that the director has not met the relevant standard of conduct described in section 8.51.

(b) The undertaking required by subsection (a)(2) must be an unlimited general obligation of the director but need not be secured and may be accepted without reference to the financial ability of the director to make repayment.

(c) Authorizations under this section shall be made:

(1) by the board of directors:

(i) if there are two or more qualified directors, by a majority vote of all the qualified directors (a majority of whom shall for such purpose constitute a quorum) or by a majority of the members of a committee of two or more qualified directors appointed by such a vote; or

(ii) if there are fewer than two qualified directors, by the vote necessary for action by the board in accordance with section 8.24(c), in which authorization directors who are not qualified directors may participate; or

(2) by the shareholders, but shares owned by or voted under the control of a director who at the time is not a qualified director may not be voted on the authorization.

CROSS-REFERENCES

Committees of the board, see § 8.25.
"Corporation" defined, see § 8.50(1).
Court-ordered indemnification, see § 8.54.
Determination of indemnification, see § 8.55.
"Director" defined, see § 8.50(2).
"Expenses" defined, see § 1.40.
Limits on indemnification and advance for expenses, see § 8.58(c).
"Party" defined, see § 8.50(5).
"Proceeding" defined, see § 8.50(6).
"Qualified director" defined, see § 1.43.
Quorum of directors, see § 8.24(a).
Standard for indemnification, see § 8.51.

OFFICIAL COMMENT

Section 8.53 authorizes, but does not require, a corporation to pay for or reimburse, in advance, a director's reasonable expenses if two conditions are met. This authorization is subject to any limitations set forth in the articles of incorporation pursuant to section 8.58(c).

Section 8.53 recognizes an important difference between indemnification and an advance for expenses: indemnification is retrospective and, therefore, enables the persons determining whether to indemnify to do so on the basis of known facts, including the outcome of the proceeding. Advance for expenses is necessarily prospective and the individuals making the decision whether to advance expenses generally have fewer known facts on which to base their decision. Indemnification may include reimbursement for nonadvanced expenses.

Section 8.53 reflects a determination that it is sound public policy to permit the corporation to advance (by direct payment or by reimbursement) the defense expenses of a director so long as the director (i) believes in good faith that the director was acting in accordance with the relevant standard for indemnification set forth in section 8.51 or that the proceeding involves conduct for which liability has been eliminated pursuant to section 2.02(b)(4) and (ii) agrees to repay any amounts advanced if it is ultimately determined that the director is not entitled to indemnification. This policy is based upon the view that a person who serves an entity in a representative capacity should not be required to finance his or her own defense. Moreover, adequate legal representation often involves substantial expenses during the course of the proceeding and many individuals are willing to serve as directors only if they have the assurance that the corporation has the power to advance these expenses. In fact, many corporations enter into contractual obligations (e.g., by a provision in the articles or bylaws or by individual agreements) to advance expenses for directors. See section 8.58(a).

Section 8.53(a) requires the director's written affirmation as to the good faith belief that the director has met the relevant standard of conduct necessary for indemnification by the corporation and a written undertaking by the director to repay any funds advanced if it is ultimately determined that such standard of conduct has not been met. A single undertaking may cover all funds advanced from time to time in connection with the proceeding. Under subsection (b), the undertaking need not be secured and financial ability to repay is not a prerequisite. The theory underlying this subsection is that wealthy directors should not be favored over directors whose financial resources are modest. The undertaking must be made by the director and not by a third party. If the director or the corporation wishes some third party to be responsible for the director's obligation in this regard, either is free to make those arrangements separately with the third party.

In the absence of an obligatory provision established pursuant to section 8.58(a), the decision to advance expenses must be made in accordance with subsection (c). Section 8.53 does not address the question of the standard by which the decision to advance expenses is to be made. Accordingly, the standards of section 8.30 should, in general, govern. The conditions for advance for expenses are different from the conditions for indemnification. Directors normally meet the standards of section 8.30 in approving an advance for expenses if they limit their consideration to the financial ability of the corporation to pay the amount in question and do not have actual knowledge of facts sufficient to cause them to believe that the subsection (a)(1) affirmation was not made in good faith. The directors are not required by section 8.30 to make any inquiry into the merits of the proceeding or the good faith of the belief stated in that affirmation. Thus, in the great majority of cases, no special inquiry will be required. The directors acting on a decision to advance expenses may, but are not required to, consider any additional matters they deem appropriate and may condition the advance of expenses upon compliance with any additional requirements they desire to impose.

A corporation may obligate itself pursuant to section 8.58(a) to advance for expenses under section 8.53 by means of a provision set forth in its articles of incorporation or bylaws, by a resolution of its shareholders or board of directors, by a contract or otherwise. However, any such obligatory arrangement must comply with the requirements of subsection (a) regarding furnishing of an affirmation and undertaking. No other procedures are contemplated, although obligatory arrangements may include notice and other procedures in connection with advancement of expenses and indemnification requests.

At least one court has held that a general obligatory provision requiring indemnification to the extent permitted by law does not include advance for expenses if not specifically mentioned. See, e.g., *Advanced Mining Systems, Inc.* v. Fricke, 623 A.2d 82 (Del. 1992). Unless provided otherwise, section 8.58(a) requires the opposite result, unless provided otherwise.

The decision to advance expenses is required to be made only one time with respect to each proceeding rather than each time a request for payment of expenses is received by the corporation. However, the directors are free to reconsider the decision at any time (e.g., upon a change in the financial ability of the corporation to pay the amounts in question). The decision as to the reasonableness of any expenses may be made by any officer or agent of the corporation duly authorized to do so.

The procedures set forth in subsection (c) for authorizing an advance for expenses parallel the procedures set forth in section 8.55(b) for selecting the person or persons to make the determination that indemnification is permissible. If the advance for expenses is not authorized by the shareholders under subsection c)(2), the procedure specified in subsection (c)(1)(i) must be used. If it is unavailable, then the procedure under subsection (c)(1)(ii) may be used.

Under subsection (c)(l)(i), the vote required when the qualified directors act as a group is an absolute majority of their number. A majority of the qualified directors constitutes a quorum for board action for this purpose.

The committee of two or more qualified directors referred to in subsection (c)(l)(i) may be a committee of the board of directors to which the power to authorize advances for expenses from time to time has been delegated, so long as (1) the committee was appointed by a majority vote of directors who were, at the time of appointment of the committee, qualified directors and (2) each advance is authorized by a majority vote of members of the committee who, at the time of the vote, are qualified directors.

Under subsection (c)(1)(ii), which is available only if subsection (c)(1)(i) is not available, the board's action must be taken in accordance with section 8.20 or section 8.21, as the case may be, and directors who are not qualified directors may participate in the vote. Allowing directors who at the time are not qualified directors to participate in the authorization decision, if there is no or only one qualified director, is a principle of prudence that is based on the concept that, if there are not at least two qualified directors, then it is preferable to return the power to make the decision to the full board (even though it includes nonqualified directors) than to leave it with one qualified director.

Illustration 1: The board consists of 15 directors, four of whom are nonqualified directors. Of the 11 qualified directors, nine are present at the meeting at which the authorization is to be made (or the committee is to be appointed). Under subsection (c)(1)(i), a quorum is present and at least six of the nine qualified directors present at the board meeting must authorize any advance for expenses because six is an absolute majority of the 11 qualified directors. Alternatively, six of the nine qualified directors present at the board meeting may appoint a committee of two or more of the qualified directors (up to all 11) to decide whether to authorize the advance. Action by the committee would require an absolute majority of the qualified directors appointed as members.

Illustration 2: The board consists of 15 directors, only one of whom is a qualified director. Subsection (c)(1)(i) is not available because the number of qualified directors is less than two. Accordingly, the decision must be made by the board under subsection (c)(1)(ii) (or, as is always permitted, by the shareholders under subsection (c)(2).

Authorizations by shareholders rather than by directors are permitted by subsection (c)(2), but shares owned by or voted under the control of directors who at the time are not qualified directors may not be voted on the authorizations. This does not affect general rules, as to the required presence of a quorum at the meeting, otherwise governing the authorization.

The fact that there has been an advance for expenses does not determine whether a director is entitled to indemnification. Repayment of any advance is required only if it is ultimately determined that the director did not meet the relevant standard of conduct in section 8.51. A proceeding will often terminate without a judicial or other determination as to whether the director's conduct met that standard. Nevertheless, the board of directors should make, or cause to be made, an affirmative determination of entitlement to indemnification at the conclusion of the proceeding. This decision should be made in accordance with the procedures set forth in section 8.55.

Judicial enforcement of rights granted by or pursuant to section 8.53 is specifically contemplated by section 8.54.

§ 8.54. COURT-ORDERED INDEMNIFICATION AND ADVANCE FOR EXPENSES

(a) A director who is a party to a proceeding because he or she is a director may apply for indemnification or an advance for expenses to the court conducting the proceeding or to another court of competent jurisdiction. After receipt of an application and after giving any notice it considers necessary, the court shall:

(1) order indemnification if the court determines that the director is entitled to mandatory indemnification under section 8.52;

(2) order indemnification or advance for expenses if the court determines that the director is entitled to indemnification or advance for expenses pursuant to a provision authorized by section 8.58(a); or

(3) order indemnification or advance for expenses if the court determines, in view of all the relevant circumstances, that it is fair and reasonable

(i) to indemnify the director, or

(ii) to advance expenses to the director, even if he or she has not met the relevant standard of conduct set forth in section 8.51(a), failed to comply with section 8.53 or was adjudged liable in a proceeding referred to in subsection 8.51(d)(1) or (d)(2), but if the director was adjudged so liable indemnification shall be limited to expenses incurred in connection with the proceeding.

(b) If the court determines that the director is entitled to indemnification under subsection (a)(1) or to indemnification or advance for expenses under subsection (a)(2), it shall also order the corporation to pay the director's expenses incurred in connection with obtaining court-ordered indemnification or advance for expenses. If the court determines that the director is entitled to indemnification or advance for expenses under subsection (a)(3), it may also order the corporation to pay the director's expenses to obtain court-ordered indemnification or advance for expenses.

CROSS-REFERENCES

Advance for expenses, see § 8.53.
"Corporation" defined, see § **8.50(1).**
"Director" defined, see § 8.50(2).
"Expenses" defined, see § 1.40.
Limits on indemnification and advance for expenses, see § 8.58(c).
Mandatory indemnification, see § 8.52.
Obligatory indemnification, see § 8.58(a).
"Party" defined, see § 8.50(5).
Permissible indemnification, see § 8.51.
"Proceeding" defined, see § 8.50(6).

OFFICIAL COMMENT

Section 8.54(a) provides for court-ordered indemnification in three situations:

(1) A director is entitled to mandatory indemnification under section 8.52. If so, the director may enforce that right by judicial proceeding.

(2) A director is entitled to indemnification or advance for expenses pursuant to a provision in the articles or bylaws, board or shareholder resolution, or contract. If so, the director may enforce that right by judicial proceeding. To the extent that these rights are contractual, the corporation may have contractual defenses. If the corporation has contracted to indemnify a director to the fullest extent permitted by law, a court may, nevertheless, deny an advance for expenses if it determines that the director did not have, at the time of delivering the affirmation required by section 8.53(a)(1), a good faith belief that he or she met the relevant standard of conduct.

(3) A court in its discretion determines that it is fair and reasonable under all the relevant circumstances to order an advance for expenses or indemnification for the amount of a settlement or judgment (in addition to expenses), whether or not the director met the relevant standard of conduct in section 8.51 or is otherwise ineligible for indemnification. However, there are two exceptions: an adverse judgment in a derivative proceeding (section 8.51(d)(1)) and an adverse judgment in a proceeding charging receipt of an improper financial benefit (section 8.51(d)(2)), although in either case the court may order payment of expenses. Thus, with these exceptions, section 8.54(a)(3) permits a court to order indemnification for amounts paid in settlement of and expenses incurred in connection with a derivative proceeding or a proceeding charging receipt of an improper financial benefit. Section 8.54(a)(3) applies to (a) a situation in which a provision in the articles of incorporation, bylaws, resolution, or contract obligates the corporation to indemnify or to advance expenses but the relevant standard of conduct has not been met and (b) a situation involving a permissive provision pursuant to which the board declines to exercise its authority to indemnify or to advance expenses. However, in determining whether indemnification or expense advance would be "fair and reasonable," a court should give appropriate deference to an informed decision of a board or committee made in good faith and based upon full information. Ordinarily, a court should not determine that it is "fair and reasonable" to order indemnification or expense advance where the director has not met conditions and procedures to which he or she agreed.

The discretionary authority of the court to order indemnification of a derivative proceeding settlement under section 8.54(a)(3) contrasts with the denial of similar authority under section 145(b) of the Delaware General Corporation Law. A director seeking court-ordered indemnification or expense advance under section 8.54(a)(3) must show that there are facts peculiar to his or her situation that make it fair and reasonable to both the corporation and to the director to override an intracorporate declination or any otherwise applicable statutory prohibition against indemnification, e.g., sections 8.5 1(a) or (d).

Aside from the two exceptions noted above and other than the fairness and reasonableness requirement, there are no statutory outer limits on the court's power to order indemnification under section 8.54(a)(3). In an appropriate case, a court may wish to refer to the provisions of section 2.02(b)(4) establishing the outer limits of a liability-limiting charter provision. It would be an extraordinary situation in which a court would want to provide indemnification going beyond the limits of section 2.02(b)(4), but if the court, as the independent decision-maker, finds that it is "fair and reasonable' then the court is permitted to do so. It should be emphasized again, however, that the director seeking indemnification must make a showing of fairness and reasonableness and that exercise of the power granted by section 8.54(a)(3) is committed to the court's discretion.

Among the factors a court may want to consider are the gravity of the offense, the financial impact upon the corporation, the occurrence of a change in control or, in the case of an advance for expenses, the inability of the director to finance a defense. A court may want to give special attention to certain other issues. First, has the corporation joined in the application to the court for indemnification or an advance for expenses? This factor may be particularly important where under section 8.51(d) indemnification is not permitted for an amount paid in settlement of a proceeding brought by or in the right of the corporation. Second, in a case where indemnification would have been available under section 8.51(a) (2) if the corporation had adopted a provision authorized by section 2.02(b)(5), was the decision to adopt such a provision presented to and rejected by the shareholders and, if not, would exculpation of the director's conduct have resulted under a section 2.02(b)(4) provision? Third, in connection with considering indemnification for expenses under section 8.51(d)(2) in a proceeding in which a director was adjudged liable for receiving a financial benefit to which he or she was not entitled, was such financial benefit insubstantial-particularly in relation to the other aspects of the transaction involved-and what was the degree of the director's involvement in the transaction and the decision to participate?

Under section 8.54(b), if a director successfully sues to enforce the right to indemnification of expenses under subsection (a)(1) or to indemnification or advance for expenses under subsection (a)(2), then the court must order the corporation to pay the director's expenses in the enforcement proceeding. However, if a director successfully sues for indemnification or advance for expenses under subsection (a)(3), then the court may (but is not required to) order the corporation to pay the director's expenses in the proceeding under subsection (a)(3). The basis for the distinction is that the corporation breached its obligation in the first two cases but not in the third.

Application for indemnification under section 8.54 may be made either to the court in which the proceeding was heard or to another court of appropriate jurisdiction. For example, a defendant in a criminal proceeding who has been convicted but believes that indemnification would be proper could apply either to the court which heard the criminal proceeding or bring an action against the corporation in another forum.

A decision by the board of directors not to oppose the request for indemnification is governed by the general standards of conduct of section 8.30. Even if the corporation decided not to oppose the request, the court must satisfy itself that the person seeking indemnification is deserving of receiving it under section 8.54.

As provided in section 8.5 8(c), a corporation may limit the rights of a director under section 8.54 by a provision in its articles of incorporation. In the absence of such a provision, the court has general power to exercise the authority granted under this section.

§ **8.55. DETERMINATION AND AUTHORIZATION OF INDEMNIFICATION**

(a) A corporation may not indemnify a director under section 8.51 unless authorized for a specific proceeding after a determination has been made that indemnification is permissible because the director has met the relevant standard of conduct set forth in section 8.51.

(b) The determination shall be made:

(1) if there are two or more qualified directors, by the board of directors by a majority vote of all the qualified directors (a majority of whom shall for such purpose constitute a quorum), or by a majority of the members of a committee of two or more qualified directors appointed by such a vote;

(2) by special legal counsel:

(i) selected in the manner prescribed in subdivision (1); or

(ii) if there are fewer than two qualified directors, selected by the board of directors (in which selection directors who are not qualified directors may participate); or

(3) by the shareholders, but shares owned by or voted under the control of a director who at the time is not a qualified director may not be voted on the determination.

(c) Authorization of indemnification shall be made in the same manner as the determination that indemnification is permissible except that if there are fewer than two qualified directors, or if the determination is made by special legal counsel, authorization of indemnification shall be made by those entitled to select special legal counsel under subsection (b)(2)(ii).

CROSS-REFERENCES

Advance for expenses, see **§** 8.53.
Committees of the board, see **§** 8.25.
"Corporation" defined, see **§** 8.50(1).
"Director" defined, see **§** 8.50(2).
"Party" defined, see **§** 8.50(5).
"Proceeding" defined, see **§** 8.50(6).
"Qualified director" defined, see **§** 1.43.
Quorum of directors, see **§** 8.24(a).
Standard for indemnification, see **§** 8.51.

OFFICIAL COMMENT

Section 8.55 provides the method for determining whether a corporation should indemnify a director under section 8.51. In this section a distinction is made between a "determination" and an "authorization' A "determination" involves a decision whether under the circumstances the person seeking indemnification has met the relevant standard of conduct under section 8.51 and is therefore eligible for indemnification. This decision may be made by the individuals or groups described in section 8.55(b). In addition, after a favorable "determination" has been made, the corporation must decide whether to "authorize" indemnification except to the extent that an obligatory provision under section 8.58(a) is applicable. This decision includes a review of the reasonableness of the expenses, the financial ability of the corporation to make the payment, and the judgment whether the limited financial resources of the corporation should be devoted to this or some other use. While special legal counsel may make the "determination" of eligibility for indemnification, counsel may not "authorize" the indemnification. A pre-existing obligation under section 8.58(a) to indemnify if the director is eligible for indemnification dispenses with the second-step decision to "authorize" indemnification.

Section 8.55(b) establishes procedures for selecting the person or persons who will make the determination of permissibility of indemnification. As indicated in the Official Comment to section 8.53(c), the committee of qualified directors referred to in subsection (b) (1) may include a committee of the board to which has been delegated the power to determine whether to indemnify a director so long as the appointment and composition of the committee members comply with subsection (b)(1). In selecting special legal counsel under subsection (b)(2), directors who are parties to the proceeding may participate in the decision if there are insufficient qualified directors to satisfy subsection (b)(l). Directors who are not eligible to act as qualified directors may also participate in the decision to "authorize" indemnification on the basis of a favorable "determination" if necessary to permit action by the board of directors. The authorization of indemnification is the decision that results in payment of any amounts to be indemnified. This limited participation of interested directors in the authorization decision is justified by the principle of necessity.

Under subsection (b) (1), the vote required when the qualified directors act as a group is an absolute majority of their number. A majority of the qualified directors constitutes a quorum for board action for this purpose. If there are not at least two qualified directors, then the determination of entitlement to indemnification must be made by special legal counsel or by the shareholders.

Legal counsel authorized to make the required determination is referred to as "special legal counsel." In earlier versions of the Model Act, and in the statutes of many states, reference is made to "independent" legal counsel. The word "special" is felt to be more descriptive of the role to be performed; it is intended that the counsel selected should be independent in accordance with governing legal precepts. "Special legal counsel" normally should be counsel having no prior professional relationship with those seeking indemnification, should be retained for the specific purpose, and should not be or have been either inside counsel or regular outside counsel to the corporation. Special legal counsel also should not have any familial, financial or other relationship with any of those seeking indemnification that would, in the circumstances, reasonably be expected to exert an influence on counsel in making the determination. It is important that the process be sufficiently flexible to permit selection of counsel in light of the particular circumstances and so that unnecessary expense may be avoided. Hence the phrase "special legal counsel" is not defined in the statute.

Determinations by shareholders, rather than by directors or special legal counsel, are permitted by subsection (b)(3), but shares owned by or voted under the control of directors who at the time are not qualified directors may not be voted on the determination of eligibility for indemnification. This does not affect general rules as to the required presence of a quorum at the meeting in order for the determination to be made.

Section 8.55 is subject to section 8.58(a), which authorizes an arrangement obligating the corporation in advance to provide indemnification or to advance expenses.

§ **8.56. INDEMNIFICATION OF OFFICERS**

(a) A corporation may indemnify and advance expenses under this subchapter to an officer of the corporation who is a party to a proceeding because he or she is an officer of the corporation

(1) to the same extent as a director; and

(2) if he or she is an officer but not a director, to such further extent as may be provided by the articles of incorporation, the bylaws, a resolution of the board of directors, or contract except for

(A) liability in connection with a proceeding by or in the right of the corporation other than for expenses incurred in connection with the proceeding or

(B) liability arising out of conduct that constitutes

(i) receipt by the officer of a financial benefit to which he or she is not entitled,

(ii) an intentional infliction of harm on the corporation or the shareholders, or

(iii) an intentional violation of criminal law.

(b) The provisions of subsection (a)(2) shall apply to an officer who is also a director if the basis on which he or she is made a party to the proceeding is an act or omission solely as an officer.

(c) An officer of a corporation who is not a director is entitled to mandatory indemnification under section 8.52, and may apply to a court under section 8.54 for indemnification or an advance for expenses, in each case to the same extent to which a director may be entitled to indemnification or advance for expenses under those provisions.

CROSS-REFERENCES

Advance for expenses, see § 8.53.
Agents, indemnification of and advance for expenses for, see § 8.58(e).
Articles of incorporation, see § 2.02, ch. 10A.
Bylaws, see § 2.06, ch. 10B.
"Corporation" defined, see § 8.50(1).
"Director" defined, see § 8.50(2).
Employees, indemnification of and advance for expenses for, see § 8.58(e).
"Expenses" defined, see § 1.40.
"Liability" defined, see § 8.50(5).
Limits on rights to indemnification and advance for expenses, see § 8.58(c).
Obligatory indemnification, see § § 2.02(b) (5), 8.58(a).
"Officer" defined, see § 8.50(2).
Officer standards of conduct, see § 8.42.
"Party" defined, see § 8.50(5).
"Proceeding" defined, see § 8.50(6).

OFFICIAL COMMENT

Section 8.56 correlates the general legal principles relating to the indemnification of officers of the corporation with the limitations on indemnification in subchapter E. This correlation may be summarized in general terms as follows.

(1) An officer of a corporation who is *not* a director may be indemnified by the corporation on a discretionary basis to the same extent as though he or she were a director, and, in addition, may have additional indemnification rights apart from subchapter E, but the outer limits of such rights are specified. See sections 8.56(a)(2) and (c).

(2) An officer who is *also* a director of the corporation is entitled to the indemnification rights of a director and of an officer who is not a director (see preceding paragraph) if the conduct that is the subject of the proceeding was solely in his or her capacity as an officer. See section 8.56(b).

(3) An *officer* of a corporation who is not a director has the right of mandatory indemnification granted to directors under section 8.52 and the right to apply for court-ordered indemnification under section 8.54. See section 8.56(c).

Section 8.56 does not deal with indemnification of employees and agents because the concerns of self-dealing that arise when directors provide for their own indemnification and expense advance (and sometimes for senior executive officers) are not present when directors (or officers) provide for indemnification and expense advance for employees and agents who are not directors or officers. Moreover, the rights of employees and agents to indemnification and advance for expenses derive from principles of agency, the doctrine of *respondeat superior*, collective bargaining or other contractual arrangements rather than from a corporation statute. It would be presumptuous for a corporation statute to seek to limit the indemnification bargain that a corporation may wish to make with those it hires or retains. The same standard applicable to directors and officers may not be appropriate for office workers and hazardous waste workers, brokers and custodians, engineers and farm workers. None of their roles or responsibilities are prescribed by the Model Act.

Section 3.02 grants broad powers to corporations, including powers to make contracts, appoint and fix the compensation of employees and agents and to make payments furthering the business and affairs of the corporation. Many corporations provide for the exercise of these powers in the same provisions in the articles, bylaws or otherwise in which they provide for expense advance and indemnification for directors and officers.

Indemnification may also be provided to protect employees or agents from liabilities incurred while serving at a corporation's request as a director, officer, partner, trustee, or agent of another commercial, charitable, or nonprofit venture.

Although employees and agents are not covered by subchapter E, the principles and procedures set forth in the subchapter for indemnification and advance for expenses for directors and officers may be helpful to counsel and courts in dealing with indemnification and expense advance for employees and agents. Careful consideration should be given to extending mandatory maximum indemnification and expense advance to employees and agents. The same considerations that may favor mandatory maximum indemnification for directors and officers--*e.g.* encouraging qualified individuals to serve-may not be present in the cases of employees and agents. Many corporations may prefer to retain the discretion to decide, on a case-by-case basis, whether to indemnify and advance expenses to employees and agents (and perhaps even officers, especially nonexecutive officers) rather than binding themselves in advance to do so.

1. Officers Who Are Not Directors

While section 8.56 does not prescribe the standards governing the rights of officers to indemnification, subsection (a) does set outer limits beyond which the corporation may not indemnify. These outer limits for officers (see subsection (a)(2)) are substantially the same as the outer limits on the corporation's power to indemnify directors: (i) in a proceeding by or in the right of the corporation, indemnification is not allowed other than for reasonable expenses incurred in connection therewith and (ii) in any proceeding, indemnification is not allowed in those situations in which directors' liability to the corporation or its shareholders could not be eliminated by a provision included in the articles pursuant to section 2.02(b)(4), i.e., where there has been receipt of a financial benefit to which the officer is not entitled, intentional infliction of harm on the corporation or shareholders or intentional violation of criminal law. Since officers are held to substantially the same standards of conduct as directors (see section 8.42), there does not appear to be any reasoned basis for granting officers greater indemnification rights as a substantive matter. Procedurally, however, there is an important difference. To permit greater flexibility, officers may be indemnified (within the above-mentioned outer limits) with respect to conduct that does not meet the standards set by section 8.51(a)(1) simply by authorization of the board of directors, whereas directors' indemnification can reach beyond those standards, as contemplated by section 8.51(a) (2), only with a shareholder-approved provision included in the articles pursuant to section 2.02(b)(5). This procedural difference reflects the reduced risk of self-dealing as to officers.

Section 8.56(c) grants nondirector officers the same rights to mandatory indemnification under section 8.52 and to apply to a court for indemnification under section 8.54 as are granted to directors. Since their substantive rights to indemnification are essentially the same as those of directors, it is appropriate to grant officers the same affirmative procedural rights to judicial relief as are provided to directors.

The broad authority in section 8.56(a)(2) to grant indemnification may be limited by appropriate provisions in the articles of incorporation. See section 8.58(c).

2. Officers Who Are Also Directors

Subsection (b) provides, in effect, that an officer of the corporation who is also a director is subject to the same standards of indemnification as other directors and cannot avail himself of the provisions of subsection (a) unless the person can establish that the act or omission that is the subject of the proceeding was committed solely in his or her capacity as officer. Thus, a vice president for sales who is also a director and whose actions failed to meet section 8.51(a) standards could be indemnified provided that the conduct was within the outer limits of subsection (a)(2) and involved only his or her officer capacity.

This more flexible approach for situations where the individual is not acting as a director seems appropriate as a matter of fairness. There are many instances where officers who also serve as directors assume responsibilities and take actions in their nondirector capacities. It is hard to justify a denial of indemnification to an officer who failed to meet a standard applicable only to directors when the officer can establish that he did not act as a director. Nor are there likely to be complications or difficulties because some directors are treated differently than others where the high burden of proof-solely as officer-is met. Obviously, the burden will be especially difficult to meet where the roles of officer and director are closely intertwined, as is often the case with a chief executive officer.

For a director-officer to be indemnified under section 8.51 for conduct in the capacity as a director when he or she has not satisfied the standards of section 8.51(a), a provision in the articles under section 2.02(b)(5) is required. If such a provision is included in the articles, the standards for indemnification are those specified in section 2.02(b)(5). For a director-officer to be indemnified for conduct solely in the capacity as an officer, even though the director officer has not satisfied the standards of section 8.56(a), only a resolution of the board authorizing such indemnification is required, rather than a provision in the articles. If such a resolution is adopted, the standards for indemnification are those specified in subsection (a)(2). However, when a director-officer seeks indemnification or expense advance under subsections (b) and (a)(2) on the basis of having acted solely in the capacity as an officer, indemnification or expense advance must be approved through the same procedures as set forth in sections 8.55 or 8.53(c), as the case may be, for approval of indemnification or expense advance for a director when acting in the capacity of a director.

§ 8.57. INSURANCE

A corporation may purchase and maintain insurance on behalf of an individual who is a director or officer of the corporation, or who, while a director or officer of the corporation, serves at the corporation's request as a director, officer, partner, trustee, employee, or agent of another domestic or foreign corporation, partnership, joint venture, trust, employee benefit plan, or other entity, against liability asserted against or incurred by the individual in that capacity or arising from his or her status as a director or officer, whether or not the corporation would have power to indemnify or advance expenses to the individual against the same liability under this subchapter.

CROSS-REFERENCES

"Corporation" defined, see **§** 8.50(1).
"Director" defined, see **§** 8.50(2).
Employees and agents, see **§** 8.58(e).
"Expenses" defined, see **§** 1.40(9AA).
"Liability" defined, see **§** 8.50(3).
"Officer" defined, see **§** 8.50(2).
"Official capacity" defined, see **§** 8.50(4).
Standard for indemnification, see **§** 8.51.

OFFICIAL COMMENT

Section 8.57 authorizes a corporation to purchase and maintain insurance on behalf of directors and officers against liabilities imposed on them by reason of actions in their official capacity, or their status as such, or arising from their service to the corporation or another entity at the corporation's request. Insurance is not limited to claims against which a corporation is entitled to indemnify under this subchapter. This insurance, usually referred to as "D&O liability insurance," provides protection to directors and officers in addition to the rights of indemnification created by or pursuant to this subchapter (as well as typically protecting the individual insureds against the corporation's failure to pay indemnification required or permitted by this subchapter) and provides a source of reimbursement for corporations which indemnify directors and others for conduct covered by the insurance. On the other hand, policies typically do not cover uninsurable matters, such as actions involving dishonesty, self-dealing, bad faith, knowing violations of the securities acts, or other willful misconduct. Johnston, "Corporate Indemnification and Liability Insurance for Directors and Officers," 33 Bus. LAW. 1993, 2024-29 (1978). See also Knepper & *Bailey, Liability of Corporate Officers and Directors,* section 21.07 (4th ed. 1988).

Although this section does not include employees and agents for the reasons stated in the Official Comment to section 8.56, the corporation has the power under section 3.02 to purchase and maintain insurance on their behalf. This power is confirmed in section 8.58(d).

This section is not intended to set the outer limits on the type of insurance which a corporation may maintain or the persons to be covered. Rather, it is included to remove "any doubt as to the power to carry insurance and to maintain it on behalf of directors, officers, employees and agents." Sebring, "Recent Legislative Changes in the Law of Indemnification of Directors, Officers and Others," 23 Bus. LAW. 95, 106 (1967).

§ **8.58. VARIATION BY CORPORATE ACTION; APPLICATION OF SUBCHAPTER**

(a) A corporation may, by a provision in its articles of incorporation or bylaws or in a resolution adopted or a contract approved by its board of directors or shareholders, obligate itself in advance of the act or omission giving rise to a proceeding to provide indemnification in accordance with section 8.51 or advance funds to pay for or reimburse expenses in accordance with section 8.53. Any such obligatory provision shall be deemed to satisfy the requirements for authorization referred to in section 8.53(c) and in section 8.55(c). Any such provision that obligates the corporation to provide indemnification to the fullest extent permitted by law shall be deemed to obligate the corporation to advance funds to pay for or reimburse expenses in accordance with section 8.53 to the fullest extent permitted by law, unless the provision specifically provides otherwise.

(b) Any provision pursuant to subsection (a) shall not obligate the corporation to indemnify or advance expenses to a director of a predecessor of the corporation, pertaining to conduct with respect to the predecessor, unless otherwise specifically provided. Any provision for indemnification or advance for expenses in the articles of incorporation, bylaws, or a resolution of the board of directors or shareholders of a predecessor of the corporation in a merger or in a contract to which the predecessor is a party, existing at the time the merger takes effect, shall be governed by section 11.07(a) (4).

(c) A corporation may, by a provision in its articles of incorporation, limit any of the rights to indemnification or advance for expenses created by or pursuant to this subchapter.

(d) This subchapter does not limit a corporation's power to pay or reimburse expenses incurred by a director or an officer in connection with appearing as a witness in a proceeding at a time when he or she is not a party.

(e) This subchapter does not limit a corporation's power to indemnify, advance expenses to or provide or maintain insurance on behalf of an employee or agent.

CROSS-REFERENCES

Advance for expenses, see **§** 8.53.
Articles of incorporation, see **§** 2.02, ch. 10A.
Amendments to articles of incorporation, see **§** 10.09.
Bylaws, see **§** 2.06, ch. 10B.

"Corporation" defined, see **§** 8.50(1).
"Director" defined, see **§** 8.50(2).
"Expenses" defined, see **§** 1.40.
Indemnification generally, see **§** 8.51-8.56.
Insurance, power to provide, see **§** 8.57.
"Officer" defined, see **§** 8.50(2).
"Party" defined, see **§** 8.50(5).
Predecessor, see **§** 8.50(1).
"Proceeding" defined, see **§** 8.50(6).

OFFICIAL COMMENT

Section 8.58(a) authorizes a corporation to make obligatory the permissive provisions of subchapter E in advance of the conduct giving rise to the request for assistance. Many corporations have adopted such provisions, often with shareholder approval. An obligatory provision satisfies the requirements for authorization in subsection (c) of sections 8.53 and 8.55, but compliance would still be required with subsections (a) and (b) of these sections.

Section 8.58(a) further provides that a provision requiring indemnification to the fullest extent permitted by law shall be deemed, absent an express statement to the contrary, to include an obligation to advance expenses under section 8.53. This provision of the statute is intended to avoid a decision such as *that of the Delaware Supreme Court in Advanced Mining Systems, Inc. v. Fricke,* 623 A.2d 82 (Del. 1992). If a corporation provides for obligatory indemnification and not for obligatory advance for expenses, the provision should be reviewed to ensure that it properly reflects the intent in light of the third sentence of section 8.58(a). Also, a corporation should consider whether obligatory expense advance is intended for direct suits by the corporation as well as for derivative suits by shareholders in the right of the corporation. In the former case, assuming compliance with subsections (a) and (b) of section 8.53, the corporation could be required to fund the defense of a defendant director even where the board of directors has already concluded that the director has engaged in significant wrongdoing. See Official Comment to section 8.53.

Section 8.58(b) provides that an obligatory indemnification provision as authorized by subsection (a) does not, unless specific provision is made to the contrary, bind the corporation with respect to a predecessor. An obligatory indemnification provision of a predecessor is treated as a liability (to the extent it is one) under section 1 1.07(a)(4), which governs the effect of a merger.

Section 8.58(c) permits a corporation to limit the right of the corporation to indemnify or advance expenses by a provision in its articles of incorporation. As provided in section 10.09, no such limitation will affect rights in existence when the provision becomes effective pursuant to section 1.23.

Section 8.58(d) makes clear that subchapter E deals only with actual or threatened defendants or respondents in a proceeding, and that expenses incurred by a director in connection with appearance as a witness may be indemnified without regard to the limitations of subchapter E. Indeed, most of the standards described in sections 8.51 and 8.54(a) by their own terms can have no meaningful application to a director whose only connection with a proceeding is that he or she has been called as a witness.

Subchapter E does not regulate the power of the corporation to indemnify or advance expenses to employees and agents. That subject is governed by the law of agency and related principles and frequently by contractual arrangements between the corporation and the employee or agent. Section 8.58(e) makes clear that, while indemnification, advance for expenses, and insurance for employees and agents are beyond the scope of this subchapter, the elaboration in subchapter E of standards and procedures for indemnification, expense advance, and insurance for directors and officers is not in any way intended to cast doubt on the power of the corporation to indemnify or advance expenses to or purchase and maintain insurance for employees and agents under section 3.02 or otherwise.

§ **8.59. EXCLUSIVITY OF SUBCHAPTER**

A corporation may provide indemnification or advance expenses to a director or an officer only as permitted by this subchapter.

CROSS-REFERENCES

Advance for expenses, see § 8.53.
"Corporation" defined, see § 8.50(1).
"Director" defined, see § 8.50(2).
"Expenses" defined, see § 1.40.
"Officer" defined, see § 8.50(2).
Standards for indemnification, see § 8.51-8.56.

OFFICIAL COMMENT

This subchapter is the exclusive source for the power of a corporation to indemnify or advance expenses to a director or an officer.

Section 8.59 does not preclude provisions in articles of incorporation, bylaws, resolutions, or contracts designed to provide procedural machinery in addition to (but not inconsistent with) that provided by this subchapter. For example, a corporation may properly obligate the board of directors to consider and act expeditiously on an application for indemnification or advance for expenses or to cooperate in the procedural steps required to obtain a judicial determination under section 8.54.

Subchapter F.

DIRECTORS' CONFLICTING INTEREST TRANSACTIONS

1. Purposes and Special Characteristics of Subchapter F

The common law, drawing by analogy on the fiduciary principles of the law of trusts, initially took the position that any transaction between a corporation and a director of that corporation was contaminated by the director's conflicting interest, that the transaction was null and void or at least voidable and, suggesting by implication, that the interested director who benefited from the transaction could be required to disgorge any profits and be held liable for any damages.

Eventually, it was perceived that a flat void/voidable rule could work against a corporation's best interests. Although self-interested transactions carry a potential for injury to the corporation, they also carry a potential for benefit. A director who is self-interested may nevertheless act fairly, and there may be cases where a director either owns a unique asset that the corporation needs or is willing to offer the corporation more favorable terms than are available on the market (for example, where the director is more confident of the corporation's financial ability to perform than a third person would be). Accordingly, the courts dropped the flat void/voidable rule, and substituted in its stead the rule that a self-interested transaction will be upheld if the director shoulders the burden of showing that the transaction was fair.

Later still, the Model Act and the state legislatures entered the picture by adopting statutory provisions that sheltered the transaction from any challenge that the transaction was void or voidable where it was approved by disinterested directors or shareholders. Until 1989, the successive Model Act provisions concerning director conflict-of-interest transactions and the statutory provisions in force in most states reflected basically the same objective; that is, their safe harbor procedures concentrated on protection for the transaction, with no attention given to the possible vulnerability of the director whose conflicting interest would give rise to the transaction's potential challenge. However, in 1989 the relevant provisions were significantly reworked in subchapter F of Chapter 8. Four basic elements in the architecture of the 1989 version of subchapter F distinguished the approach of the subchapter from most other statutory provisions of the time.

First, most other statutory provisions did not define what constituted a director's conflict-of-interest transaction. In contrast, subchapter F defined, with bright-line rules, the transactions that were to be treated as director's conflict of-interest transactions.

Second, because most other statutory provisions did not define what constitutes a director's conflict-of-interest transaction, they left open how to deal with transactions that involved only a relatively minor conflict. In contrast, subchapter F explicitly provided that a director's transaction that was not within the statutory definition of a director's conflict of interest transaction was not subject to judicial review for fairness on the ground that it involved a conflict of interest (although circumstances that fall outside the statutory definition could, of course, afford the basis for a legal attack on the transaction on some other ground), even if the transaction involved some sort of conflict lying outside the statutory definition, such as a remote familial relationship.

Third, subchapter F made explicit, as many other statutory provisions did not, that if a director's conflict-of-interest transaction, as defined, was properly approved by disinterested (or "qualified") directors or shareholders, the transaction was thereby insulated from judicial review for fairness (although, again, it might be open to attack on some basis other than the conflict).

Fourth, subchapter F also made explicit, as no other statutory provisions had done, that if a director's conflict-of-interest transaction, as defined, was properly approved by disinterested (or "qualified") directors or shareholders, the conflicted director could not be subject to an award of damages or other sanctions with respect thereto (although the director could be subject to claims on some basis other than the conflict).

Bright-line provisions of any kind represent a trade-off between the benefits of certainty, and the danger that some transactions or conduct that fall outside the area circumscribed by the bright-lines may be so similar to the transactions and conduct that fall within the area that different treatment may seem anomalous. Subchapter F reflected the considered judgment that in corporate matters, where planning is critical, the clear and important efficiency gains that result from certainty through defining director's conflict-of-interest transactions clearly exceeded any potential and uncertain efficiency losses that might occasionally follow from excluding other director's transactions from judicial review for fairness on conflict-of-interest grounds.

The 2004 revisions of subchapter F rest on the same basic judgment that animated the original subchapter. Accordingly, the revisions made do not alter the fundamental elements and approach of the subchapter. However, the revisions refine the definition of director's conflict-of-interest transactions, simplify the text of the statute, and, within the basic approach of the original subchapter, make various clarifying and substantive changes throughout the text and comments. One of these substantive changes expands the category of persons whose interest in a transaction will be attributed to the director for purposes of subchapter F. At the same time, the revisions delete coverage of a director's interest that lies outside the transaction itself but might be deemed to be "closely related to the transaction." The latter phraseology was determined to be excessively vague and unhelpful. In combination, these revisions clarify the coverage of subchapter F, while ensuring that a transaction that poses a significant risk of adversely affecting a director's judgment will not escape statutory coverage.

2. *Scope of Subchapter F*

The focus of subchapter F is sharply defined and limited.

First, the subchapter is targeted on legal challenges based on interest conflicts only. Subchapter F does not undertake to define, regulate, or provide any form of procedure regarding other possible claims. For example, subchapter F does not address a claim that a controlling shareholder has violated a duty owed to the corporation or minority shareholders.

Second, subchapter F does not shield misbehavior by a director or other person that is actionable under other provisions of the Model Act, such as section 8.31, or under other legal rules, regardless of whether the misbehavior is incident to a transaction with the corporation and regardless of whether the rule is one of corporate law.

Third, subchapter F does not preclude the assertion of defenses, such as statute of limitations or failure of a condition precedent, that are based on grounds other than a director's conflicting interest in the transaction.

Fourth, the subchapter is applicable only when there is a "transaction" by or with the corporation. For purposes of subchapter F, "transaction" generally connotes negotiations or consensual arrangements between the corporation and another party or parties that concern their respective and differing economic rights or interests-not simply a unilateral action by the corporation or a director, but rather a "deal." 'Whether safe harbor procedures of some kind might be available to the director and the corporation with respect to nontransactional matters is discussed in numbered paragraph 4 of this Introductory Comment.

Fifth, subchapter F deals with directors only. Correspondingly, subchapter F does not deal with controlling shareholders in their capacity as such. If a corporation is wholly owned by a parent corporation or other person, there are no outside shareholders who might be injured as a result of transactions entered into between the corporation and the owner of its shares. However, transactions between a corporation and a parent corporation or other controlling shareholder who owns less than all of its shares may give rise to the possibility of abuse of power by the controlling shareholder. Subchapter F does not speak to proceedings brought on that basis because section 8.61 concerns only proceedings that are brought on the ground that a "director has an interest respecting the transaction."

Sixth, it is important to stress that the voting procedures and conduct standards prescribed in subchapter F deal solely with the complicating element presented by the director's conflicting interest. A transaction that receives favorable directors' or shareholders' action complying with subchapter F may still fail to satisfy a different quorum requirement or to achieve a different vote that may be needed for substantive approval of the transaction under other applicable statutory provisions or under the articles of incorporation, and vice versa. (Under the Model Act, latitude is granted for setting higher voting requirements and different quorum requirements in the articles of incorporation. See sections 2.02(b)(2) and 7.27.)

Seventh, a few corporate transactions or arrangements in which directors inherently have a special personal interest are of a unique character and are regulated by special procedural provisions of the Model Act. See sections 8.51 and 8.52 dealing with indemnification arrangements, section 7.44 dealing with termination of derivative proceedings by board action and section 8.11 dealing with directors' compensation. Any corporate transactions or arrangements affecting directors that are governed by such regulatory sections of the Act are not governed by subchapter F.

3. *Structure of Subchapter F*

Subchapter F has only four parts. Definitions are in section 8.60. Section 8.61 prescribes what a court may or may not do in various situations. Section 8.62 prescribes procedures for action by boards of directors or duly authorized committees regarding a director's conflicting interest transaction. Section 8.63 prescribes corresponding procedures for shareholders. Thus, the most important operative section of the subchapter is section 8.61.

4. *Nontransactional Situations Involving Interest Conflicts*

Many situations arise in which a director's personal economic interest is or may be adverse to the economic interest of the corporation, but which do not entail a "transaction" by or with the corporation. How does the subchapter bear upon those situations?

CORPORATE OPPORTUNITY

The corporate opportunity doctrine is anchored in a significant body of case law clustering around the core question whether the corporation has a legitimate interest in a business opportunity, either because of the nature of the opportunity or the way in which the opportunity came to the director, of such a nature that the corporation should be afforded prior access to the opportunity before it is pursued (or, to use the case law's phrase, "usurped") by a director. Because judicial determinations in this area often seem to be driven by the particular facts of a case, outcomes are often difficult to predict.

The subchapter, as such, does not apply by its terms to corporate or business opportunities since no transaction between the corporation and the director is involved in the taking of an opportunity. However, new subchapter G of chapter 8 of the Model Act provides, in effect, that the safe harbor procedures of section 8.62 or 8.63 may be employed, at the interested director's election, to protect the taking of a business opportunity that might be challenged under the doctrine. Otherwise, subchapter F has no bearing on enterprise rights or director obligations under the corporate opportunity doctrine.

OTHER SITUATIONS

Many other kinds of situations can give rise to a clash of economic interests between a director and the corporation. For example, a director's personal financial interests can be impacted by a nontransactional policy decision of the board, such as where it decides to establish a divisional headquarters in the director's small hometown. In other situations, simple inaction by a board might work to a director's personal advantage, or a flow of ongoing business relationships between a director and that director's corporation may, without centering upon any discrete "transaction," raise questions of possible favoritism, unfair dealing, or undue influence. If a director decides to engage in business activity that directly competes with the corporation's own business, the economic interest in that competing activity ordinarily will conflict with the best interests of the corporation and put in issue the breach of the director's duties to the corporation. Basic conflicts and improprieties can also arise out of a director's personal appropriation of corporate assets or improper use of corporate proprietary or inside information.

The circumstances in which such nontransactional conflict situations should be brought to the board or shareholders for clearance, and the legal effect, if any, of such clearance, are matters for development under the common law and lie outside the ambit of subchapter F. 'While these nontransactional situations are unaffected one way or the other by the provisions of subchapter F, a court may well recognize that the subchapter F procedures provide a useful analogy for dealing with such situations. Where similar procedures are followed, the court may, in its discretion, accord to them an effect similar to that provided by subchapter F.

Note on Terms in Comment

In the Official Comments to subchapter F sections, the director who has a conflicting interest is for convenience referred to as "the director" or ″D,” and the corporation of which he or she is a director is referred to as "the corporation" or "X Co." A subsidiary of the corporation is referred to as "S Co." Another corporation dealing with X Co. is referred to as ″Y Co.″

§ 8.60. SUBCHAPTER DEFINITIONS

In this subchapter:

(1) "Director's conflicting interest transaction" means a transaction effected or proposed to be effected by the corporation (or by an entity controlled by the corporation)

(i) to which, at the relevant time, the director is a party; or

(ii) respecting which, at the relevant time, the director had knowledge and a material financial interest known to the director; or

(iii) respecting which, at the relevant time, the director knew that a related person was a party or had a material financial interest.

(2) "Control" (including the term "controlled by") means (i) having the power, directly or indirectly, to elect or remove a majority of the members of the board of directors or other governing body of an entity, whether through the ownership of voting shares or interests, by contract, or otherwise, or (ii) being subject to a majority of the risk of loss from the entity's activities or entitled to receive a majority of the entity's residual returns.

(3) "Relevant time" means (i) the time at which directors' action respecting the transaction is taken in compliance with section 8.62, or (ii) if the transaction is not brought before the board of directors of the corporation (or its committee) for action under section 8.62, at the time the corporation (or an entity controlled by the corporation) becomes legally obligated to consummate the transaction.

(4) "Material financial interest" means a financial interest in a transaction that would reasonably be expected to impair the objectivity of the director's judgment when participating in action on the authorization of the transaction.

(5) "Related person" means:

(i) the director's spouse;

(ii) a child, stepchild, grandchild, parent, step parent, grandparent, sibling, step sibling, half sibling, aunt, uncle, niece or nephew (or spouse of any thereof) of the director or of the director's spouse;

(iii) an individual living in the same home as the director;

(iv) an entity (other than the corporation or an entity controlled by the corporation) controlled by the director or any person specified above in this subdivision (5);

(v) a domestic or foreign (A) business or nonprofit corporation (other than the corporation or an entity controlled by the corporation) of which the director is a director, (B) unincorporated entity of which the director is a general partner or a member of the governing body, or (C) individual, trust or estate for whom or of which the director is a trustee, guardian, personal representative or like fiduciary; or

(vi) a person that is, or an entity that is controlled by, an employer of the director.

(6) "Fair to the corporation" means, for purposes of section 8.61(b)(3), that the transaction as a whole was beneficial to the corporation, taking into appropriate account whether it was (i) fair in terms of the director's dealings with the corporation, and (ii) comparable to what might have been obtainable in an arm's length transaction, given the consideration paid or received by the corporation.

(7) "Required disclosure" means disclosure of (i) the existence and nature of the director's conflicting interest, and (ii) all facts known to the director respecting the subject matter of the transaction that a director free of such conflicting interest would reasonably believe to be material in deciding whether to proceed with the transaction.

CROSS-REFERENCES

Committees of board of directors, see **§** 8.25.
Director action, see **§** 8.20 & 8.21.
"Entity" defined, see **§** 1.40.

Indemnification, see § 8.50-8.59.
"Proceeding" defined, see § 1.40.
Quorum and voting:
by directors, see § 8.24.
by shareholders, see § 7.25-7.27.
Shareholder action, see § 7.0 1-7.04.
Standards of conduct:
officers, see § 8.42.
Vote needed to approve transactions by shareholders:
amendment to articles of incorporation, see § 10.03.
disposition of assets, see § 12.02.generally, see § 7.25 & 7.26.
mergers and share exchanges, see § 11.04.
"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

The definitions set forth in section 8.60 apply only to subchapter F's provisions and, except to the extent relevant to subchapter G, have no application elsewhere in the Model Act. (For the meaning and use of certain terms used below, such as "D," *"X* Go?' and *"Y* Co.' see the Note at the end of the Introductory Comment of subchapter F.)

1. Director's Conflicting Interest Transaction

The definition of "director's conflicting interest transaction" in subdivision (1) is the core concept underlying subchapter F, demarcating the transactional area that lies within-and without-the scope of the subchapter's provisions. The definition operates preclusively in that, as used in section 8.61, it denies the power of a court to invalidate transactions or otherwise to remedy conduct that falls outside the statutory definition of "director's conflicting interest transaction" solely on the ground that the director has a conflict of interest in the transaction. (Nevertheless, as stated in the Introductory Comment, the transaction might be open to attack under rules of law concerning director misbehavior other than rules based solely on the existence of a conflict of interest transaction, as to which subchapter F is preclusive).

A. TRANSACTION

For a director's conflicting interest transaction to arise, there must first be a transaction effected or proposed to be effected by the corporation or an entity controlled by the corporation to which the director or a related person is a party or in which the director or a related person has a material financial interest. As discussed in the Introductory Comment, the provisions of subchapter F do not apply where there is no "transaction" by the corporation-no matter how conflicting the director's interest may be. For example, a corporate opportunity usurped by a director by definition does not involve a transaction by the corporation, and thus is not covered by subchapter F, even though it may be proscribed under fiduciary duty principles.

Moreover, for purposes of subchapter F, "transaction" means (and requires) a bilateral (or multilateral) arrangement to which the corporation or an entity controlled by the corporation is a party. Subchapter F does not apply to transactions to which the corporation is not a party. Thus, a purchase or sale by the director of the corporation's shares on the open market or from or to a third party is not a "director's conflicting interest transaction" within the meaning of subchapter F because the corporation is not a party to the transaction.

B. PARTY TO THE TRANSACTION-THE CORPORATION

In the usual case, the transaction would be effected by X Co. Assume, however, that X Co. controls the vote for directors of S Co. *D* wishes to sell a building *D* owns to X Co. and X Co. is willing to buy it. As a business matter, it makes no difference to X Co. whether it takes the title directly or indirectly through its subsidiary S Co. or some other entity that X Co. controls. The applicability of subchapter F does not depend upon that formal distinction, because the subchapter includes within its operative framework transactions by entities controlled by X Co. Thus, subchapter F would apply to a sale of the building by D to S Co.

C. PARTY TO THE TRANSACTION-THE DIRECTOR OR A RELATED PERSON

To constitute a director's conflicting interest transaction, D (the director identified in the subchapter from time to time as a "conflicted director") must, at the relevant time, (i) be a party to the transaction, or (ii) know of the transaction and D'*s* material financial interest in it, or (iii) know that a related person of D was a party to the transaction or (iv) know that a related person of D has a material financial interest in the transaction. A material financial interest (as defined in subdivision (4)) is one that would reasonably be expected to impair the objectivity of the director's judgment if *D* were to participate in action by the directors (or by a committee thereof) taken on the authorization of the transaction.

Routine business transactions frequently occur between companies with overlapping directors. If X Co. and Y Co. have routine, frequent business dealings whose terms are dictated by competitive market forces, then even if a director of X Co. has a relevant relationship with Y Co., the transactions would almost always be defensible, regardless of approval by disinterested directors or shareholders, on the ground that they are "fair." For example, a common transaction involves a purchase of the corporation's product line by Y Co., or perhaps by D or a related person, at prices normally charged by the corporation. In such circumstances, it usually will not be difficult for D to show that the transaction was on arms-length terms and was fair. Even a purchase by D of a product of X Co. at a usual "employee's discount," while technically assailable as a conflicting interest transaction, would customarily be viewed as a routine incident of the office of director and, thus, "fair" to the corporation.

D can have a conflicting interest in only two ways.

First, a conflicting interest can arise under either subdivision (1)(i) or (ii). This will be the case if, under clause (i), the transaction is between D and X Co. A conflicting interest also will arise under clause (ii) if D is not a party to the transaction, but knows about it and knows that he or she has a material financial interest in it. The personal economic stake of the director must be in the transaction itself-that is, the director's gain must flow directly from the transaction. A remote gain (for example, a future reduction in tax rates in the local community) is not enough to give rise to a conflicting interest under subdivision (1)(ii).

Second, a conflicting interest for D can arise under subdivision (1) (iii) from the involvement in the transaction of a "related person" of D that is either a party to the transaction or has a "material financial interest" in it. "Related person" is defined in subdivision (5).

Circumstances may arise where a director could have a conflicting interest under more than one clause of subdivision (1). For example, if Y Co. is a party to or interested in the transaction with X Co. and Y Co. is a related person of D*,* the matter would be governed by subdivision (1)(iii), but *D* also may have a conflicting interest under subdivision (1) (ii) if D's economic interest in Y Co. is sufficiently material and if the importance of the transaction to Y Co. is sufficiently material.

A director may have relationships and linkages to persons and institutions that are not specified in subdivision (l)(iii). Such relationships and linkages fall outside subchapter F because the categories of persons described in subdivision (1)(iii) constitute the exclusive universe for purposes of subchapter F. For example, in a challenged transaction between X Co. and Y Co., suppose the court confronts the argument that *D* also is a major creditor of *Y* Co. and that creditor status in Y Co. gives D a conflicting interest. The court should rule that *D's* creditor status in Y Co. does not fit any category of subdivision (1); and therefore, the conflict of interest claim must be rejected by reason of section 8.6 1(a). The result would be different if Y Co.'s debt to D were of such economic significance to D that it would either fall under subdivision (1) (ii) or, if it placed Din control of Y Co., it would fall under subdivision (1)(iii) (because Y Co. is a related person of D under subdivision (5)(iv)). To explore the example further, if D is also a shareholder of Y Co., but D does not have a material financial interest in the transaction and does not control Y Co., no director's conflicting interest transaction arises and the transaction cannot be challenged on conflict of interest grounds. To avoid any appearance of impropriety, D, nonetheless, should consider recusal from the other directors' deliberations and voting on the transaction between X Co. and Y Co.

It should be noted that any director's interest in a transaction that meets the criteria of section 8.60(1) is considered a "director's conflicting interest transaction." If the director's interest satisfies those criteria, subchapter F draws no distinction between a director's interest that clashes with the interests of the corporation and a director's interest that coincides with, or is parallel to, or even furthers the interests of the corporation. In any of these cases, if the director's "interest" is present, a "conflict" will exist.

2. Control

The definition of "control" in subdivision (2) contains two independent clauses. The first clause addresses possession of the voting or other power, directly or indirectly, to elect or remove a majority of the members of an entity's governing body. That power can arise, for example, from articles of incorporation or a shareholders' agreement. The second clause addresses the circumstances where a person is (i) subject to a majority of the risk of loss from the entity's activities, or (ii) entitled to receive a majority of the entity's residual returns. The second clause of the definition includes, among other circumstances, complex financial structures that do not have voting interests or a governing body in the traditional sense, such as special purpose entities. Although the definition of "control" operates independently of the accounting rules adopted by the U.S. accounting profession, it is consistent with the relevant generally accepted accounting principle (made effective in 2003) that governs when an entity must be included in consolidated financial statements.

3. Relevant Time

The definition of director's conflicting interest transaction requires that, except where he or she is a party, the director know of the transaction. It also requires that where not a party, the director know of the transaction either at the time it is brought before the corporation's board of directors or, if it is not brought before the corporation's board of directors (or a committee thereof), at the time the corporation (or an entity controlled by the corporation) becomes legally bound to consummate the transaction. Where the director lacks such knowledge, the risk to the corporation that the director's judgment might be improperly influenced, or the risk of unfair dealing by the director, is not present. In a corporation of significant size, routine transactions in the ordinary course of business, which typically involve decision making at lower management levels, normally will not be known to the director and, if that is the case, will be excluded from the "knowledge" requirement of the definition in subdivision (1)(ii) or (iii).

4. Material Financial Interest

The "interest" of a director or a related person in a transaction can be direct or indirect (e.g., as an owner of an entity or a beneficiary of a trust or estate), but it must be financial for there to exist a "director's conflicting interest transaction' Thus, for example, an interest in a transaction between X Co. and a director's alma mater, or any other transaction involving X Co. and a party with which *D* might have emotional involvement but no financial interest, would not give rise to a director's conflicting interest transaction. Moreover, whether a financial interest is material does not turn on any assertion by the possibly conflicted director that the interest in question would not impair his or her objectivity if called upon to vote on the authorization of the transaction. Instead, assuming a court challenge asserting the materiality of the financial interest, the standard calls upon the trier of fact to determine whether the objectivity of a reasonable director in similar circumstances would reasonably be expected to have been impaired by the financial interest when voting on the matter. Thus, the standard is objective, not subjective.

Under subdivision (1)(ii), at the relevant time a director must have knowledge of his or her financial interest in the transaction in addition to knowing about the transaction itself. As a practical matter, a director could not be influenced by a financial interest about which that director had no knowledge. For example, the possibly conflicted director might know about X Co.'s transaction with Y Co., but might not know that his or her money manager recently established a significant position in Y Co. stock for the director's portfolio. In such circumstances, the transaction with *Y* Co. would not give the director a "material financial interest' notwithstanding the portfolio investment's significance. Analytically, if the director did not know about the *Y* Co. portfolio investment, it could not reasonably be expected to impair the objectivity of that director's judgment.

Similarly, under subdivision (l)(iii), a director must know about his or her related person's financial interest in the transaction for the matter to give rise to a "material financial interest" under subdivision (4). If there is such knowledge and "interest" (i.e., the financial interest could be expected to influence the director's judgment), then the matter involves a director's conflicting interest transaction under subdivision (1).

5. Related Person

Six categories of "related person" of the director are set out in subdivision (5). These categories are specific, exclusive and preemptive.

The first three categories involve closely related family, or near-family, individuals as specified in clauses (i) through (iii). The clauses are exclusive insofar as family relationships are concerned and include adoptive relationships. The references to a "spouse" include a common law spouse. Clause (iii) covers personal, as opposed to business, relationships; for example, clause (iii) does not cover a lessee.

Regarding the subcategories of persons described in clause (v) from the perspective of X Co., certain of D's relationships with other entities and D's fiduciary relationships are always a sensitive concern, separate and apart from whether D has a financial interest in the transaction. Clause (v) reflects the policy judgment that D cannot escape D's legal obligation to act in the best interests of another person for whom D has such a relationship and, accordingly, that such a relationship (without regard to any financial interest on D's part) should cause the relevant entity to have "related person" status.

The term "employer" as used in subdivision (5)(vi) is not separately defined but should be interpreted sensibly in light of the purpose of the subdivision. The relevant inquiry is whether *D,* because of an employment relationship with an employer who has a significant stake in the outcome of the transaction, is likely to be influenced to act in the interest of that employer rather than in the interest of X Co.

6. Fair to the Corporation

The term "fair" accords with traditional language in the case law, but for purposes of subchapter F it also has a special meaning. The transaction, viewed as a whole, must have been beneficial to the corporation, in addition to satisfying the traditional "fair price" and "fair dealing" concepts. In determining whether the transaction was beneficial, the consideration and other terms of the transaction and the process (including the conflicted director's dealings with the corporation) are relevant, but whether the transaction advanced the corporation's commercial interests is to be viewed "as a whole'

In considering the "fairness" of the transaction, the court will be required to consider not only the market fairness of the terms of the deal-whether it is comparable to what might have been obtainable in an arm's length transaction-but also (as the board would have been required to do) whether the transaction was one that was reasonably likely to yield favorable results (or reduce detrimental results). Thus, if a manufacturing company that lacks sufficient working capital allocates some of its scarce funds to purchase a sailing yacht owned by one of its directors, it will not be easy to persuade the court that the transaction was "fair" in the sense that it was reasonably made to further the business interests of the corporation. The facts that the price paid for the yacht was a "fair" market price, and that the full measure of disclosures made by the director is beyond challenge, may still not be enough to defend and uphold the transaction.

A. CONSIDERATION AND OTHER TERMS OF THE TRANSACTION

The fairness of the consideration and other transaction terms are to be judged at the relevant time. The relevant inquiry is whether the consideration paid or received by the corporation or the benefit expected to be realized by the corporation was adequate in relation to the obligations assumed or received or other consideration provided by or to the corporation. If the issue in a transaction is the "fairness" of a price, "fair" is not to be taken to imply that there is one single "fair" price, all others being "unfair' It is settled law that a "fair" price is any price within a range that an unrelated party might have been willing to pay or willing to accept, as the case may be, for the relevant property, asset, service or commitment, following a normal arm's-length business negotiation. The same approach applies not only to gauging the fairness of price, but also to the fairness evaluation of any other key term of the deal.

Although the "fair" criterion used to assess the consideration under section 8.61(b)(3) is also a range rather than a point, the width of that range may be narrower than would be the case in an arm's-length transaction. For example, the quality and completeness of disclosures, if any, made by the conflicted director that bear upon the consideration in question are relevant in determining whether the consideration paid or received by the corporation, although otherwise commercially reasonable, was "fair" for purposes of section 8.61(b) (3).

B. PROCESS OF DECISION AND THE DIRECTOR'S CONDUCT

In some circumstances, the behavior of the director having the conflicting interest may affect the finding and content of "fairness." Fair dealing requires that the director make required disclosure (per subdivision (7)) at the relevant time (per subdivision (3)) even if the director plays no role in arranging or negotiating the terms of the transaction. One illustration of unfair dealing is the director's failure to disclose fully the director's interest or hidden defects known to the director regarding the transaction. Another illustration would be the exertion by the director of improper pressure upon the other directors or other parties that might be involved with the transaction. Whether a transaction can be successfully challenged by reason of deficient or improper conduct, notwithstanding the fairness of the economic terms, will turn on the court's evaluation of the conduct and its impact on the transaction.

7. Required Disclosure

A critically important element of subchapter F's safe harbor procedures is that those acting for the corporation be able to make an informed judgment. In view of this requirement, subdivision (7) defines "required disclosure" to mean disclosure of all facts known to D about the subject of the transaction that a director free of the conflicting interest would reasonably believe to be material to the decision whether to proceed with the transaction. For example, if D knows that the land the corporation is proposing to buy from D is sinking into an abandoned coal mine, D must disclose not only D's interest in the transaction but also that the land is subsiding. As a director of X Co., D may not invoke caveat emptor. On the other hand, D does not have any obligation to reveal the price that D paid for the property 10 years ago, or the fact that D inherited the property, because that information is not material to the board's evaluation of the property and its business decision whether to proceed with the transaction. Further, while material facts respecting the subject of the transaction must be disclosed, D is not required to reveal personal or subjective information that bears upon D's negotiating position (such as, for example, D's urgent need for cash, or the lowest price D would be willing to accept). This is true even though such information would be highly relevant to the corporation's decision making in the sense that, if the information were known to the corporation, it could enable the corporation to hold out for more favorable terms.

§ **8.61. JUDICIAL ACTION**

(a) A transaction effected or proposed to be effected by the corporation (or by an entity controlled by the corporation) may not be the subject of equitable relief, or give rise to an award of damages or other sanctions against a director of the corporation, in a proceeding by a shareholder or by or in the right of the corporation, on the ground that the director has an interest respecting the transaction, if it is not a director's conflicting interest transaction.

(b) A director's conflicting interest transaction may not be the subject of equitable relief, or give rise to an award of damages or other sanctions against a director of the corporation, in a proceeding by a shareholder or by or in the right of the corporation, on the ground that the director has an interest respecting the transaction, if:

(1) directors' action respecting the transaction was taken in compliance with section 8.62 at any time; or

(2) shareholders' action respecting the transaction was taken in compliance with section 8.63 at any time; or

(3) the transaction, judged according to the circumstances at the relevant time, is established to have been fair to the corporation.

CROSS-REFERENCES

Directors' action, see § 8.62.
"Director's conflicting interest transaction" defined, see § 8.60(1).
"Fair to the corporation" defined, see § 8.60(6).
General standards for directors, see § 8.30.
"Related person" defined, see § 8.60(3).
"Relevant time" defined, see 8.60.
"Required disclosure" defined, see § 8.60(4).
Shareholders' action, see § 8.63.
Time of commitment, see § 8.60(5).

OFFICIAL COMMENT

Section 8.61 is the operational section of subchapter F, as it prescribes the judicial consequences of the other sections.

Speaking generally:

(i) If the section 8.62 or section 8.63 procedures are complied with, or if it is established that at the relevant time a director's conflicting interest transaction was fair to the corporation, then a director's conflicting interest transaction is immune from attack on the ground of an interest of the director. However, the narrow scope of subchapter F must again be strongly emphasized; if the transaction is vulnerable to attack on some other ground, observance of subchapter F's procedures does not make it less so.

(ii) If a transaction is *not* a director's conflicting interest transaction as defined in section 8.60(1), then the transaction may *not* be enjoined, rescinded, or made the basis of other sanction on the ground of a conflict of interest of a director, whether or not it went through the procedures of subchapter F. In that sense, subchapter F is specifically intended to be both comprehensive and exclusive.

(iii) If a director's conflicting interest transaction that was not at any time the subject of action taken in compliance with section 8.62 or section 8.63 is challenged on grounds of the director's conflicting interest, and is not shown to be fair to the corporation, then the court may take such remedial action as it considers appropriate under the applicable law of the jurisdiction.

1. Section 8.61(a)

As previously noted, section 8.61(a) makes clear that a transaction between a corporation and another person cannot be the subject of equitable relief, or give rise to an award of damages or other sanctions against a director, on the ground that the director has an interest respecting the transaction, unless the transaction falls within the bright-line definition of "director's conflicting interest transaction" in section 8.60. So, for example, a transaction will not constitute a director's conflicting interest transaction and, therefore, will not be subject to judicial review on the ground that a director had an interest in the transaction, where the transaction is made with a relative of a director who is not one of the relatives specified in section 8.60(5), or on the ground of an alleged interest other than a material financial interest, such as a financial interest of the director that is not material, as defined in section 8.60(4), or a nonfinancial interest. (As noted in the Introductory Comment, however, subchapter F does not apply to, and therefore does not preclude, a challenge to such a transaction based on grounds other than the director's interest.)

If there is reason to believe that the fairness of a transaction involving D could be questioned, D is well advised to subject the transaction to the safe harbor procedures of subchapter F. Sometimes, a director may be uncertain whether a particular person would be held to fall within a related person category, or whether the scale of the financial interest is material as defined in Section 8.60. In such circumstances, the obvious avenue to follow is to clear the matter with qualified directors under section 8.62 or with the holders of qualified shares under section 8.63. If it is later judicially determined that a conflicting interest in the challenged transaction did exist, the director will have safe harbor protection. It may be expected, therefore, that the procedures of section 8.62 (and, to a lesser extent, section 8.63) will probably be used for many transactions that may lie outside the sharp definitions of section 8.60-a result that is healthy and constructive.

It is important to stress that subchapter F deals only with "transactions." If a nontransactional corporate decision is challenged on the ground that *D* has a conflicting personal stake in it, subsection 8.61(a) is irrelevant.

2. Section 8.61(b)

Clause (1) of subsection (b) provides that if a director has a conflicting interest respecting a transaction, neither the transaction nor the director is legally vulnerable on the ground of the director's conflict if the procedures of section 8.62 have been properly followed. If board action under section 8.62(b)(1) is interposed as a defense in a proceeding challenging a director's conflicting interest transaction, the plaintiff then bears the burden of overcoming that defense under section 8.31.

Challenges to that board action may be based on a failure to meet the specific requirements of section 8.62 or to conform with general standards of director conduct. For example, a challenge addressed to section 8.62 compliance might question whether the acting directors were "qualified directors" or might dispute the quality and completeness of the disclosures made by D to the qualified directors. If such a challenge is successful, the board action is ineffective for purposes of subsection (b)(1) and both D and the transaction may be subject to the full range of remedies that might apply, absent the safe harbor, unless the fairness of the transaction can be established under subsection (b)(3). The fact that a transaction has been nominally passed through safe harbor procedures does not preclude a subsequent challenge based on any failure to meet the requirements of section 8.62. Recognizing the importance of traditional corporate procedures where the economic interests of a fellow director are concerned, a challenge to the effectiveness of board action for purposes of subsection (b)(1) might also assert that, while the conflicted director's conduct in connection with the process of approval by qualified directors may have been consistent with the statute's expectations, the qualified directors dealing with the matter did not act in good faith or on reasonable inquiry. The kind of relief that may be appropriate when qualified directors have approved a transaction but have not acted in good faith or have failed to become reasonably informed-and, again, where the fairness of the transaction has not been established under subsection (b)(3)-will depend heavily on the facts of the individual case; therefore, it must be largely a matter of sound judicial discretion.

Clause (2) of subsection (b) regarding shareholders' approval of the transaction is the matching piece to clause (1) regarding directors' approval.

The language "at any time" in clauses (1) and (2) of subsection (b) permits the directors or the shareholders to ratify a director's conflicting interest transaction after the fact for purposes of subchapter F. However, good corporate practice is to obtain appropriate approval prior to consummation of a director's conflicting interest transaction.

Clause (3) of subsection (b) provides that a director's conflicting interest transaction will be secure against the imposition of legal or equitable relief if it is established that, although neither directors' nor shareholders' action was taken in compliance with section 8.62 or 8.63, the transaction was fair to the corporation within the meaning of section 8.60(6). Under section 8.61(b)(3) the interested director has the burden of establishing that the transaction was fair.

Note on Directors' Compensation

Directors' fees and other forms of director compensation are typically set by the board and are specially authorized (though not regulated) by section 8.11 of the Model Act. Although in the usual case a corporation's directors' compensation practices fall within normal patterns and their fairness can be readily established, they do involve a conflicting interest on the part of most if not all of the directors and, in a given case, may be abused. Therefore, while as a matter of practical necessity these practices will normally be generally accepted in principle, it must be kept in mind that board action on directors' compensation and benefits would be subject to judicial sanction if they are not favorably acted upon by shareholders pursuant to section 8.63 or if they are not in the circumstances fair to the corporation pursuant to section 8.61(b)(3).

§ **8.62. DIRECTORS' ACTION**

(a) Directors' action respecting a director's conflicting interest transaction is effective for purposes of section 8.61(b)(l) if the transaction has been authorized by the affirmative vote of a majority (but no fewer than two) of the qualified directors who voted on the transaction, after required disclosure by the conflicted director of information not already known by such qualified directors, or after modified disclosure in compliance with subsection (b), provided that:

(1) the qualified directors have deliberated and voted outside the presence of and without the participation by any other director; and

(2) where the action has been taken by a committee, all members of the committee were qualified directors, and either (i) the committee was composed of all the qualified directors on the board of directors or (ii) the members of the committee were appointed by the affirmative vote of a majority of the qualified directors on the board.

(b) Notwithstanding subsection (a), when a transaction is a director's conflicting interest transaction only because a related person described in clause (v) or clause (vi) of section 8.60(5) is a party to or has a material financial interest in the transaction, the conflicted director is not obligated to make required disclosure to the extent that the director reasonably believes that doing so would violate a duty imposed under law, a legally enforceable obligation of confidentiality, or a professional ethics rule, provided that the conflicted director discloses to the qualified directors voting on the transaction:

(1) all information required to be disclosed that is not so violative,

(2) the existence and nature of the director's conflicting interest, and

(3) the nature of the conflicted director's duty not to disclose the confidential information.

(c) A majority (but no fewer than two) of all the qualified directors on the board of directors, or on the committee, constitutes a quorum for purposes of action that complies with this section.

(d) Where directors' action under this section does not satisfy a quorum or voting requirement applicable to the authorization of the transaction by reason of the articles of incorporation, the bylaws or a provision of law, independent action to satisfy those authorization requirements must be taken by the board of directors or a committee, in which action directors who are not qualified directors may participate.

CROSS-REFERENCES

"Director's conflicting interest transaction" defined, see **§** 8.60(1).
General standards for directors, see **§** 8.30.
Judicial action, see **§** 8.61.
"Qualified director" defined, see **§** 1.43.
"Related person" defined , see **§** 8.60(5).
"Relevant time" defined, see **§** 8.60(3).
"Required disclosure" defined, see **§** 8.60(7).
Shareholders' action, see **§** 8.63.

OFFICIAL COMMENT

Section 8.62 provides the procedure for action by the board of directors or by a board committee under subchapter F. In the normal course this section, together with section 8.61(b), will be the key method for addressing directors' conflicting interest transactions. Any discussion of section 8.62 must be conducted in light of the overarching requirements that directors act in good faith and on reasonable inquiry. Director action that does not comply with those requirements, even if otherwise in compliance with section 8.62, will be subject to challenge and not be given effect under section 8.62. See the Official Comment to section 8.6 1(b).

1. Section 8.62(a)

The safe harbor for directors' conflicting interest transactions will be effective under section 8.62 if and only if it is authorized by qualified directors. (For the definition of "qualified director' see section 1.43 and the related official comment.) Obviously, safe harbor protection cannot be provided by fellow directors who themselves are not qualified directors; only qualified directors can do so under subsection (a). The definition of "qualified director" in section 1.43 excludes a conflicted director but its exclusions go significantly further, i.e., beyond the persons specified in the categories of section 8.60(5) for purposes of the "related person" definition. For example, if any familial or financial connection or employment or professional relationship with *D* would be likely to impair the objectivity of the director's judgment when participating in a vote on the transaction, that director would not be a qualified director.

Action by the board of directors is effective for purposes of section 8.62 if the transaction is approved by the affirmative vote of a majority (but not less than two) of the qualified directors on the board. Action may also be taken by a duly authorized committee of the board but, for the action to be effective, all members of the committee must be qualified directors and the committee must either be composed of all of the qualified directors on the board or must have been appointed by the affirmative vote of a majority of the qualified directors on the board. This requirement for effective committee action is intended to preclude the appointment as committee members of a favorably inclined minority from among all the qualified directors. Except to the limited extent found in subsection (b), authorization by the qualified directors acting on the matter must be preceded by required disclosure pursuant to subsection (a) followed by deliberation and voting outside the presence of and without the participation by, any other director. Should there be more than one conflicted director interested in the transaction, the need for required disclosure would apply to each. After the qualified directors have had the opportunity to question the conflicted director about the material facts communicated about the transaction, action complying with subsection (a) may be taken at any time before or after the time it becomes a legal obligation. A written record of the qualified directors' deliberations and action is strongly encouraged.

2. Section 8.62(b)

Subsection (b) is a special provision designed to accommodate, in a practical way, situations where a director who has a conflicting interest is not able to comply fully with the disclosure requirement of subsection (a) because of an extrinsic duty of confidentiality that such director reasonably believes to exist. The director may, for example, be prohibited from making full disclosure because of legal restrictions that happen to apply to the transaction (e.g., grand jury seal or national security statute) or professional canon (e.g., attorney-client privilege). The most frequent use of subsection (b), however, will likely involve common directors who find themselves in a position of dual fiduciary obligations that clash. If *D* is also a director of *Y Co., D* may have acquired privileged information from one or both directorships relevant to a transaction between X *Co.* and *Y Co.,* which *D* cannot reveal to one without violating a fiduciary duty owed to the other. In such circumstances, subsection (b) enables the conflicting interest complication to be presented for consideration under subsection (a), and thereby enables X *Co.* (and *Y Co.)* and *D* to secure for the transaction the protection afforded by subchapter F even though *D* cannot, by reason of applicable law, confidentiality strictures or a professional ethics rule, make the full disclosure otherwise required.

To comply with subsection (b), *D* must (i) notify the qualified directors who are to vote on the transaction respecting the conflicting interest, (ii) disclose to them all information required to be disclosed that does not violate the duty not to disclose, as the case may be, to which *D* reasonably believes he or she is subject, and (iii) inform them of the nature of the duty (e.g., that the duty arises out of an attorney-client privilege or out of a duty as a director of Y *Co.* that prevents *D* from making required disclosure as otherwise mandated by clause (ii) of section 8.60(7)). *D* must then play no personal role in the board's (or committee's) ultimate deliberations or action. The purpose of subsection (b) is to make it clear that the provisions of subchapter F may be employed to "safe harbor" a transaction in circumstances where a conflicted director cannot, because of enforced fiduciary silence, disclose all the known facts.1 Of course, if *D* invokes subsection (b) and does not make required disclosure before leaving the meeting, the qualified directors may decline to act on the transaction out of concern that *D* knows (or may know) something they do not. On the other hand, if *D* is subject to an extrinsic duty of confidentiality but has no knowledge of material facts that should otherwise be disclosed, *D* would normally state just that and subsection (b) would be irrelevant. Having disclosed the existence and nature of the conflicting interest, *D* would thereby comply with section 8.60(7).

While subchapter F explicitly contemplates that subsection (b) will apply to the frequently recurring situation where transacting corporations have common directors (or where a director of one party is an officer of the other), it should not otherwise be read as attempting to address the scope, or mandate the consequences, of various silence-privileges. That is a topic reserved for local law.

Subsection (b) is available to *D* if a transaction is a director's conflicting interest transaction only because a related person described in section 8.60(5)(v) or (vi) is a party to or has a material financial interest in the transaction. Its availability is so limited because in those instances a director owes a fiduciary duty to such a related person. If *D* or a related person of *D* other than a related person described in section 8.60(5)(v) or (vi) is a party to or has a material financial interest in the transaction, *D's* only options are satisfying the required disclosure obligation on an unrestricted basis, abandoning the transaction, or accepting the risk of establishing fairness under section 8.61(b)(3), if the transaction is challenged in a court proceeding.

Whenever a conflicted director proceeds in the manner provided in subsection (b), the other directors should recognize that the conflicted director may have information that in usual circumstances *D* would be required to reveal to the qualified directors who are acting on the transaction-information that could well indicate that the transaction would be either favorable or unfavorable for X *Co*

A director could, of course, encounter the same problem of mandated silence with regard to any matter that comes before the board; that is, the problem of forced silence is not linked at all to the problems of transactions involving a conflicting interest of a director. It could happen that at the same board meeting of X Co. at which D invokes Section 8.62(b), another director who has absolutely no financial interest in the transaction might conclude that under local law he or she is bound to silence (because of attorney-client privilege, for example) and would under general principles of sound director conduct withdraw from participation in the board's deliberations and action.

3. Section8.62(c)

Subsection (c) states the special quorum requirement for action by qualified directors to be effective under section 8.62. Obviously, conflicted directors are excluded. Also excluded are board members who, while not conflicted directors, are not eligible to be qualified directors. As stated in subsection (a), the qualified directors taking action respecting a director's conflicting interest transaction are to deliberate and vote outside the presence of, and without participation by, any other member of the board.

4. Section 8.62(d)

This subsection underscores the fact that the directors' voting procedures and requirements set forth in subsections (a) through (c) treat only the director's conflicting interest. A transaction authorized by qualified directors in accordance with subchapter F may still need to satisfy different voting and quorum requirements in order to achieve substantive approval of the transaction under other applicable statutory provisions or provisions contained in X *Co.'s* articles of incorporation or bylaws, and vice versa. Thus, in any case where the quorum and/or voting requirements for substantive approval of a transaction differ from the quorum and/or voting requirements for "safe harbor" protection under section 8.62, the directors may find it necessary to conduct (and record in the minutes of the proceedings) two separate votes-one for section 8.62 purposes and the other for substantive approval purposes.

§ **8.63. SHAREHOLDERS' ACTION**

(a) Shareholders' action respecting a director's conflicting interest transaction is effective for purposes of section 8.61(b)(2) if a majority of the votes cast by the holders of all qualified shares are in favor of the transaction after (1) notice to shareholders describing the action to be taken respecting the transaction, (2) provision to the corporation of the information referred to in subsection (b), and (3) communication to the shareholders entitled to vote on the transaction of the information that is the subject of required disclosure, to the extent the information is not known by them.

(b) A director who has a conflicting interest respecting the transaction shall, before the shareholders' vote, inform the secretary or other officer or agent of the corporation authorized to tabulate votes, in writing, of the number of shares that the director knows are not qualified shares under subsection (c), and the identity of the holders of those shares.

(c) For purposes of this section: (1) "holder" means and "held by" refers to shares held by both a record shareholder (as defined in section 13.01(7)) and a beneficial shareholder (as defined in section 13.01(2)); and (2) "qualified shares" means all shares entitled to be voted with respect to the transaction except for shares that the secretary or other officer or agent of the corporation authorized to tabulate votes either knows, or under subsection (b) is notified, are held by (A) a director who has a conflicting interest respecting the transaction or (B) a related person of the director (excluding a person described in clause (vi) of Section 8.60(5)).

(d) A majority of the votes entitled to be cast by the holders of all qualified shares constitutes a quorum for purposes of compliance with this section. Subject to the provisions of subsection (e), shareholders' action that otherwise complies with this section is not affected by the presence of holders, or by the voting, of shares that are not qualified shares.

(e) If a shareholders' vote does not comply with subsection (a) solely because of a director's failure to comply with subsection (b), and if the director establishes that the failure was not intended to influence and did not in fact determine the outcome of the vote, the court may take such action respecting the transaction and the director, and may give such effect, if any, to the shareholders' vote, as the court considers appropriate in the circumstances.

(f) 'Where shareholders' action under this section does not satisfy a quorum or voting requirement applicable to the authorization of the transaction by reason of the articles of incorporation, the bylaws or a provision of law, independent action to satisfy those authorization requirements must be taken by the shareholders, in which action shares that are not qualified shares may participate.

CROSS-REFERENCES

Directors' action, see § 8.62.
"Director's conflicting interest transaction" defined, see § 8.60(2).
Judicial action, see § 8.61.
"Related person" defined, see § 8.60(5).
"Required disclosure" defined, see § 8.60(7).

OFFICIAL COMMENT

Section 8.63 provides the machinery for shareholders' action that confers safe harbor protection for a director's conflicting interest transaction, just as section 8.62 provides the machinery for directors' action that confers subchapter F safe harbor protection for such a transaction.

1. Section 8.63(a)

Subsection (a) specifies the procedure required to confer effective safe harbor protection for a director's conflicting interest transaction through a vote of shareholders. In advance of the vote, three steps must be taken: (1) shareholders must be given timely and adequate notice describing the transaction; (2) D must disclose the information called for in subsection (b); and (3) disclosure must be made to the shareholders entitled to vote, as required by section 8.60(7). In the case of smaller closely-held corporations, this disclosure shall be presented by the director directly to the shareholders gathered at the meeting place where the vote is to be held, or provided in writing to the secretary of the corporation for transmittal with the notice of the meeting. In the case of larger publicly held corporations where proxies are being solicited, the disclosure is to be made by the director to those responsible for preparing the proxy materials, for inclusion therein. If the holders of a majority of all qualified shares (as defined in subsection (b)) entitled to vote on the matter vote favorably, the safe harbor provision of section 8.61(b)(2) becomes effective. Action that complies with subsection (a) may be taken at any time, before or after the time when the corporation becomes legally obligated to complete the transaction.

Section 8.63 does not contain a "limited disclosure" provision that is comparable to section 8.62(b). Thus, the safe harbor protection of subchapter F is not available through shareholder action under section 8.63 in a case where D either remains silent or makes less than required disclosure because of an extrinsic duty of confidentiality. This omission is intentional. 'While the section 8.62(b) procedure is workable in the collegial setting of the boardroom, that is far less likely in the case of action by the shareholder body, especially in large corporations where there is heavy reliance upon the proxy mechanic. Unlike the dynamic that would normally occur in the boardroom, in most situations no opportunity exists for shareholders to quiz D about the confidentiality duty and to discuss the implications of acting without the full benefit of D's knowledge about the conflict transaction. In a case of a closely held corporation where section 8.63 procedures are followed, but with D acting in a way that would be permitted by section 8.62(b), a court could attach significance to a favorable shareholder vote in evaluating the fairness of the transaction to the corporation.

2. Section 8.63(b)

In many circumstances, the secretary or other vote tabulator of X *Co.* will have no way to know which of X Co.'s outstanding shares should be excluded from the tabulation. Subsection (b) (together with subsection (c)) therefore obligates a director who has a conflicting interest respecting the transaction, as a prerequisite to safe harbor protection by shareholder action, to inform the secretary, or other officer or agent authorized to tabulate votes, of the number and holders of shares known to be held by the director or by a related person described in clauses (i) through (v) of section 8.60(5).

If the tabulator of votes knows, or is notified under subsection (b), that particular shares should be excluded but for some reason fails to exclude them from the count and their inclusion in the vote does not affect its outcome, the shareholders' vote will stand. If the improper inclusion determines the outcome, the shareholders' vote fails because it does not comply with subsection (a). But see subsection (e) as to cases where the notification under subsection (b) is defective but not determinative of the outcome of the vote.

3. Section 8.63(c)

Under subsection (a), only "qualified shares" may be counted in the vote for purposes of safe harbor action under section 8.61(b)(2). Subsection (b) defines "qualified shares" to exclude all shares that, before the vote, the secretary or other tabulator of the vote knows, or is notified under subsection (b), are held by the director who has the conflicting interest, or by any specified related person of that director.

The definition of "qualified shares" excludes shares held by D or a "related person" as defined in the first five categories of section 8.60(5). That definition does not exclude shares held by entities or persons described in clause (vi) of section 8.60(5), i.e., a person that is, or is an entity that is controlled by, an employer of D. If D is an employee of Y Co., that fact does not prevent Y Co. from exercising its usual rights to vote any shares it may hold in X Co. D may be unaware of, and would not necessarily monitor, whether his or her employer holds X Co. shares. Moreover, D will typically have no control over his or her employer and how it may vote its X Co. shares.

4. Section 8.63(e)

If D did not provide the information required under subsection (b), on its face the shareholders' action is not in compliance with subsection (a) and D has no safe harbor under subsection (a). In the absence of that safe harbor, D can be put to the burden of establishing the fairness of the transaction under section 8.61(b)(3).

That result is proper where D's failure to inform was determinative of the vote results or, worse, was part of a deliberate effort on D's part to influence the outcome. But if D's omission was essentially an act of negligence, if the number of unreported shares if voted would not have been determinative of the outcome of the vote, and if the omission was not motivated by D's effort to influence the integrity of the voting process, then the court should be free to fashion an appropriate response to the situation in light of all the considerations at the time of its decision. The court should not, in the circumstances, be automatically forced by the mechanics of subchapter F to a lengthy and retrospective trial on "fairness." Subsection (e) grants the court that discretion in those circumstances and permits it to accord such effect, if any, to the shareholders' vote, or to grant such relief respecting the transaction or D, as the court may find appropriate.

Despite the presumption of regularity customarily accorded the secretary's record, a plaintiff may go behind the secretary's record for purposes of subsection (e).

5. Section 8.63(f)

This subsection underscores that the shareholders' voting procedures and requirements set forth in subsections (a) through (e) treat only the director's conflicting interest. A transaction that receives a shareholders' vote that complies with subchapter F may well fail to achieve a different vote or quorum that may be required for substantive approval of the transaction under other applicable statutory provisions or provisions contained in X Co.'s articles of incorporation or bylaws, and vice versa. Thus, in any case where the quorum and/or voting requirements for substantive approval of a transaction differ from the quorum and/or voting requirements for "safe harbor" protection under section 8.63, the corporation may find it necessary to conduct (and record in the minutes of the proceedings) two separate shareholder votes-one for section 8.63 purposes and the other for substantive approval purposes (or, if appropriate, conduct two separate tabulations of one vote).

Subchapter G.

BUSINESS OPPORTUNITIES

§ 8.70. BUSINESS OPPORTUNITIES

(a) A director's taking advantage, directly or indirectly, of a business opportunity may not be the subject of equitable relief, or give rise to an award of damages or other sanctions against the director, in a proceeding by or in the right of the corporation on the ground that such opportunity should have first been offered to the corporation, if before becoming legally obligated respecting the opportunity the director brings it to the attention of the corporation and:

(1) action by qualified directors disclaiming the corporation's interest in the opportunity is taken in compliance with the procedures set forth in section 8.62, as if the decision being made concerned a director's conflicting interest transaction, or

(2) shareholders' action disclaiming the corporation's interest in the opportunity is taken in compliance with the procedures set forth in section 8.63, as if the decision being made concerned a director's conflicting interest transaction; except that, rather than making "required disclosure" as defined in section 8.60, in each case the director shall have made prior disclosure to those acting on behalf of the corporation of all material facts concerning the business opportunity that are then known to the director.

(b) In any proceeding seeking equitable relief or other remedies based upon an alleged improper taking advantage of a business opportunity by a director, the fact that the director did not employ the procedure described in subsection (a) before taking advantage of the opportunity shall not create an inference that the opportunity should have been first presented to the corporation or alter the burden of proof otherwise applicable to establish that the director breached a duty to the corporation in the circumstances.

OFFICIAL COMMENT

Section 8.70 provides a safe harbor for a director weighing possible involvement with a prospective business opportunity that might constitute a "corporate opportunity." By action of the board of directors or shareholders of the corporation under section 8.70, the director can receive a disclaimer of the corporation's interest in the matter before proceeding with such involvement. In the alternative, the corporation may (i) decline to disclaim its interest, (ii) delay a decision respecting granting a disclaimer pending receipt from the director of additional information (or for any other reason), or (iii) attach conditions to the disclaimer **it** grants under section 8.70(a). The safe harbor granted to the director pertains only to the specific opportunity and does not have broader application, such as to a line of business or a geographic area.

The common law doctrine of "corporate opportunity" has long been recognized as a core part of the director's duty of loyalty. The doctrine stands for the proposition that the corporation has a right prior to that of its director to act on certain business opportunities that come to the attention of the director. In such situations, a director who acts on the opportunity for the benefit of the director or another without having first presented it to the corporation can be held to have "usurped" or "intercepted" a right of the corporation. A defendant director who is found by a court to have violated the duty of loyalty in this regard is subject to damages or an array of equitable remedies, including injunction, disgorgement or the imposition of a constructive trust in favor of the corporation. 'While the doctrine's concept is easily described, whether it will be found to apply in a given case depends on the facts and circumstances of the particular situation and is thus frequently unpredictable. Ultimately, the doctrine requires the court to balance the corporation's legitimate expectations that its directors will faithfully promote its best interests against the legitimate right of individual directors to pursue their own economic interests in other contexts and venues.

In response to this difficult balancing task, courts have developed several (sometimes overlapping) principles to cabin the doctrine. Although the principles applied have varied from state to state, courts have sought to determine, for example, whether a disputed opportunity presented a business opportunity that was the same as, or similar to, the corporation's current or planned business activities ("line of business" test); one that the corporation had already formulated plans or taken steps to acquire for its own use ("expectancy" test); developed by the director through the use of the corporation's property, personnel or proprietary information ("appropriation" test); or presented to the director with the explicit or implicit expectation that the director would present it to the corporation for its consideration-or in contrast, one that initially came to the director's attention in the director's individual capacity unrelated to the director's corporate role ("capacity" test).

Finally, in recognition that the corporation need not pursue every business opportunity of which it becomes aware, an opportunity coming within the doctrine's criteria that has been properly presented to and declined by the corporation may then be pursued by the presenting director without breach of the director's duty of loyalty.

The fact-intensive nature of the corporate opportunity doctrine resists statutory definition. Instead, subchapter G employs the broader notion of "business opportunity" that encompasses any opportunity, without regard to whether it would come within the judicial definition of a "corporate opportunity" as it may have been developed by courts in a jurisdiction. When properly employed, it provides a safe-harbor mechanism enabling a director to pursue an opportunity for his or her own account or for the benefit of another free of possible challenge claiming conflict with the director's duty of loyalty on the ground that the opportunity should first have been offered to the corporation. Section 8.70 is modeled on the safe-harbor and approval procedures of subchapter F pertaining to directors' conflicting interest transactions with, however, some modifications necessary to accommodate differences in the two topics.

1. Section 8.70(a)

Subsection (a) describes the safe harbor available to a director who elects to subject a business opportunity, regardless of whether the opportunity would be classified as a "corporate opportunity' to the disclosure and approval procedures set forth therein. The safe harbor provided is as broad as that provided for a director's conflicting interest transaction in section 8.61: if the director makes required disclosure of the facts specified and the corporation's interest in the opportunity is disclaimed by director action under subsection (a)(1) or shareholder action under subsection (a)(2), the director has foreclosed any claimed breach of the duty of loyalty and may not be subject to equitable relief, damages or other sanctions if the director thereafter takes the opportunity for his or her own account or for the benefit of another person. As a general proposition, disclaimer by director action under subsection (a)(1) must meet all of the requirements provided in section 8.62 with respect to a director's conflicting interest transaction and disclaimer by shareholder action under subsection (a)(2) must likewise comply with all of the requirements for shareholder action under section 8.63. Note, however, two important differences.

In contrast to director or shareholder action under sections 8.62 and 8.63, which may be taken at any time, section 8.70(a) requires that the director must present the opportunity and secure director or shareholder action disclaiming it *before* acting on the opportunity. The safe-harbor concept contemplates that the corporation's decision maker will have full freedom of action in deciding whether the corporation should take over a proffered opportunity or elect to disclaim the corporation's interest in it. If the interested director could seek ratification after acting on the opportunity, the option of taking over the opportunity would, in most cases, in reality be foreclosed and the corporation's decision maker would be limited to denying ratification or blessing the interested director's past conduct with a disclaimer. In sum, the safe harbor's benefit is available only when the corporation can entertain the opportunity in a fully objective way.

The second difference also involves procedure. Instead of employing section 8.60(7)'s definition of "required disclosure" that is incorporated in sections 8.62 and 8.63, section 8.70(a) requires the alternative disclosure to those acting for the corporation of "all material facts concerning the business opportunity that are then known to the director." As a technical matter, section 8.60(7) calls for, in part, disclosure of "the existence and nature of the director's conflicting interest"-that information is not only nonexistent but irrelevant for purposes of subsection (a). But there is another consideration justifying replacement of the section 8.60(7) definition. In the case of the director's conflicting interest transaction, the director proposing to enter into a transaction with the corporation has presumably completed due diligence and made an informed judgment respecting the matter; accordingly, that interested director is in a position to disclose "all facts known to the director respecting the subject matter of the transaction that a director free of such conflicting interest would reasonably believe to be material in deciding whether to proceed with the transaction." The interested director, placing himself or herself in the independent director's position, should be able to deal comfortably with the objective materiality standard. In contrast, the director proffering a business opportunity will often not have undertaken due diligence and made an informed judgment to pursue the opportunity following a corporate disclaimer. Thus, the disclosure obligation of subsection (a) requires only that the director reveal all material facts concerning the business opportunity that, at the time when disclosure is made, are known to the director. The safe-harbor procedure shields the director even if a material fact regarding the business opportunity is not disclosed, so long as the proffering director had no knowledge of such fact. In sum, the disclosure requirement for subsection (a) must be and should be different from that called for by subchapter F's provisions.

2. *Section 8.70(b)*

Subsection (b) reflects a fundamental difference between the coverage of subchapters F and G. Because subchapter F provides an exclusive definition of "director's conflicting interest transaction' any transaction meeting the definition that is not approved in accordance with the provisions of subchapter F is not entitled to its safe harbor. Unless the interested director can, upon challenge, establish the transaction's fairness, the director's conduct is presumptively actionable and subject to the full range of remedies that might otherwise be awarded by a court. In contrast, the concept of "business opportunity" under section 8.70 is not defined but is intended to be broader than what might be regarded as an actionable "corporate opportunity." This approach recognizes that, given the vagueness of the corporate opportunity doctrine, a director might be inclined to seek safe-harbor protection under section 8.70 before pursuing an opportunity that might or might not at a later point be subject to challenge as a "corporate opportunity." By the same token, a director might conclude that a business opportunity is not a "corporate opportunity" under applicable law and choose to pursue it without seeking a disclaimer by the corporation under section 8.70. Accordingly, subsection (b) provides that a director's decision not to employ the procedures of section 8.70(a) neither creates a negative inference nor alters the burden of proof in any subsequent proceeding seeking damages or equitable relief based upon an alleged improper taking of a "corporate opportunity."

CROSS-REFERENCES

Directors' action, see § 8.62.
"Qualified director" defined, see § 1.43.
Shareholders' action, see § 8.63.

CHAPTER 9

Domestication and Conversion

INTRODUCTORY COMMENT

This chapter provides a series of procedures by which a domestic business corporation may become a different form of entity or, conversely, an entity that is not a domestic business corporation may become a domestic business corporation. These various types of procedures are as follows:

Domestication. The procedures in subchapter 9B permit a corporation to change its state of incorporation, thus allowing a domestic business corporation to become a foreign business corporation or a foreign business corporation to become a domestic business corporation.

Nonprofit Conversion. The procedures in subchapter 9C permit a domestic business corporation to become either a domestic nonprofit corporation or a foreign nonprofit corporation.

Foreign Nonprofit Domestication and Conversion. The procedures in subchapter 9D permit a foreign nonprofit corporation to become a domestic business corporation.

Entity Conversion. The procedures in subchapter 9E permit a domestic business corporation to become a domestic or foreign other entity, and also permit a domestic or foreign other entity to become a domestic business corporation.

Each of the foregoing transactions could previously be accomplished by a merger under chapter 11 with a wholly owned subsidiary of the appropriate type. An important purpose of this chapter is to permit the transactions to be accomplished directly.

The provisions of this chapter apply only if a domestic business corporation is present either immediately before or immediately after a transaction. Some states may wish to generalize the provisions of this chapter so that they are not limited to transactions involving a domestic business corporation, for example, to permit a domestic limited partnership to become a domestic limited liability company. The Model Entity Transactions Act prepared by the Ad Hoc Committee on Entity Rationalization of the Section of Business Law is such a generalized statute.

The procedures of this chapter do not permit the combination of two or more entities into a single entity. Transactions of that type must continue to be conducted under chapters 11 and 12.

Subchapter A.
PRELIMINARY PROVISIONS

§ 9.01. EXCLUDED TRANSACTIONS

This chapter may not be used to effect a transaction that:

(1) [converts an insurance company organized on the mutual principle to one organized on a stock-share basis];

(2)

(3)

OFFICIAL COMMENT

The purpose of this section is to prohibit certain transactions from being effectuated under chapter 9. A state should use this section to list all the situations in which the state has enacted specific legislation governing the conversion of domestic business corporations that are of a particular type or that do business in a regulated industry to any other form of corporation or to an unincorporated entity. A mutual to stock conversion of an insurance company has been listed in section 9.01(1) as one example of such a transaction.

The Official Comment to section 9.30 notes that subchapter 9C has been limited to transactions in which a domestic business corporation converts to a domestic or foreign nonprofit corporation, but suggests that a state may wish to consider broadening the scope of subchapter 9C to authorize conversions of nonprofit corporations to business corporations if it does not have a separate nonprofit corporation law. If a state chooses to include conversions of nonprofit corporations, consideration should be given to also listing in this section sensitive or controversial transactions where the entity involved is a not-for-profit corporation before the transaction, such as the conversion of Blue Cross and Blue Shield plans to for-profit status.

§ 9.02. REQUIRED APPROVALS [OPTIONAL]

(a) If a domestic or foreign business corporation or eligible entity may not be a party to a merger without the approval of the [attorney general], the [department of banking], the [department of insurance] or the [public utility commission], the corporation or eligible entity shall not be a party to a transaction under this chapter without the prior approval of that agency.

(b) Property held in trust or for charitable purposes under the laws of this state by a domestic or foreign eligible entity shall not, by any transaction under this chapter, be diverted from the objects for which it was donated, granted or devised, unless and until the eligible entity obtains an order of [court] [the attorney general] specifying the disposition of the property to the extent required by and pursuant to [cite state statutory cy pres or other nondiversion statute].

CROSS-REFERENCES

Appeal from secretary of state's refusal to file document, see § 1.26.

"Domestic business corporation" defined, see § 1.40.

Filing duty of secretary of state, see § 1.25.

OFFICIAL COMMENT

Section 9.02(a) is an optional provision that should be considered in states where corporations or other entities that conduct regulated activities such as banking, insurance or the provision of public utility services are incorporated or organized under general laws instead of under special laws applicable only to entities conducting the regulated activity. Because the provisions of chapter 9 are new, there is a possibility that existing state laws that require regulatory approval of mergers by those types of entities may not be worded in a fashion that will include the transactions authorized by this chapter. If this section is used, the list of agencies should be conformed to the laws of the enacting state.

The purpose of section 9.02(a) is to ensure that transactions under chapter 9 will be subject to the same regulatory approval as mergers, in contrast to section 9.01 which is an outright prohibition on conducting certain transactions under chapter 9. This section is based on whether a merger by a regulated entity requires prior approval because the transactions authorized by this chapter may be effectuated indirectly under chapter 11 by just establishing a wholly-owned subsidiary of the desired type and then merging into it. The list of agencies in subsection (a) should be conformed to the laws of the enacting state. The consequences of violating subsection (a) will be the same as in the case of a merger consummated without the required approval.

Nonprofit corporations and unincorporated entities may participate in transactions under this chapter. As in the case of laws regulating particular industries, a state's laws governing the nondiversion of charitable and trust property to other uses may not be worded in a fashion that will include all of the transactions authorized by this chapter. To prevent the procedures in this chapter from being used to avoid restrictions on the use of property held by nonprofit entities, section 9.02(b) requires approval of the effect of transactions under this chapter by the appropriate arm of government having supervision of nonprofit entities.

Subchapter B.
DOMESTICATION

§ 9.20. DOMESTICATION

(a) A foreign business corporation may become a domestic business corporation only if the domestication is permitted by the organic law of the foreign corporation.

(b) A domestic business corporation may become a foreign business corporation if the domestication is permitted by the laws of the foreign jurisdiction. Regardless of whether the laws of the foreign jurisdiction require the adoption of a plan of domestication, the domestication shall be approved by the adoption by the corporation of a plan of domestication in the manner provided in this subchapter.

(c) The plan of domestication must include:

(1) a statement of the jurisdiction in which the corporation is to be domesticated;

(2) the terms and conditions of the domestication;

(3) the manner and basis of reclassifying the shares of the corporation following its domestication into shares or other securities, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing; and

(4) any desired amendments to the articles of incorporation of the corporation following its domestication.

(d) The plan of domestication may also include a provision that the plan may be amended prior to filing the document required by the laws of this state or the other jurisdiction to consummate the domestication, except that subsequent to approval of the plan by the shareholders the plan may not be amended to change:

(1) the amount or kind of shares or other securities, obligations, rights to acquire shares or other securities, cash, or other property to be received by the shareholders under the plan;

(2) the articles of incorporation as they will be in effect immediately following the domestication, except for changes permitted by section 10.05 or by comparable provisions of the laws of the other jurisdiction; or

(3) any of the other terms or conditions of the plan if the change would adversely affect any of the shareholders in any material respect.

(e) Terms of a plan of domestication may be made dependent upon facts objectively ascertainable outside the plan in accordance with section 1.20(k).

(f) If any debt security, note or similar evidence of indebtedness for money borrowed, whether secured or unsecured, or a contract of any kind, issued, incurred or executed by a domestic business corporation before [the effective date of this subchapter] contains a provision applying to a merger of the corporation and the document does not refer to a domestication of the corporation, the provision shall be deemed to apply to a domestication of the corporation until such time as the provision is amended subsequent to that date.

CROSS-REFERENCES

Abandonment of domestication, see § 9.25.

Approval of plan, see § 9.21.

Articles of domestication, see § 9.22.

Articles of incorporation following domestication, see § 9.22(b).

"Domestic business corporation" defined, see § 1.40.

Effect of domestication, see § 9.24.

Excluded transactions, see § 9.01.

"Foreign corporation" defined, see § 1.40.

"Organic law" defined, see § 1.40.

[Required approvals, see § 9.02.]

OFFICIAL COMMENT

1. Applicability

This subchapter authorizes a foreign business corporation to become a domestic business corporation. It also authorizes a domestic business corporation to become a foreign business corporation. In each case, the domestication is authorized only if the laws of the foreign jurisdiction permit the domestication. Whether and on what terms a foreign business corporation is authorized to domesticate in this state are issues governed by the laws of the foreign jurisdiction, not by this subchapter.

A foreign corporation is not required to have in effect a valid certificate of authority under chapter 15 in order to domesticate in this state.

2. Terms and Conditions of Domestication

This subchapter imposes virtually no restrictions or limitations on the terms and conditions of a domestication, except for those set forth in section 9.20(d) concerning provisions in a plan of domestication for amendment of the plan after it has been approved by the shareholders. Shares of a domestic business corporation that domesticates in another jurisdiction may be reclassified into shares or other securities, obligations, rights to acquire shares or other securities, cash or other property. The capitalization of the corporation may be restructured in the domestication, and its articles of incorporation may be amended by the articles of domestication in any way deemed appropriate. When a foreign business corporation domesticates in this state, the laws of the foreign jurisdiction determine which of the foregoing actions may be taken.

Although this subchapter imposes virtually no restrictions or limitations on the terms and conditions of a domestication, section 9.20(c) requires that the terms and conditions be set forth in the plan of domestication. The plan of domestication is not required to be publicly filed, and the articles of domestication that are filed with the secretary of state by a foreign corporation domesticating in this state are not required to include a plan of domestication. See section 9.22. Similarly, articles of charter surrender that are filed with the secretary of state by a domestic business corporation domesticating in another jurisdiction are not required to include a plan of domestication. See section 9.23.

The list in section 9.20(c) of required provisions in a plan of domestication is not exhaustive and the plan may include any other provisions that may be desired.

3. Amendments of Articles of Incorporation

A corporation's articles of incorporation may be amended in a domestication. Under section 9.20(c)(4), a plan of domestication of a domestic business corporation proposing to domesticate in a foreign jurisdiction may include amendments to the articles of incorporation and should include, at a minimum, any amendments required to conform the articles of incorporation to the requirements for articles of incorporation of a corporation incorporated in the foreign jurisdiction. It is assumed that the foreign jurisdiction will give effect to the articles of incorporation as amended to the same extent that it would if the articles had been independently amended before the domestication.

The laws of the foreign jurisdiction determine whether and to what extent a foreign corporation may amend its articles of incorporation when domesticating in this state. Following the domestication of a foreign corporation in this state, of course, its articles of incorporation may be amended under chapter 10.

4. Adoption and Approval; Abandonment

The domestication of a domestic business corporation in a foreign jurisdiction must be adopted and approved as provided in section 9.21. Under section 9.25, the board of directors of a domestic business corporation may abandon a domestication before its effective date even if the plan of domestication has already been approved by the corporation's shareholders.

5. Appraisal Rights

A shareholder of a domestic business corporation that adopts and approves a plan of domestication has appraisal rights if the shareholder does not receive shares in the foreign corporation resulting from the domestication that have terms as favorable to the shareholder in all material respects, and represent at least the same percentage interest of the total voting rights of the outstanding shares of the corporation, as the shares held by the shareholder before the domestication. See section 9.24(b) and 13.02(a)(6).

6. Transitional Rule

Because the concept of domestication is new, a person contracting with a corporation or loaning it money who drafted and negotiated special rights relating to the transaction before the enactment of this subchapter should not be charged with the consequences of not having dealt with the concept of domestication in the context of those special rights. Section 9.20(f) accordingly provides a transitional rule that is intended to protect such special rights. If, for example, a corporation is a party to a contract that provides that the corporation cannot participate in a merger without the consent of the other party to the contract, the requirement to obtain the consent of the other party will also apply to the domestication of the corporation in another jurisdiction. If the corporation fails to obtain the consent, the result will be that the other party will have the same rights it would have if the corporation were to participate in a merger without the required consent.

The purpose of section 9.20(f) is to protect the third party to a contract with the corporation, and section 9.20(f) should not be applied in such a way as to impair unconstitutionally the third party's contract. As applied to the corporation, section 9.20(f) is an exercise of the reserved power of the state legislature set forth in section 1.02.

The transitional rule in section 9.20(f) ceases to apply at such time as the provision of the agreement or debt instrument giving rise to the special rights is first amended after the effective date of this subchapter because at that time the provision may be amended to address expressly a domestication of the corporation.

A similar transitional rule governing the application to a domestication of special voting rights of directors and shareholders and other internal corporate procedures is found in section 9.21(7).

§ 9.21. ACTION ON A PLAN OF DOMESTICATION

In the case of a domestication of a domestic business corporation in a foreign jurisdiction:

(1) The plan of domestication must be adopted by the board of directors.

(2) After adopting the plan of domestication, the board of directors must submit the plan to the shareholders for their approval. The board of directors must also transmit to the shareholders a recommendation that the shareholders approve the plan, unless the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation, in which case the board of directors must transmit to the shareholders the basis for that determination.

(3) The board of directors may condition its submission of the plan of domestication to the shareholders on any basis.

(4) If the approval of the shareholders is to be given at a meeting, the corporation must notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the plan of domestication is to be submitted for approval. The notice must state that the purpose, or one of the purposes, of the meeting is to consider the plan and must contain or be accompanied by a copy or summary of the plan. The notice shall include or be accompanied by a copy of the articles of incorporation as they will be in effect immediately after the domestication.

(5) Unless the articles of incorporation, or the board of directors acting pursuant to paragraph (3), requires a greater vote or a greater number of votes to be present, approval of the plan of domestication requires the approval of the shareholders at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast on the plan exists, and, if any class or series of shares is entitled to vote as a separate group on the plan, the approval of each such separate voting group at a meeting at which a quorum of the voting group consisting of at least a majority of the votes entitled to be cast on the domestication by that voting group exists.

(6) Separate voting by voting groups is required by each class or series of shares that:

(i) are to be reclassified under the plan of domestication into other securities, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing;

(ii) would be entitled to vote as a separate group on a provision of the plan that, if contained in a proposed amendment to articles of incorporation, would require action by separate voting groups under section 10.04; or

(iii) is entitled under the articles of incorporation to vote as a voting group to approve an amendment of the articles.

(7) If any provision of the articles of incorporation, bylaws or an agreement to which any of the directors or shareholders are parties, adopted or entered into before [the effective date of this subchapter], applies to a merger of the corporation and that document does not refer to a domestication of the corporation, the provision shall be deemed to apply to a domestication of the corporation until such time as the provision is amended subsequent to that date.

CROSS-REFERENCES

Abandonment of domestication, see § 9.25.

Contents of plan of domestication, see § 9.20.

"Domestic business corporation" defined, see § 1.40.

"Foreign business corporation" defined, see § 1.40.

OFFICIAL COMMENT

1. In General

This section sets forth the rules for adoption and approval of a plan of domestication of a domestic business corporation in a foreign jurisdiction. The manner in which the domestication of a foreign business corporation in this state must be adopted and approved will be controlled by the laws of the foreign jurisdiction. The provisions of this section follow generally the rules in chapter 11 for adoption and approval of a plan of merger or share exchange.

A plan of domestication must be adopted by the board of directors. Although section 9.21(2) permits the board to refrain from making a recommendation to the shareholders that they approve the plan, that does not change the underlying requirement that the board first adopt the plan before it is submitted to the shareholders. Approval by the shareholders of a plan of domestication is always required.

2. Voting by Separate Groups

Section 9.21(6) provides that a class or series has a right to vote on a plan of domestication as a separate voting group if, as part of the domestication, the class or series would be reclassified into other securities, interests, obligations, rights to acquire shares or other securities, cash or other property. A class or series also is entitled to vote as a separate voting group if the class or series would be entitled to vote as a separate group on a provision in the plan that, if contained in an amendment to the articles of incorporation, would require approval by that class or series under section 10.04. In this latter case, a class or series will be entitled to vote as a separate voting group if the terms of that class or series are being changed, or if the shares of that class or series are being reclassified into shares of any other class or series. It is not intended that immaterial changes in the language of the articles of incorporation made to conform to the usage of the laws of the foreign jurisdiction will alone create an entitlement to vote as a separate group.

Under section 10.04, and therefore under section 9.21(6), if a change that requires voting by separate voting groups affects two or more classes or two or more series in the same or a substantially similar way, the relevant classes or series will vote together, rather than separately, on the change. For the mechanics of voting where voting by voting groups is required under section 9.2 1(6), see sections 7.25 and 7.26.

If a domestication would amend the articles of incorporation to change the voting requirements on future amendments of the articles, the transaction must also be approved by the vote required by section 7.27.

3. Quorum and Voting

Section 9.21(5) provides that approval of a plan of domestication requires approval of the shareholders at a meeting at which there exists a quorum consisting of a majority of the votes entitled to be cast on the plan. Section 9.2 1(5) also provides that if any class or series of shares are entitled to vote as a separate group on the plan, the approval of each such separate group must be given at a meeting at which there exists a quorum consisting of at least a majority of the votes entitled to be cast on the plan by that class or series. If a quorum is present, then under sections 7.25 and 7.26 the plan will be approved if more votes are cast in favor of the plan than against it by each voting group entitled to vote on the plan.

In lieu of approval at a shareholders' meeting, approval can be given by the consent of all the shareholders entitled to vote on the domestication, under the procedures set forth in section 7.04.

4. Transitional Rule

Because the concept of domestication is new, persons who drafted and negotiated special rights for directors or shareholders before the enactment of this subchapter should not be charged with the consequences of not having dealt with the concept of domestication in the context of those special rights. Section 9.21(7) accordingly provides a transitional rule that is intended to protect such special rights. Other documents, in addition to the articles of incorporation and bylaws that may contain such special rights include shareholders agreements, voting trust agreements, vote pooling agreements or other similar arrangements. If, for example, the articles of incorporation provide that the corporation cannot participate in a merger without a supermajority vote of the shareholders, that supermajority requirement will also apply to the domestication of the corporation in another jurisdiction.

The purpose of section 9.21(7) is to protect persons who negotiated special rights for directors or shareholders whether in a contract with the corporation or in the articles of incorporation or bylaws, and section 9.21(7) should not be applied in such a way as to impair unconstitutionally the rights of any party to a contract with the corporation. As applied to the corporation, section 9.21(7) is an exercise of the reserved power of the state legislature set forth in section 1.02. The transitional rule in section 9.21(7) ceases to apply at such time as the provision of the articles of incorporation, bylaws or agreement giving rise to the special rights is first amended after the effective date of this subchapter because at that time the provision may be amended to address expressly a domestication of the corporation.

A similar transitional rule with regard to the application to a domestication of special contractual rights of third parties is found in section 9.20(e).

§ 9.22. ARTICLES OF DOMESTICATION

(a) After the domestication of a foreign business corporation has been authorized as required by the laws of the foreign jurisdiction, articles of domestication shall be signed by any officer or other duly authorized representative. The articles shall set forth:

(1) the name of the corporation immediately before the filing of the articles of domestication and, if that name is unavailable for use in this state or the corporation desires to change its name in connection with the domestication, a name that satisfies the requirements of section 4.01;

(2) the jurisdiction of incorporation of the corporation immediately before the filing of the articles of domestication and the date the corporation was incorporated in that jurisdiction; and

(3) a statement that the domestication of the corporation in this state was duly authorized as required by the laws of the jurisdiction in which the corporation was incorporated immediately before its domestication in this state.

(b) The articles of domestication shall either contain all of the provisions that section 2.02(a) requires to be set forth in articles of incorporation and any other desired provisions that section 2.02(b) permits to be included in articles of incorporation, or shall have attached articles of incorporation. In either case, provisions that would not be required to be included in restated articles of incorporation may be omitted.

(c) The articles of domestication shall be delivered to the secretary of state for filing, and shall take effect at the effective time provided in section 1.23.

(d) If the foreign corporation is authorized to transact business in this state under chapter 15, its certificate of authority shall be cancelled automatically on the effective date of its domestication.

CROSS-REFERENCES

"Deliver" defined, see § 1.40.

Effect of domestication, see § 9.24.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

"Foreign business corporation" defined, see § 1.40.

Required approvals, see § 9.02.

Surrender of charter upon domestication, see § 9.23.

OFFICIAL COMMENT

The filing of articles of domestication under this section makes the domestication of a foreign corporation in this state a matter of public record. It also makes of public record the articles of incorporation of the corporation as a corporation of this state. If the foreign corporation is authorized to transact business in this state, section 9.22(d) automatically cancels its certificate of authority.

This section applies only when a foreign corporation is domesticating in this state. When a domestic business corporation is domesticating in a foreign jurisdiction, the filing required in the foreign jurisdiction is determined by the laws of that jurisdiction. When a domestic business corporation domesticates in a foreign jurisdiction, the filing required in this state is described in section 9.23.

The filing requirements for articles of domestication are set forth in section 1.20. Under section 1.23, a document may specify a delayed effective time and date, and if it does so the document becomes effective at the time and date specified, except that a delayed effective date may not be later than the 90th day after the date the document is filed. To avoid any question about a gap in the continuity of its existence, it is recommended that a corporation use a delayed effective date provision in its domestication filings in both this state and the foreign jurisdiction, or otherwise coordinate those filings, so that the filings becoming effective at the same time.

As section 9.20(c)(4) makes clear, a corporation may amend its articles of incorporation in connection with a domestication. Because the articles of domestication will either contain or have attached to them an integrated set of articles of incorporation, they will also have the effect of restating the articles of incorporation.

§ 9.23. SURRENDER OF CHARTER UPON DOMESTICATION

(a) Whenever a domestic business corporation has adopted and approved, in the manner required by this subchapter, a plan of domestication providing for the corporation to be domesticated in a foreign jurisdiction, articles of charter surrender shall be signed on behalf of the corporation by any officer or other duly authorized representative. The articles of charter surrender shall set forth:

(1) the name of the corporation;

(2) a statement that the articles of charter surrender are being filed in connection with the domestication of the corporation in a foreign jurisdiction;

(3) a statement that the domestication was duly approved by the shareholders and, if voting by any separate voting group was required, by each such separate voting group, in the manner required by this Act and the articles of incorporation;

(4) the corporation's new jurisdiction of incorporation.

(b) The articles of charter surrender shall be delivered by the corporation to the secretary of state for filing. The articles of charter surrender shall take effect on the effective time provided in section 1.23.

CROSS-REFERENCES

"Deliver" defined, see § 1.40.

"Domestic business corporation" defined, see § 1.40.

Effect of domestication, see § 9.24.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

"Foreign business corporation" defined, see § 1.40.

Required approvals, see § 9.02.

OFFICIAL COMMENT

The filing of articles of charter surrender makes the domestication of the corporation in its new jurisdiction of incorporation a matter of public record in this state. It also terminates the status of the corporation as a corporation incorporated under the laws of this state. Once the articles of charter surrender have become effective, the corporation will no longer be in good standing in this state. The corporation may, however, apply for a certificate of authority as a foreign corporation under subchapter 15A.

Where a foreign corporation domesticates in this state, the filing required to terminate its status as a corporation incorporated under the laws of the foreign jurisdiction is determined by the laws of that jurisdiction.

The filing requirements for articles of charter surrender are set forth in sections 1.20 and 1.23. Under section 1.23, a document may specify a delayed effective time and date, and if it does so the document becomes effective at the time and date specified, except that a delayed effective date may not be later than the 90th day after the date the document is filed. To avoid any question about a gap in the continuity of its existence, it is recommended that a corporation use a delayed effective date provision in its domestication filings in both this state and the foreign jurisdiction, or otherwise coordinate those filings, so that the filings become effective at the same time.

§ 9.24. EFFECT OF DOMESTICATION

(a) When a domestication becomes effective:

(1) the title to all real and personal property, both tangible and intangible, of the corporation remains in the corporation without reversion or impairment;

(2) the liabilities of the corporation remain the liabilities of the corporation;

(3) an action or proceeding pending against the corporation continues against the corporation as if the domestication had not occurred;

(4) the articles of domestication, or the articles of incorporation attached to the articles of domestication, constitute the articles of incorporation of a foreign corporation domesticating in this state;

(5) the shares of the corporation are reclassified into shares, other securities, obligations, rights to acquire shares or other securities, or into cash or other property in accordance with the terms of the domestication, and the shareholders are entitled only to the rights provided by those terms and to any appraisal rights they may have under the organic law of the domesticating corporation; and

(6) the corporation is deemed to:

(i) be incorporated under and subject to the organic law of the domesticated corporation for all purposes;

(ii) be the same corporation without interruption as the domesticating corporation; and

(iii) have been incorporated on the date the domesticating corporation was originally incorporated.

(b) When a domestication of a domestic business corporation in a foreign jurisdiction becomes effective, the foreign business corporation is deemed to:

(1) appoint the secretary of state as its agent for service of process in a proceeding to enforce the rights of shareholders who exercise appraisal rights in connection with the domestication; and

(2) agree that it will promptly pay the amount, if any, to which such shareholders are entitled under chapter 13.

(c) The owner liability of a shareholder in a foreign corporation that is domesticated in this state shall be as follows:

(1) The domestication does not discharge any owner liability under the laws of the foreign jurisdiction to the extent any such owner liability arose before the effective time of the articles of domestication.

(2) The shareholder shall not have owner liability under the laws of the foreign jurisdiction for any debt, obligation or liability of the corporation that arises after the effective time of the articles of domestication.

(3) The provisions of the laws of the foreign jurisdiction shall continue to apply to the collection or discharge of any owner liability preserved by paragraph (1), as if the domestication had not occurred.

(4) The shareholder shall have whatever rights of contribution from other shareholders are provided by the laws of the foreign jurisdiction with respect to any owner liability preserved by paragraph (1), as if the domestication had not occurred.

(d) A shareholder who becomes subject to owner liability for some or all of the debts, obligations or liabilities of the corporation as a result of its domestication in this state shall have owner liability only for those debts, obligations or liabilities of the corporation that arise after the effective time of the articles of domestication.

CROSS-REFERENCES

"Domestic business corporation" defined, see § 1.40.

"Foreign corporation" defined, see § 1.40.

"Owner liability" defined, see § 1.40.

OFFICIAL COMMENT

When a corporation is domesticated in this state under this subchapter, the corporation becomes a domestic business corporation with the same status as if it had been originally incorporated under this Act. Thus, the domesticated corporation will have all of the powers, privileges and rights granted to corporations originally incorporated in this state and will be subject to all of the duties, liabilities and limitations imposed on domestic business corporations. Except as provided in section 9.24(b), the effect of domesticating a corporation of this state in a foreign jurisdiction is governed by the laws of the foreign jurisdiction. See section 9.24(a)(6)(i).

A domestication is not a conveyance, transfer or assignment. It does not give rise to claims of reverter or impairment of title based on a prohibited conveyance, transfer or assignment. Nor does it give rise to a claim that a contract with the corporation is no longer in effect on the ground of nonassignability, unless the contract specifically provides that it does not survive domestication.

Section 9.24(a)(1)–(3) and (b) are similar to section 11.07(a)(3)–(5) and (d) with respect to the effects of a merger. Although section 9.24(a)(1)–(3) would be implied by the general rule stated in section 9.24(a)(6) even if not stated expressly, those rules have been included to avoid any question as to whether a different result was intended.

The rule in section 9.24(a)(6)(iii) that the date of incorporation of the foreign corporation remains its date of incorporation after the corporation has been domesticated in this state is a specific application of the general rule in section 9.24(a)(6)(ii). The date of incorporation is required by section 9.22(a)(2) to be set forth in the articles of domestication.

One of the continuing liabilities of the corporation following its domestication in a foreign jurisdiction is the obligation to its shareholders who exercise appraisal rights to pay them the amount, if any, to which they are entitled under chapter 13.

Section 9.24(c) preserves liability only for owner liabilities to the extent they arise before the domestication. Owner liability is not preserved for subsequent changes in an underlying liability, regardless of whether a change is voluntary or involuntary.

Section 9.24(d) is an optional provision that will not be needed in most states. It should be included only when the statutory laws of a state impose personal liability on the shareholders of a corporation, for example, for unpaid wages owed to employees of the corporation.

§ 9.25. ABANDONMENT OF A DOMESTICATION

(a) Unless otherwise provided in a plan of domestication of a domestic business corporation, after the plan has been adopted and approved as required by this subchapter, and at any time before the domestication has become effective, it may be abandoned by the board of directors without action by the shareholders.

(b) If a domestication is abandoned under subsection (a) after articles of charter surrender have been filed with the secretary of state but before the domestication has become effective, a statement that the domestication has been abandoned in accordance with this section, signed by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing prior to the effective date of the domestication. The statement shall take effect upon filing and the domestication shall be deemed abandoned and shall not become effective.

(c) If the domestication of a foreign business corporation in this state is abandoned in accordance with the laws of the foreign jurisdiction after articles of domestication have been filed with the secretary of state, a statement that the domestication has been abandoned, signed by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing. The statement shall take effect upon filing and the domestication shall be deemed abandoned and shall not become effective.

CROSS-REFERENCES

Approval of domestication, see § 9.21.

"Deliver" defined, see § 1.40.

"Domestic business corporation" defined, see § 1.40.

Effective time and date of filing, see § 1.23.

Filing requirements, see § 1.20.

"Foreign corporation" defined, see § 1.40.

OFFICIAL COMMENT

Unless otherwise provided in a plan of domestication, a domestic business corporation proposing to domesticate in another jurisdiction may abandon the transaction without shareholder approval, even though the domestication has been previously approved by the shareholders. Whether the domestication of a foreign business corporation in this state may be abandoned is determined by the laws of the foreign jurisdiction.

Subchapter C.
NONPROFIT CONVERSION

§ 9.30. NONPROFIT CONVERSION

(a) A domestic business corporation may become a domestic nonprofit corporation pursuant to a plan of nonprofit conversion.

(b) A domestic business corporation may become a foreign nonprofit corporation if the nonprofit conversion is permitted by the laws of the foreign jurisdiction. Regardless of whether the laws of the foreign jurisdiction require the adoption of a plan of nonprofit conversion, the foreign nonprofit conversion shall be approved by the adoption by the domestic business corporation of a plan of nonprofit conversion in the manner provided in this subchapter.

(c) The plan of nonprofit conversion must include:

(1) the terms and conditions of the conversion;

(2) the manner and basis of reclassifying the shares of the corporation following its conversion into memberships, if any, or securities, obligations, rights to acquire memberships or securities, cash, other property, or any combination of the foregoing;

(3) any desired amendments to the articles of incorporation of the corporation following its conversion; and

(4) if the domestic business corporation is to be converted to a foreign nonprofit corporation, a statement of the jurisdiction in which the corporation will be incorporated after the conversion.

(d) The plan of nonprofit conversion may also include a provision that the plan may be amended prior to filing articles of nonprofit conversion, except that subsequent to approval of the plan by the shareholders the plan may not be amended to change:

(1) the amount or kind of memberships or securities, obligations, rights to acquire memberships or securities, cash, or other property to be received by the shareholders under the plan;

(2) the articles of incorporation as they will be in effect immediately following the conversion, except for changes permitted by section 10.05; or

(3) any of the other terms or conditions of the plan if the change would adversely affect any of the shareholders in any material respect.

(e) Terms of a plan of nonprofit conversion may be made dependent upon facts objectively ascertainable outside the plan in accordance with section 1.20(k).

(f) If any debt security, note or similar evidence of indebtedness for money borrowed, whether secured or unsecured, or a contract of any kind, issued, incurred or executed by a domestic business corporation before [the effective date of this subchapter] contains a provision applying to a merger of the corporation and the document does not refer to a nonprofit conversion of the corporation, the provision shall be deemed to apply to a nonprofit conversion of the corporation until such time as the provision is amended subsequent to that date.

CROSS-REFERENCES

Abandonment of nonprofit status conversion, see § 9.35.

Approval of plan, see § 9.31.

Articles of nonprofit conversion, see § 9.32.

"Domestic business corporation" defined, see § 1.40.

"Domestic nonprofit corporation" defined, see § 1.40.

Effect of nonprofit status conversion, see § 9.34. Excluded transactions, see § 9.01.

"Foreign nonprofit corporation" defined, see § 1.40.

"Membership" defined, see § 1.40.

[Required approvals, see § 9.02.]

OFFICIAL COMMENT

1. Applicability

This subchapter provides a procedure for a domestic business corporation to change its status from for-profit to not-for-profit and thus become a domestic nonprofit corporation. It is anticipated that a counterpart to this subchapter will be added to the Model Nonprofit Corporation Act which will provide a similar procedure for a nonprofit corporation to become a domestic business corporation subject to this Act by changing its status from not-for-profit to for-profit. In states that do not have a separate nonprofit corporation law, the provisions of this subchapter may be generalized to also permit nonprofit corporations (often referred to in such states as nonstock corporations) to acquire for-profit status.

This subchapter also provides a procedure for a domestic business corporation to become a foreign nonprofit corporation, which is in effect a combination of a domestication and a nonprofit conversion. However, section 9.30(b) permits a domestic business corporation to become a foreign nonprofit corporation only if the laws of the foreign jurisdiction permit the transaction.

This subchapter does not provide a procedure for a foreign business corporation to become a domestic nonprofit corporation because it is anticipated that such a procedure will be added to the Model Nonprofit Corporation Act. However, a foreign business corporation can achieve the same result by first domesticating in this state pursuant to subchapter 9B and then converting to a nonprofit corporation under this subchapter.

A separate procedure is provided in Subchapter 9D for a foreign nonprofit corporation to become a domestic business corporation.

2. Terms and Conditions of Nonprofit Conversion

This subchapter imposes virtually no restrictions or limitations on the terms and conditions of a nonprofit conversion, except for those set forth in section 9.30(d) concerning provisions in a plan of nonprofit conversion for amendment of the plan after it has been approved by the shareholders. Shares of a domestic business corporation that converts to a nonprofit corporation may be reclassified into memberships or securities, obligations, rights to acquire memberships or securities, cash or other property. The articles of incorporation of the converting business corporation will need to be amended to eliminate the provisions on its capital stock, and may be amended by the articles of nonprofit conversion in any other way deemed appropriate so long as the amended articles satisfy the requirements for articles of incorporation of a nonprofit corporation.

Although this subchapter imposes virtually no restrictions or limitations on the terms and conditions of a nonprofit conversion, section 9.30(c) requires that the terms and conditions be set forth in the plan of nonprofit conversion. The plan of nonprofit conversion is not required to be publicly filed, and the articles of nonprofit conversion that are filed with the secretary of state when a domestic business corporation converts to a domestic nonprofit corporation are not required to include a plan of nonprofit conversion. See section 9.32. Similarly, articles of charter surrender that are filed with the secretary of state by a domestic business corporation converting to a foreign nonprofit corporation are not required to include a plan of nonprofit conversion. See section 9.33.

The list in section 9.30(c) of required provisions in a plan of nonprofit conversion is not exhaustive and the plan may include any other provisions that may be desired.

3. Amendments of Articles of Incorporation

A corporation's articles of incorporation will need to be amended in its conversion to a nonprofit corporation so that the articles satisfy the requirements for articles of a nonprofit corporation. See section 9.32(b). Similarly, where a domestic business corporation converts to a foreign nonprofit corporation, the articles of incorporation will need to be amended to conform to the law of the foreign jurisdiction on the contents of articles of incorporation for a nonprofit corporation.

4. Adoption and Approval; Abandonment

The conversion of a domestic business corporation to a nonprofit corporation must be adopted and approved as provided in section 9.31. Under section 9.35, the board of directors of a domestic business corporation may abandon a conversion to nonprofit status before its effective date even if the plan of nonprofit conversion has already been approved by the corporation's shareholders.

5. Appraisal Rights

Shareholders of a domestic business corporation that adopts and approves a plan of nonprofit conversion have appraisal rights. See section 9.34(b) and chapter 13.02(a)(7).

6. Transitional Rule

Because the concept of nonprofit conversion is new, a person contracting with a corporation or loaning it money who drafted and negotiated special rights relating to the transaction before the enactment of this subchapter should not be charged with the consequences of not having dealt with the concept of nonprofit conversion in the context of those special rights. Section 9.30(e) accordingly provides a transitional rule that is intended to protect such special rights. If, for example, a corporation is a party to a contract that provides that the corporation cannot participate in a merger without the consent of the other party to the contract, the requirement to obtain the consent of the other party will also apply to the conversion of the corporation to a domestic or foreign nonprofit corporation. If the corporation fails to obtain the consent, the result will be that the other party will have the same rights it would have if the corporation were to participate in a merger without the required consent.

The purpose of section 9.30(f) is to protect the third party to a contract with the corporation, and section 9.30(f) should not be applied in such a way as to impair unconstitutionally the third party's contract. As applied to the corporation, section 9.30(f) is an exercise of the reserved power of the state legislature set forth in section 1.02.

The transitional rule in section 9.30(f) ceases to apply at such time as the provision of the agreement or debt instrument giving rise to the special rights is first amended after the effective date of this subchapter because at that time the provision may be amended to address expressly a nonprofit conversion of the corporation.

A similar transitional rule governing the application to a nonprofit conversion of special voting rights of directors and shareholders and other internal corporate procedures is found in section 9.31(6).

§ 9.31. ACTION ON A PLAN OF NONPROFIT CONVERSION

In the case of a conversion of a domestic business corporation to a domestic or foreign nonprofit corporation:

(1) The plan of nonprofit conversion must be adopted by the board of directors.

(2) After adopting the plan of nonprofit conversion, the board of directors must submit the plan to the shareholders for their approval. The board of directors must also transmit to the shareholders a recommendation that the shareholders approve the plan, unless the board of directors makes a determination that because of conflicts of interest or other

special circumstances it should not make such a recommendation, in which case the board of directors must transmit to the shareholders the basis for that determination.

(3) The board of directors may condition its submission of the plan of nonprofit conversion to the shareholders on any basis.

(4) If the approval of the shareholders is to be given at a meeting, the corporation must notify each shareholder of the meeting of shareholders at which the plan of nonprofit conversion is to be submitted for approval. The notice must state that the purpose, or one of the purposes, of the meeting is to consider the plan and must contain or be accompanied by a copy or summary of the plan. The notice shall include or be accompanied by a copy of the articles of incorporation as they will be in effect immediately after the nonprofit conversion.

(5) Unless the articles of incorporation, or the board of directors acting pursuant to paragraph (3), requires a greater vote or a greater number of votes to be present, approval of the plan of nonprofit conversion requires the approval of each class or series of shares of the corporation voting as a separate voting group at a meeting at which a quorum of the voting group consisting of at least a majority of the votes entitled to be cast on the nonprofit conversion by that voting group exists.

(6) If any provision of the articles of incorporation, bylaws or an agreement to which any of the directors or shareholders are parties, adopted or entered into before [the effective date of this subchapter], applies to a merger of the corporation and the document does not refer to a nonprofit conversion of the corporation, the provision shall be deemed to apply to a nonprofit conversion of the corporation until such time as the provision is amended subsequent to that date.

CROSS-REFERENCES

Abandonment of nonprofit conversion, see § 9.35.

Contents of plan of nonprofit conversion, see § 9.30.

"Domestic business corporation" defined, see § 1.40.

"Domestic nonprofit corporation" defined, see § 1.40.

"Foreign nonprofit corporation" defined, see § 1.40.

OFFICIAL COMMENT

1. In General

This section sets forth the rules for adoption and approval of a plan of nonprofit conversion of a domestic business corporation to a domestic or foreign nonprofit corporation.

A plan of nonprofit conversion must be adopted by the board of directors. Although section 9.31(2) permits the board to refrain from making a recommendation to the shareholders that they approve the plan, that does not change the underlying requirement that the board first adopt the plan before it is submitted to the shareholders. Approval by the shareholders of a plan of nonprofit conversion is always required.

2. Quorum and Voting

Section 9.31(5) provides that if the corporation has more than one class or series of shares, approval of a nonprofit conversion requires the approval of each class or series voting as a separate voting group at a meeting at which there exists a quorum consisting of at least a majority of the votes entitled to be cast on the plan by that class or series. If a quorum is present, then under sections 7.25 and 7.26 the plan will be approved if more votes are cast in favor of the plan than against it by each voting group entitled to vote on the plan. If the shares of a corporation are not divided into two or more classes or series, all of the shares together will constitute a single class for purposes of section 9.31(5).

In lieu of approval at a shareholders' meeting, approval can be given by the consent of all the shareholders entitled to vote on the conversion, under the procedures set forth in section 7.04.

3. Transitional Rule

Because the concept of nonprofit conversion is new, persons who drafted and negotiated special rights for directors or shareholders before the enactment of this subchapter should not be charged with the consequences of not having dealt with the concept of nonprofit conversion in the context of those special rights. Section 9.31(6) accordingly provides a transitional rule that is intended to protect such special rights. Other documents, in addition to the articles of incorporation and bylaws that may contain such special rights include shareholders agreements, voting trust agreements, vote pooling agreements or other similar arrangements. If, for example, the articles of incorporation provide that the corporation cannot participate in a merger without a supermajority vote of the shareholders, that supermajority requirement will also apply to the conversion of the corporation to a domestic or foreign nonprofit corporation.

The purpose of section 9.31(6) is to protect persons who negotiated special rights for directors or shareholders whether in a contract with the corporation or in the articles of incorporation or bylaws, and section 9.31(6) should not be applied in such a way as to impair unconstitutionally the rights of any party to a contract with the corporation. As applied to the corporation, section 9.31(6) is an exercise of the reserved power of the state legislature set forth in section 1.02.

The transitional rule in section 9.31(6) ceases to apply at such time as the provision of the articles of incorporation, bylaws or agreement giving rise to the special rights is first amended after the effective date of this subchapter because at that time the provision may be amended to address expressly a nonprofit conversion of the corporation.

A similar transitional rule with regard to the application to a nonprofit conversion of special contractual rights of third parties is found in section 9.30(f).

§ 9.32. ARTICLES OF NONPROFIT CONVERSION

(a) After a plan of nonprofit conversion providing for the conversion of a domestic business corporation to a domestic nonprofit corporation has been adopted and approved as required by this Act, articles of nonprofit conversion shall be signed on behalf of the corporation by any officer or other duly authorized representative. The articles shall set forth:

(1) the name of the corporation immediately before the filing of the articles of nonprofit conversion and if that name does not satisfy the requirements of [the Model Nonprofit Corporation Act], or the corporation desires to change its name in connection with the conversion, a name that satisfies the requirements of [the Model Nonprofit Corporation Act];

(2) a statement that the plan of nonprofit conversion was duly approved by the shareholders in the manner required by this Act and the articles of incorporation.

(b) The articles of nonprofit conversion shall either contain all of the provisions that [the Model Nonprofit Corporation Act] requires to be set forth in articles of incorporation of a domestic nonprofit corporation and any other desired provisions permitted by [the Model Nonprofit Corporation Act], or shall have attached articles of incorporation that satisfy the requirements of [the Model Nonprofit Corporation Act]. In either case, provisions that would not be required to be included in restated articles of incorporation of a domestic nonprofit corporation may be omitted.

(c) The articles of nonprofit conversion shall be delivered to the secretary of state for filing, and shall take effect at the effective time provided in section 1.23.

CROSS-REFERENCES

"Deliver" defined, see § 1.40.

"Domestic business corporation" defined, see § 1.40.

"Domestic nonprofit corporation" defined, see § 1.40.

Effect of nonprofit conversion, see § 9.34.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

Required approvals, see § 9.02.

Surrender of charter upon foreign nonprofit conversion, see § 9.33.

OFFICIAL COMMENT

The filing of articles of nonprofit conversion makes the conversion of a domestic business corporation to a domestic nonprofit corporation a matter of public record. Where a domestic business corporation is converting to a foreign nonprofit corporation, the filing required in the foreign jurisdiction is determined by the laws of that jurisdiction. The filing required in this state when a domestic business corporation converts to a foreign nonprofit corporation is described in section 9.33.

The filing requirements for articles of nonprofit conversion are set forth in section 1.20. Under section 1.23, a document may specify a delayed effective time and date, and if it does so the document becomes effective at the time and date specified, except that a delayed effective date may not be later than the 90th day after the date the document is filed.

The articles of incorporation that must be included in or attached to the articles of nonprofit conversion will satisfy the requirements of [the Model Nonprofit Corporation Act] for incorporating a nonprofit corporation.

This section and section 9.34(a)(6) assume that all nonprofit corporations are incorporated under the same law. If that is not the case, appropriate changes must be made to this section and section 9.34(a)(6) so that the type of nonprofit corporation that will result from the conversion is made clear.

§ 9.33. SURRENDER OF CHARTER UPON FOREIGN NONPROFIT CONVERSION

(a) Whenever a domestic business corporation has adopted and approved, in the manner required by this subchapter, a plan of nonprofit conversion providing for the corporation to be converted to a foreign nonprofit corporation, articles of charter surrender shall be signed on behalf of the corporation by any officer or other duly authorized representative. The articles of charter surrender shall set forth:

(1) the name of the corporation;

(2) a statement that the articles of charter surrender are being filed in connection with the conversion of the corporation to a foreign nonprofit corporation;

(3) a statement that the foreign nonprofit conversion was duly approved by the shareholders in the manner required by this Act and the articles of incorporation;

(4) the corporation's new jurisdiction of incorporation.

(b) The articles of charter surrender shall be delivered by the corporation to the secretary of state for filing. The articles of charter surrender shall take effect on the effective time provided in section 1.23.

CROSS-REFERENCES

"Deliver" defined, see § 1.40.

"Domestic business corporation" defined, see § 1.40.

Effect of nonprofit conversion, see § 9.34.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

"Foreign nonprofit corporation" defined, see § 1.40.

Required approvals, see § 9.02.

OFFICIAL COMMENT

The filing of articles of charter surrender makes the conversion of the domestic business corporation to a foreign nonprofit corporation in its new jurisdiction of incorporation a matter of public record in this state. It also terminates the status of the corporation as a corporation incorporated under the laws of this state. Once the articles of charter surrender have become effective, the corporation will no longer be in good standing in this state. The corporation may, however, apply for a certificate of authority as a foreign nonprofit corporation under [subchapter 15A of the Model Nonprofit Corporation Act].

The filing requirements for articles of charter surrender are set forth in sections 1.20 and 1.23. Under section 1.23, a document may specify a delayed effective time and date, and if it does so the document becomes effective at the time and date specified, except that a delayed effective date may not be later than the 90th day after the date the document is filed. To avoid any question about a gap in the continuity of its existence, it is recommended that a corporation use a delayed effective date provision in its nonprofit conversion filings in both this state and the foreign jurisdiction, or otherwise coordinate those filings, so that the filings become effective at the same time.

§ 9.34. EFFECT OF NONPROFIT CONVERSION

(a) When a conversion of a domestic business corporation to a domestic nonprofit corporation becomes effective:

(1) the title to all real and personal property, both tangible and intangible, of the corporation remains in the corporation without reversion or impairment;

(2) the liabilities of the corporation remain the liabilities of the corporation;

(3) an action or proceeding pending against the corporation continues against the corporation as if the conversion had not occurred;

(4) the articles of incorporation of the domestic or foreign nonprofit corporation become effective;

(5) the shares of the corporation are reclassified into memberships, securities, obligations, rights to acquire memberships or securities, or into cash or other property in accordance with the plan of conversion, and the shareholders are entitled only to the rights provided in the plan of nonprofit conversion or to any rights they may have under chapter 13; and

(6) the corporation is deemed to:

(i) be a domestic nonprofit corporation for all purposes;

(ii) be the same corporation without interruption as the corporation that existed prior to the conversion; and

(iii) have been incorporated on the date that it was originally incorporated as a domestic business corporation.

(b) When a conversion of a domestic business corporation to a foreign nonprofit corporation becomes effective, the foreign nonprofit corporation is deemed to:

(1) appoint the secretary of state as its agent for service of process in a proceeding to enforce the rights of shareholders who exercise appraisal rights in connection with the conversion; and

(2) agree that it will promptly pay the amount, if any, to which such shareholders are entitled under chapter 13.

(c) The owner liability of a shareholder in a domestic business corporation that converts to a domestic nonprofit corporation shall be as follows:

(1) The conversion does not discharge any owner liability of the shareholder as a shareholder of the business corporation to the extent any such owner liability arose before the effective time of the articles of nonprofit conversion.

(2) The shareholder shall not have owner liability for any debt, obligation or liability of the nonprofit corporation that arises after the effective time of the articles of nonprofit conversion.

(3) The laws of this state shall continue to apply to the collection or discharge of any owner liability preserved by paragraph (1), as if the conversion had not occurred and the nonprofit corporation was still a business corporation.

(4) The shareholder shall have whatever rights of contribution from other shareholders are provided by the laws of this state with respect to any owner liability preserved by paragraph (1), as if the conversion had not occurred and the nonprofit corporation were still a business corporation.

(d) A shareholder who becomes subject to owner liability for some or all of the debts, obligations or liabilities of the nonprofit corporation shall have owner liability only for those debts, obligations or liabilities of the nonprofit corporation that arise after the effective time of the articles of nonprofit conversion.]

CROSS-REFERENCES

"Domestic business corporation" defined, see § 1.40.

"Domestic nonprofit corporation" defined, see § 1.40.

"Membership" defined, see § 1.40.

"Owner liability" defined, see § 1.40.

OFFICIAL COMMENT

When a corporation is converted under this subchapter, the corporation becomes a domestic nonprofit corporation with the same status as if it had been originally incorporated under [the Model Nonprofit Corporation Act]. Thus, the converted corporation will have all of the powers, privileges and rights granted to nonprofit corporations originally incorporated as such in this state and will be subject to all of the duties, liabilities and limitations imposed on domestic nonprofit corporations.

A nonprofit conversion is not a conveyance, transfer or assignment. It does not give rise to claims of reverter or impairment of title based on a prohibited conveyance, transfer or assignment. Nor does it give rise to a claim that a contract with the corporation is no longer in effect on the ground of nonassignability, unless the contract specifically provides that it does not survive a conversion.

Section 9.34(a)(1)–(3) are similar to section 11.07(a)(3)–(5) with respect to the effects of a merger. Although section 9.34(a)(1)–(3) would be implied by the general rule stated in section 9.34(a) (6) even if not stated expressly, those rules have been included to avoid any question as to whether a different result was intended.

The rule in section 9.34(a)(6)(iii) that the date of incorporation of the corporation remains its date of incorporation after the corporation has been converted is a specific application of the general rule in section 9.34(a)(6)(ii). The date of incorporation is already a matter of public record in this state as a result of the original incorporation of the corporation.

One of the continuing liabilities of the corporation following its conversion to nonprofit status is the obligation to its shareholders who exercise appraisal rights to pay them the amount, if any, to which they are entitled under chapter 13.

Section 9.34(c) and (d) are optional provisions that will not be needed in most states. Those provisions should be included only when the statutory laws of a state impose some form of personal liability on the members of a nonprofit corporation that is not imposed on shareholders of a business corporation, or the reverse. Section 9.34(c) preserves liability only for owner liabilities to the extent they arise before the conversion. Owner liability is not preserved for subsequent changes in an underlying liability, regardless of whether a change is voluntary or involuntary.

§ 9.35. ABANDONMENT OF A NONPROFIT CONVERSION

Unless otherwise provided in a plan of nonprofit conversion of a domestic business corporation, after the plan has been adopted and approved as required by this subchapter, and at any time before the nonprofit conversion has become effective, it may be abandoned by the board of directors without action by the shareholders.

If a nonprofit conversion is abandoned under subsection (a) after articles of nonprofit conversion or articles of charter surrender have been filed with the secretary of state but before the nonprofit conversion has become effective, a statement that the nonprofit conversion has been abandoned in accordance with this section, signed by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing prior to the effective date of the nonprofit conversion. The statement shall take effect upon filing and the nonprofit conversion shall be deemed abandoned and shall not become effective.

CROSS-REFERENCES

Approval of nonprofit conversion, see § 9.31

"Deliver" defined, see § 1.40.

"Domestic business corporation" defined, see § 1.40.

Effective time and date of filing, see §§ 1.23 and 9.32(c).

Filing requirements, see § 1.20.

OFFICIAL COMMENT

Unless otherwise provided in a plan of nonprofit conversion, a domestic business corporation proposing to convert to nonprofit status may abandon the transaction without shareholder approval, even though the conversion has been previously approved by the shareholders.

Subchapter D.
FOREIGN NONPROFIT DOMESTICATION AND CONVERSION

§ 9.40. FOREIGN NONPROFIT DOMESTICATION AND CONVERSION

A foreign nonprofit corporation may become a domestic business corporation if the domestication and conversion is permitted by the organic law of the foreign nonprofit corporation.

CROSS-REFERENCES

Abandonment of foreign nonprofit domestication and conversion, see § 9.43.

Articles of domestication and conversion, see § 9.41.

Articles of incorporation following domestication and conversion, see § 9.41(b).

"Domestic business corporation" defined, see § 1.40.

Effect of foreign nonprofit domestication and conversion, see § 9.42.

Excluded transactions, see § 9.01.

"Foreign nonprofit corporation" defined, see § 1.40.

"Organic law" defined, see § 1.40.

Required approvals, see § 9.02.

OFFICIAL COMMENT

This subchapter authorizes a foreign nonprofit corporation to become a domestic business corporation. The manner in which a foreign nonprofit corporation may be domesticated in this state and converted to a domestic business corporation must be adopted and approved will be controlled by the laws of the foreign jurisdiction.

The domestication of a foreign nonprofit corporation in this state as a domestic nonprofit corporation is outside the scope of this Act. Similarly, the conversion of a foreign nonprofit corporation to a domestic other entity is also outside the scope of this Act.

§ 9.41. ARTICLES OF DOMESTICATION AND CONVERSION

(a) After the conversion of a foreign nonprofit corporation to a domestic business corporation has been authorized as required by the laws of the foreign jurisdiction, articles of domestication and conversion shall be signed by any officer or other duly authorized representative. The articles shall set forth:

(1) the name of the corporation immediately before the filing of the articles of domestication and conversion and, if that name is unavailable for use in this state or the corporation desires to change its name in connection with the domestication and conversion, a name that satisfies the requirements of section 4.01;

(2) the jurisdiction of incorporation of the corporation immediately before the filing of the articles of domestication and conversion and the date the corporation was incorporated in that jurisdiction; and

(3) a statement that the domestication and conversion of the corporation in this state was duly authorized as required by the laws of the jurisdiction in which the corporation was incorporated immediately before its domestication and conversion in this state.

(b) The articles of domestication and conversion shall either contain all of the provisions that section 2.02(a) requires to be set forth in articles of incorporation and any other desired provisions that section 2.02(b) permits to be included in articles of incorporation, or shall have attached articles of incorporation. In either case, provisions that would not be required to be included in restated articles of incorporation may be omitted.

(c) The articles of domestication and conversion shall be delivered to the secretary of state for filing, and shall take effect at the effective time provided in section 1.23.

(d) If the foreign nonprofit corporation is authorized to transact business in this state under [the foreign qualification provision of the Model Nonprofit Corporation Act], its certificate of authority shall be cancelled automatically on the effective date of its domestication and conversion.

CROSS-REFERENCES

"Deliver" defined, see § 1.40.

"Domestic business corporation" defined, see § 1.40.

Effect of domestication and conversion, see § 9.42.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

"Foreign nonprofit corporation" defined, see § 1.40.

Required approvals, see § 9.02.

OFFICIAL COMMENT

The filing of articles of domestication and conversion under this section makes the domestication of a foreign nonprofit corporation in this state and its conversion to for-profit status a matter of public record. It also makes of public record the articles of incorporation of the corporation as a corporation of this state. If the foreign corporation is authorized to transact business in this state, section 9.41(d) automatically cancels its certificate of authority.

This section only applies in the situation where a foreign nonprofit corporation is domesticating in this state and converting to for-profit status. The domestication of a foreign nonprofit corporation in this state as a domestic nonprofit corporation is not within the scope of this Act.

The filing requirements for articles of domestication and conversion are set forth in section 1.20. Under section 1.23, a document may specify a delayed effective time and date, and if it does so the document becomes effective at the time and date specified, except that a delayed effective date may not be later than the 90th day after the date the document is filed. To avoid any question about a gap in the continuity of its existence, it is recommended that a corporation use a delayed effective date provision in its domestication and conversion filings in both this state and the foreign jurisdiction, or otherwise coordinate those filings, so that the filings becoming effective at the same time.

§ 9.42. EFFECT OF FOREIGN NONPROFIT DOMESTICATION AND CONVERSION

(a) When a domestication and conversion of a foreign nonprofit corporation to a domestic business corporation becomes effective:

(1) the title to all real and personal property, both tangible and intangible, of the corporation remains in the corporation without reversion or impairment;

(2) the liabilities of the corporation remain the liabilities of the corporation;

(3) an action or proceeding pending against the corporation continues against the corporation as if the domestication and conversion had not occurred;

(4) the articles of domestication and conversion, or the articles of incorporation attached to the articles of domestication and conversion, constitute the articles of incorporation of the corporation;

(5) shares, other securities, obligations, rights to acquire shares or other securities of the corporation, or cash or other property shall be issued or paid as provided pursuant to the laws of the foreign jurisdiction, so long as at least one share is outstanding immediately after the effective time; and

(6) the corporation is deemed to:

(i) be a domestic corporation for all purposes;

(ii) be the same corporation without interruption as the foreign nonprofit corporation; and

(iii) have been incorporated on the date the foreign nonprofit corporation was originally incorporated.

(b) The owner liability of a member of a foreign nonprofit corporation that domesticates and converts to a domestic business corporation shall be as follows:

(1) The domestication and conversion does not discharge any owner liability under the laws of the foreign jurisdiction to the extent any such owner liability arose before the effective time of the articles of domestication and conversion.

(2) The member shall not have owner liability under the laws of the foreign jurisdiction for any debt, obligation or liability of the corporation that arises after the effective time of the articles of domestication and conversion.

(3) The provisions of the laws of the foreign jurisdiction shall continue to apply to the collection or discharge of any owner liability preserved by paragraph (1), as if the domestication and conversion had not occurred.

(4) The member shall have whatever rights of contribution from other members are provided by the laws of the foreign jurisdiction with respect to any owner liability preserved by paragraph (1), as if the domestication and conversion had not occurred.

(c) A member of a foreign nonprofit corporation who becomes subject to owner liability for some or all of the debts, obligations or liabilities of the corporation as a result of its domestication and conversion in this state shall have owner liability only for those debts, obligations or liabilities of the corporation that arise after the effective time of the articles of domestication and conversion.

CROSS-REFERENCES

"Domestic business corporation" defined, see § 1.40.

"Foreign nonprofit corporation" defined, see § 1.40.

"Owner liability" defined, see § 1.40.

OFFICIAL COMMENT

When a corporation is domesticated in this state and converted to for-profit status under this subchapter, the corporation becomes a domestic business corporation with the same status as if it had been originally incorporated under this Act. Thus, the domesticated business corporation will have all of the powers, privileges and rights granted to corporations originally incorporated in this state and will be subject to all of the duties, liabilities and limitations imposed on domestic business corporations.

A domestication and conversion under this subchapter is not a conveyance, transfer or assignment. It does not give rise to claims of reverter or impairment of title based on a prohibited conveyance, transfer or assignment. Nor does it give rise to a claim that a contract with the corporation is no longer in effect on the ground of nonassignability, unless the contract specifically provides that it does not survive a domestication or conversion.

Section 9.42(a)(1)–(3) are similar to section 11.07(a)(3)–(5) with respect to the effects of a merger. Although section 9.42(a)(1)–(3) would be implied by the general rule stated in section 9.42(a)(6) even if not stated expressly, those rules have been included to avoid any question as to whether a different result was intended.

The rule in section 9.42(a)(6)(iii) that the date of incorporation of the foreign corporation remains its date of incorporation after the corporation has been domesticated and converted in this state is a specific application of the general rule in section 9.42(a)(6)(ii). The date of incorporation is required by section 9.41(a) (2) to be set forth in the articles of domestication and conversion.

Section 9.42(b) preserves liability only for owner liabilities to the extent they arise before the domestication and conversion. Owner liability is not preserved for subsequent changes in an underlying liability, regardless of whether a change is voluntary or involuntary.

Section 9.42(c) is an optional provision that will not be needed in most states. It should be included only when the statutory laws of a state impose personal liability on the shareholders of a business corporation that is not imposed on the members of a nonprofit corporation.

§ 9.43. ABANDONMENT OF A FOREIGN NONPROFIT DOMESTICATION AND CONVERSION

If the domestication and conversion of a foreign nonprofit corporation to a domestic business corporation is abandoned in accordance with the laws of the foreign jurisdiction after articles of domestication and conversion have been filed with the secretary of state, a statement that the domestication and conversion has been abandoned, signed by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing. The statement shall take effect upon filing and the domestication and conversion shall be deemed abandoned and shall not become effective.

CROSS-REFERENCES

"Deliver" defined, see § 1.40.

"Domestic business corporation" defined, see § 1.40.

Effective time and date of filing, see § 1.23.

Filing requirements, see § 1.20.

"Foreign nonprofit corporation" defined, see § 1.40.

OFFICIAL COMMENT

Whether or not the domestication and conversion of a foreign nonprofit corporation may be abandoned is determined by the laws of the foreign jurisdiction.

Subchapter E.
ENTITY CONVERSION

§ 9.50. ENTITY CONVERSION AUTHORIZED; DEFINITIONS

(a) A domestic business corporation may become a domestic unincorporated entity pursuant to a plan of entity conversion.

(b) A domestic business corporation may become a foreign unincorporated entity if the entity conversion is permitted by the laws of the foreign jurisdiction.

(c) A domestic unincorporated entity may become a domestic business corporation. If the organic law of a domestic unincorporated entity does not provide procedures for the approval of an entity conversion, the conversion shall be adopted and approved, and the entity conversion effectuated, in the same manner as a merger of the unincorporated entity. If the organic law of a domestic unincorporated entity does not provide procedures for the approval of either an entity conversion or a merger, a plan of entity conversion shall be adopted and approved, the entity conversion effectuated, and appraisal rights exercised, in accordance with the procedures in this subchapter and chapter 13. Without limiting the provisions of this subsection, a domestic unincorporated entity whose organic law does not provide procedures for the approval of an entity conversion shall be subject to subsection (e) and section 9.52(7). For purposes of applying this subchapter and chapter 13:

(1) the unincorporated entity, its interest holders, interests and organic documents taken together, shall be deemed to be a domestic business corporation, shareholders, shares and articles of incorporation, respectively and vice versa, as the context may require; and

(2) if the business and affairs of the unincorporated entity are managed by a group of persons that is not identical to the interest holders, that group shall be deemed to be the board of directors.

(d) A foreign unincorporated entity may become a domestic business corporation if the organic law of the foreign unincorporated entity authorizes it to become a corporation in another jurisdiction.

(e) If any debt security, note or similar evidence of indebtedness for money borrowed, whether secured or unsecured, or a contract of any kind, issued, incurred or executed by a domestic business corporation before [the effective date of this subchapter], applies to a merger of the corporation and the document does not refer to an entity conversion of the corporation, the provision shall be deemed to apply to an entity conversion of the corporation until such time as the provision is amended subsequent to that date.

(f) As used in this subchapter:

(1) "Converting entity" means the domestic business corporation or domestic unincorporated entity that adopts a plan of entity conversion or the foreign unincorporated entity converting to a domestic business corporation.

(2) "Surviving entity" means the corporation or unincorporated entity that is in existence immediately after consummation of an entity conversion pursuant to this subchapter.

CROSS-REFERENCES

"Domestic business corporation" defined, see § 1.40.

"Domestic unincorporated entity" defined, see § 1.40.

Excluded transactions, see § 9.01.

"Foreign unincorporated entity" defined, see § 1.40.

"Interest" defined, see § 1.40.

"Interest holder" defined, see § 1.40.

"Organic document" defined, see § 1.40.

"Organic law" defined, see § 1.40.

Required approvals, see § 9.02.

OFFICIAL COMMENT

1. Scope of Subchapter

Subject to certain restrictions which are discussed below, this subchapter authorizes the following types of conversion:

1. a domestic business corporation to a domestic other entity,

2. a domestic business corporation to a foreign other entity,

3. a domestic other entity to a domestic business corporation,

4. a foreign other entity to a domestic business corporation.

This subchapter provides for the conversion of a domestic unincorporated entity only to a domestic business corporation because the conversion of a domestic unincorporated entity to another form of unincorporated entity or to a foreign business corporation would be outside of the scope of this Act. This subchapter similarly does not provide for the conversion of a foreign corporation or unincorporated entity to a domestic unincorporated entity. States may nonetheless wish to consider generalizing the provisions of this subchapter to authorize those types of conversions.

2. Procedural Requirements

The concept of entity conversion as authorized by this subchapter is not found in many laws governing the incorporation or organization of corporations and other entities. In recognition of that fact, the rules in this section vary depending on whether the corporation or other entity desiring to convert pursuant to this subchapter is incorporated or organized under the laws of this state or of some other jurisdiction.

If the organic law of a domestic unincorporated entity does not expressly authorize it to convert to a domestic business corporation, it is intended that the first sentence of subsection (c) will provide the necessary authority. Until such time as the various laws of each form of unincorporated entity have been amended to provide procedures for adopting and approving a plan of entity conversion, subsection (c) provides those procedures by reference to the procedures for mergers under the organic law of the unincorporated entity or, if there are no such merger provisions, by reference to the provisions of this subchapter applicable to domestic business corporations.

Subsection (d) provides that a foreign unincorporated entity may convert to a domestic business corporation pursuant to this subchapter only if the law under which the foreign unincorporated entity is organized permits the conversion. This rule avoids issues that could arise if this state authorized a foreign unincorporated entity to participate in a transaction in this state that its home jurisdiction did not authorize. This subchapter does not specify the procedures that a foreign unincorporated entity must follow to authorize a conversion under this subchapter on the assumption that if the law under which the foreign unincorporated entity is organized authorizes the conversion that law will also provide the applicable procedures and any safeguards considered necessary to protect the interest holders of the unincorporated entity.

3. Transitional Rule

Because the concept of entity conversion is new, a person contracting with a corporation or loaning it money who drafted and negotiated special rights relating to the transaction before the enactment of this subchapter should not be charged with the consequences of not having dealt with the concept of entity conversion in the context of those special rights. Section 9.50(e) accordingly provides a transitional rule that is intended to protect such special rights. If, for example, a corporation is a party to a contract that provides that the corporation cannot participate in a merger without the consent of the other party to the contract, the requirement to obtain the consent of the other party will also apply to the conversion of the corporation to a domestic or foreign other entity. If the corporation fails to obtain the consent, the result will be that the other party will have the same rights it would have if the corporation were to participate in a merger without the required consent.

The purpose of section 9.50(e) is to protect the third party to a contract with the corporation, and section 9.50(e) should not be applied in such a way as to impair unconstitutionally the third party's contract. As applied to the corporation, section 9.50(e) is an exercise of the reserved power of the state legislature set forth in section 1.02.

The transitional rule in section 9.50(e) ceases to apply at such time as the provision of the agreement or debt instrument giving rise to the special rights is first amended after the effective date of this subchapter because at that time the provision may be amended to address expressly an entity conversion of the corporation.

Section 9.50(e) will also apply in the case of an unincorporated entity whose organic law does not provide procedures for the approval of an entity conversion because section 9.50(c) treats such an unincorporated entity as a business corporation for purposes of section 9.50(e).

A similar transitional rule governing the application to an entity conversion of special voting rights of directors and shareholders and other internal corporate procedures is found in section 9.52(6).

§ 9.51. PLAN OF ENTITY CONVERSION

(a) A plan of entity conversion must include:

(1) a statement of the type of other entity the surviving entity will be and, if it will be a foreign other entity, its jurisdiction of organization;

(2) the terms and conditions of the conversion;

(3) the manner and basis of converting the shares of the domestic business corporation following its conversion into interests or other securities, obligations, rights to acquire interests or other securities, cash, other property, or any combination of the foregoing; and

(4) the full text, as they will be in effect immediately after consummation of the conversion, of the organic documents of the surviving entity.

(b) The plan of entity conversion may also include a provision that the plan may be amended prior to filing articles of entity conversion, except that subsequent to approval of the plan by the shareholders the plan may not be amended to change:

(1) the amount or kind of shares or other securities, interests, obligations, rights to acquire shares, other securities or interests, cash, or other property to be received under the plan by the shareholders;

(2) the organic documents that will be in effect immediately following the conversion, except for changes permitted by a provision of the organic law of the surviving entity comparable to section 10.05; or

(3) any of the other terms or conditions of the plan if the change would adversely affect any of the shareholders in any material respect.

(c) Terms of a plan of entity conversion may be made dependent upon facts objectively ascertainable outside the plan in accordance with section 1.20(k).

CROSS-REFERENCES

Abandonment of entity conversion, see § 9.56.

Application to domestic unincorporated entities, see § 9.50(c).

Approval of plan, see § 9.52.

Domestic business corporation" defined, see § 1.40.

"Domestic unincorporated entity" defined, see § 1.40.

Effect of entity conversion, see § 9.55.

"Foreign unincorporated entity" defined, see § 1.40.

"Interest" defined, see § 1.40.

"Interest holder" defined, see § 1.40.

"Organic document" defined, see § 1.40.

"Surviving entity" defined, see § 9.50(f)(2).

"Unincorporated entity" defined, see § 1.40.

OFFICIAL COMMENT

1. Terms and Conditions of Entity Conversion

This subchapter imposes virtually no restrictions or limitations on the terms and conditions of an entity conversion, except for those set forth in section 9.51(b) concerning provisions in a plan of entity conversion for amendment of the plan after it has been approved by the shareholders. Shares of a domestic business corporation that converts to an unincorporated entity may be reclassified into interests or other securities, obligations, rights to acquire interests or other securities, cash or other property. The capitalization of the entity will need to be restructured in the conversion and its organic documents or articles of incorporation may be amended by the articles of entity conversion in any way deemed appropriate. When a foreign unincorporated entity converts to a domestic business corporation, the laws of the foreign jurisdiction determine which of the foregoing actions may be taken.

Although this subchapter imposes virtually no restrictions or limitations on the terms and conditions of an entity conversion, section 9.51(a) requires that the terms and conditions be set forth in the plan of entity conversion. The plan of entity conversion is not required to be publicly filed, and the articles of entity conversion that are filed with the secretary of state are not required to include a plan of entity conversion. See section 9.53. Similarly, articles of charter surrender that are filed with the secretary of state by a domestic business corporation converting to a foreign unincorporated entity are not required to include the plan of entity conversion. See section 9.54.

The list in section 9.51(a) of required provisions in a plan of entity conversion is not exhaustive and the plan may include any other provisions that may be desired.

2. Adoption and Approval; Abandonment

The conversion of a domestic business corporation to a foreign unincorporated entity must be adopted and approved as provided in section 9.52. Shareholders of a domestic business corporation that adopts and approves a plan of entity conversion have appraisal rights. See chapter 13. Under section 9.55, the board of directors of a domestic business corporation may abandon an entity conversion before its effective date even if the plan of entity conversion has already been approved by the corporation's shareholders.

§ 9.52. ACTION ON A PLAN OF ENTITY CONVERSION

In the case of an entity conversion of a domestic business corporation to a domestic or foreign unincorporated entity:

(1) The plan of entity conversion must be adopted by the board of directors.

(2) After adopting the plan of entity conversion, the board of directors must submit the plan to the shareholders for their approval. The board of directors must also transmit to the shareholders a recommendation that the shareholders approve the plan, unless the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation, in which case the board of directors must transmit to the shareholders the basis for that determination.

(3) The board of directors may condition its submission of the plan of entity conversion to the shareholders on any basis.

(4) If the approval of the shareholders is to be given at a meeting, the corporation must notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the plan of entity conversion is to be submitted for approval. The notice must state that the purpose, or one of the purposes, of the meeting is to consider the plan and must contain or be accompanied by a copy or summary of the plan. The notice shall include or be accompanied by a copy of the organic documents as they will be in effect immediately after the entity conversion.

(5) Unless the articles of incorporation, or the board of directors acting pursuant to paragraph (3), requires a greater vote or a greater number of votes to be present, approval of the plan of entity conversion requires the approval of each class or series of shares of the corporation voting as a separate voting group at a meeting at which a quorum of the voting group consisting of at least a majority of the votes entitled to be cast on the conversion by that voting group exists.

(6) If any provision of the articles of incorporation, bylaws or an agreement to which any of the directors or shareholders are parties, adopted or entered into before [the effective date of this subchapter], applies to a merger of the corporation and the document does not refer to an entity conversion of the corporation, the provision shall be deemed to apply to an entity conversion of the corporation until such time as the provision is subsequently amended.

(7) If as a result of the conversion one or more shareholders of the corporation would become subject to owner liability for the debts, obligations or liabilities of any other person or entity, approval of the plan of conversion shall require the signing, by each such shareholder, of a separate written consent to become subject to such owner liability.

CROSS-REFERENCES

Abandonment of entity conversion, see § 9.56.

Application to domestic unincorporated entities, see § 9.50(c).

Contents of plan of entity conversion, see § 9.51.

"Domestic business corporation" defined, see § 1.40.

"Domestic unincorporated entity" defined, see § 1.40.

"Foreign unincorporated entity" defined, see § 1.40.

"Organic document" defined, see § 1.40.

"Owner liability" defined, see § 1.40.

OFFICIAL COMMENT

1. In General

This section sets forth the rules for adoption and approval of a plan of entity conversion by a domestic business corporation. The manner in which the conversion of a foreign unincorporated entity to a domestic business corporation must be adopted and approved will be controlled by the laws of the foreign jurisdiction. The provisions of this section follow generally the rules in Chapter 11 for adoption and approval of a plan of merger or share exchange.

A plan of entity conversion must be adopted by the board of directors. Although section 9.52(2) permits the board to refrain from making a recommendation to the shareholders that they approve the plan, that does not change the underlying requirement that the board adopt the plan before it is submitted to the shareholders. Approval by the shareholders of a plan of entity conversion is always required.

2. Quorum and Voting

Section 9.52(5) provides that if the corporation has more than one class or series of shares, approval of an entity conversion requires the approval of each class or series voting as a separate voting group at a meeting at which there exists a quorum consisting of at least a majority of the votes entitled to be cast on the plan by that class or series. If a quorum is present, then under sections 7.25 and 7.26 the plan will be approved if more votes are cast in favor of the plan than against it by each voting group entitled to vote on the plan. If the shares of a corporation are not divided into two or more classes or series, all of the shares together will constitute a single class for purposes of section 9.52(5).

In lieu of approval at a shareholders' meeting, approval can be given by the consent of all the shareholders entitled to vote on the domestication, under the procedures set forth in section 7.04.

3. Transitional Rule

Because the concept of entity conversion is new, persons who drafted and negotiated special rights for directors or shareholders before the enactment of this subchapter should not be charged with the consequences of not having dealt with the concept of entity conversion in the context of those special rights. Section 9.52(6) accordingly provides a transitional rule that is intended to protect such special rights. Other documents, in addition to the articles of incorporation and bylaws, which may contain such special rights, include shareholders agreements, voting trust agreements, vote pooling agreements or other similar arrangements. If, for example, the articles of incorporation provide that the corporation cannot participate in a merger without a supermajority vote of the shareholders, that supermajority requirement will also apply to the conversion of the corporation to a domestic or foreign unincorporated entity.

The purpose of section 9.52(6) is to protect persons who negotiated special rights for directors or shareholders whether in a contract with the corporation or in the articles of incorporation or bylaws, and section 9.52(6) should not be applied in such a way as to impair unconstitutionally the rights of any party to a contract with the corporation. As applied to the corporation, section 9.52(6) is an exercise of the reserved power of the state legislature set forth in section 1.02.

The transitional rule in section 9.52(6) ceases to apply at such time as the provision of the articles of incorporation, bylaws or agreement giving rise to the special rights is first amended after the effective date of this subchapter because at that time the provision may be amended to address expressly an entity conversion of the corporation.

Section 9.52(6) will also apply in the case of an unincorporated entity whose organic law does not provide procedures for the approval of an entity conversion because section 9.50(c) treats such an unincorporated entity as a business corporation for purposes of section 9.52(6).

A similar transitional rule with regard to the application to an entity conversion of special contractual rights of third parties is found in section 9.50(e).

§ 9.53. ARTICLES OF ENTITY CONVERSION

(a) After the conversion of a domestic business corporation to a domestic unincorporated entity has been adopted and approved as required by this Act, articles of entity conversion shall be signed on behalf of the corporation by any officer or other duly authorized representative. The articles shall:

(1) set forth the name of the corporation immediately before the filing of the articles of entity conversion and the name to which the name of the corporation is to be changed, which shall be a name that satisfies the organic law of the surviving entity;

(2) state the type of unincorporated entity that the surviving entity will be;

(3) set forth a statement that the plan of entity conversion was duly approved by the shareholders in the manner required by this Act and the articles of incorporation;

(4) if the surviving entity is a filing entity, either contain all of the provisions required to be set forth in its public organic document and any other desired provisions that are permitted, or have attached a public organic document; except that, in either case, provisions that would not be required to be included in a restated public organic document may be omitted.

(b) After the conversion of a domestic unincorporated entity to a domestic business corporation has been adopted and approved as required by the organic law of the unincorporated entity, articles of entity conversion shall be signed on behalf of the unincorporated entity by any officer or other duly authorized representative. The articles shall:

(1) set forth the name of the unincorporated entity immediately before the filing of the articles of entity conversion and the name to which the name of the unincorporated entity is to be changed, which shall be a name that satisfies the requirements of section 4.01;

(2) set forth a statement that the plan of entity conversion was duly approved in accordance with the organic law of the unincorporated entity;

(3) either contain all of the provisions that section 2.02(a) requires to be set forth in articles of incorporation and any other desired provisions that section 2.02(b) permits to be included in articles of incorporation, or have attached articles of incorporation; except that, in either case, provisions that would not be required to be included in restated articles of incorporation of a domestic business corporation may be omitted.

(c) After the conversion of a foreign unincorporated entity to a domestic business corporation has been authorized as required by the laws of the foreign jurisdiction, articles of entity conversion shall be signed on behalf of the foreign unincorporated entity by any officer or other duly authorized representative. The articles shall:

(1) set forth the name of the unincorporated entity immediately before the filing of the articles of entity conversion and the name to which the name of the unincorporated entity is to be changed, which shall be a name that satisfies the requirements of section 4.01;

(2) set forth the jurisdiction under the laws of which the unincorporated entity was organized immediately before the filing of the articles of entity conversion and the date on which the unincorporated entity was organized in that jurisdiction;

(3) set forth a statement that the conversion of the unincorporated entity was duly approved in the manner required by its organic law; and

(4) either contain all of the provisions that section 2.02(a) requires to be set forth in articles of incorporation and any other desired provisions that section 2.02(b) permits to be included in articles of incorporation, or have attached articles of incorporation; except that, in either case, provisions that would not be required to be included in restated articles of incorporation of a domestic business corporation may be omitted.

(d) The articles of entity conversion shall be delivered to the secretary of state for filing, and shall take effect at the effective time provided in section 1.23. Articles of entity conversion under section 9.53(a) or (b) may be combined with any required conversion filing under the organic law of the domestic unincorporated entity if the combined filing satisfies the requirements of both this section and the other organic law.

(e) If the converting entity is a foreign unincorporated entity that is authorized to transact business in this state under a provision of law similar to chapter 15, its certificate of authority or other type of foreign qualification shall be cancelled automatically on the effective date of its conversion.

CROSS-REFERENCES

"Deliver" defined, see § 1.40.

"Domestic business corporation" defined, see § 1.40.

"Domestic unincorporated entity" defined, see § 1.40.

Effect of entity conversion, see § 9.55.

"Filing entity" defined, see § 1.40.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

"Foreign unincorporated entity" defined, see § 1.40.

"Organic law" defined, see § 1.40.

"Public organic document" defined, see § 1.40.

Required approvals, see § 9.02.

"Surviving entity" defined, see § 9.50(f)(2).

"Unincorporated entity" defined, see § 1.40.

OFFICIAL COMMENT

The filing of articles of entity conversion makes the conversion a matter of public record. Where the surviving entity is organized under the laws of this state, the filing also makes of public record its articles of incorporation or public organic document. If the converting entity is a foreign unincorporated entity that is authorized to transact business in this state, section 9.53(e) automatically cancels its certificate of authority.

The filing requirements for articles of entity conversion are set forth in section 1.20. Under section 1.23, a document may specify a delayed effective time and date, and if it does so the document becomes effective at the time and date specified, except that a delayed effective date may not be later than the 90th day after the date the document is filed. In cases where an entity is changing the jurisdiction in which it is incorporated or otherwise organized, it is recommended that the entity use a delayed effective date provision in its entity conversion filings in both this state and the foreign jurisdiction, or otherwise coordinate those filings, so that the filings becoming effective at the same time. This will avoid any question about a gap in the continuity of its existence that might otherwise arise as a result of those filings taking effect at different times.

If a conversion involves a domestic unincorporated entity whose organic law also requires a filing to effectuate the conversion, section 9.53(d) permits the filings under that organic law and this Act to be combined so that only one document need be filed with the secretary of state.

§ 9.54. SURRENDER OF CHARTER UPON CONVERSION

(a) Whenever a domestic business corporation has adopted and approved, in the manner required by this subchapter, a plan of entity conversion providing for the corporation to be converted to a foreign unincorporated entity, articles of charter surrender shall be signed on behalf of the corporation by any officer or other duly authorized representative. The articles of charter surrender shall set forth:

(1) the name of the corporation;

(2) a statement that the articles of charter surrender are being filed in connection with the conversion of the corporation to a foreign unincorporated entity;

(3) a statement that the conversion was duly approved by the shareholders in the manner required by this Act and the articles of incorporation;

(4) the jurisdiction under the laws of which the surviving entity will be organized;

(5) if the surviving entity will be a nonfiling entity, the address of its executive office immediately after the conversion.

(b) The articles of charter surrender shall be delivered by the corporation to the secretary of state for filing. The articles of charter surrender shall take effect on the effective time provided in section 1.23.

CROSS-REFERENCES

"Deliver" defined, see § 1.40.

"Domestic business corporation" defined, see § 1.40.

Effect of entity conversion, see § 9.55.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

"Foreign unincorporated entity" defined, see § 1.40.

"Nonfiling entity" defined, see § 1.40.

Required approvals, see § 9.02.

"Surviving entity" defined, see § 9.50(f)(2).

OFFICIAL COMMENT

The filing of articles of charter surrender makes the conversion of the domestic business corporation to a foreign unincorporated entity a matter of public record in this state. It also terminates the status of the corporation as a corporation incorporated under the laws of this state. Once the articles of charter surrender have become effective, the corporation will no longer be in good standing in this state.

The filing requirements for articles of charter surrender are set forth in section 1.20. Under section 1.23, a document may specify a delayed effective time and date, and if it does so the document becomes effective at the time and date specified, except that a delayed effective date may not be later than the 90th day after the date the document is filed. To avoid any question about a gap in the continuity of its existence, it is recommended that a corporation use a delayed effective date provision in its entity conversion filings in both this state and the foreign jurisdiction, or otherwise coordinate those filings, so that the filings becoming effective at the same time.

§ 9.55. EFFECT OF ENTITY CONVERSION

(a) When a conversion under this subchapter becomes effective:

(1) the title to all real and personal property, both tangible and intangible, of the converting entity remains in the surviving entity without reversion or impairment;

(2) the liabilities of the converting entity remain the liabilities of the surviving entity;

(3) an action or proceeding pending against the converting entity continues against the surviving entity as if the conversion had not occurred;

(4) in the case of a surviving entity that is a filing entity, its articles of incorporation or public organic document and its private organic document become effective;

(5) in the case of a surviving entity that is a nonfiling entity, its private organic document becomes effective;

(6) the shares or interests of the converting entity are reclassified into shares, interests, other securities, obligations, rights to acquire shares, interests or other securities, or into cash or other property in accordance with the plan of conversion; and the shareholders or interest holders of the converting entity are entitled only to the rights provided to them under the terms of the conversion and to any appraisal rights they may have under the organic law of the converting entity; and

(7) the surviving entity is deemed to:

(i) be incorporated or organized under and subject to the organic law of the converting entity for all purposes;

(ii) be the same corporation or unincorporated entity without interruption as the converting entity; and

(iii) have been incorporated or otherwise organized on the date that the converting entity was originally incorporated or organized.

(b) When a conversion of a domestic business corporation to a foreign other entity becomes effective, the surviving entity is deemed to:

(1) appoint the secretary of state as its agent for service of process in a proceeding to enforce the rights of shareholders who exercise appraisal rights in connection with the conversion; and

(2) agree that it will promptly pay the amount, if any, to which such shareholders are entitled under chapter 13.

(c) A shareholder who becomes subject to owner liability for some or all of the debts, obligations or liabilities of the surviving entity shall be personally liable only for those debts, obligations or liabilities of the surviving entity that arise after the effective time of the articles of entity conversion.

(d) The owner liability of an interest holder in an unincorporated entity that converts to a domestic business corporation shall be as follows:

(1) The conversion does not discharge any owner liability under the organic law of the unincorporated entity to the extent any such owner liability arose before the effective time of the articles of entity conversion.

(2) The interest holder shall not have owner liability under the organic law of the unincorporated entity for any debt, obligation or liability of the corporation that arises after the effective time of the articles of entity conversion.

(3) The provisions of the organic law of the unincorporated entity shall continue to apply to the collection or discharge of any owner liability preserved by paragraph (1), as if the conversion had not occurred.

(4) The interest holder shall have whatever rights of contribution from other interest holders are provided by the organic law of the unincorporated entity with respect to any owner liability preserved by paragraph (1), as if the conversion had not occurred.

CROSS-REFERENCES

"Converting entity" defined, see § 9.50(f) (1).

"Domestic business corporation" defined, see § 1.40.

"Domestic unincorporated entity" defined, see § 1.40.

"Filing entity" defined, see § 1.40.

"Foreign unincorporated entity" defined, see § 1.40.

"Interest" defined, see § 1.40.

"Interest holder" defined, see § 1.40.

"Nonfiling entity" defined, see § 1.40.

"Organic law" defined, see § 1.40.

"Private organic document" defined, see § 1.40.

"Public organic document" defined, see § 1.40.

"Surviving entity" defined, see § 9.50(e) (2).

"Unincorporated entity" defined, see § 1.40.

OFFICIAL COMMENT

This section provides for the effect of an entity conversion. An entity conversion is not a conveyance, transfer or assignment. It does not give rise to claims of reverter or impairment of title based on a prohibited conveyance, transfer or assignment. Nor does it give rise to a claim that a contract with the converting entity is no longer in effect on the ground of nonassignabiity, unless the contract specifically provides that it does not survive an entity conversion.

Section 9.55(a)(1)–(3) and (c) are similar to section 11.07(a)(3)–(5) and (c) with respect to the effects of a merger. Although section 9.55(a)(1)–(3) would be implied by the general rule stated in section 9.55(a) (7) even if not stated expressly, those rules have been included to avoid any question as to whether a different result was intended.

The rule in section 9.55(a)(7)(iii) that the date of incorporation or organization of the converting entity remains its date of incorporation or organization after the entity conversion is a specific application of the general rule in section 9.55(a)(7)(ii). The date of incorporation or organization of a foreign converting unincorporated entity is required by section 9.53(c)(2) to be set forth in the articles of entity conversion.

One of the continuing liabilities of a foreign unincorporated entity to which a domestic business corporation has been converted is the obligation to the shareholders of the converting corporation who exercise appraisal rights to pay them the amount, if any, to which they are entitled under chapter 13. Where the surviving entity is a domestic other entity, it will be similarly liable to the shareholders of the converting corporation pursuant to section 9.55(a)(2).

Section 9.55(d) preserves liability only for owner liabilities to the extent they arise before the conversion. Owner liability is not preserved for subsequent changes in an underlying liability, regardless of whether a change is voluntary or involuntary.

This section does not address the issue that could arise in an entity conversion where a person who had authority to bind the converting entity loses that authority because of the conversion and yet purports to act to bind the surviving entity. For example, in a conversion of a general partnership into a corporation, a person who is a general partner but does not become an officer of the corporation will lose the authority of a general partner to bind the business to obligations incurred in the ordinary course, but might purport to commit the corporation to such an obligation in dealing with a person who does not have knowledge of the conversion. Instances in which this occurs will be rare and, in the limited instances in which it does occur, general principles of agency law are sufficient to resolve the problems created.

§ 9.56. ABANDONMENT OF AN ENTITY CONVERSION

(a) Unless otherwise provided in a plan of entity conversion of a domestic business corporation, after the plan has been adopted and approved as required by this subchapter, and at any time before the entity conversion has become effective, it may be abandoned by the board of directors without action by the shareholders.

(b) If an entity conversion is abandoned after articles of entity conversion or articles of charter surrender have been filed with the secretary of state but before the entity conversion has become effective, a statement that the entity conversion has been abandoned in accordance with this section, signed by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing prior to the effective date of the entity conversion. Upon filing, the statement shall take effect and the entity conversion shall be deemed abandoned and shall not become effective.

CROSS-REFERENCES

Approval of entity conversion, see § 9.52.

"Deliver" defined, see § 1.40.

"Domestic business corporation" defined, see § 1.40.

Effective time and date of filing, see § 1.23.

Filing requirements, see § 1.20.

OFFICIAL COMMENT

Unless otherwise provided in a plan of entity conversion, a domestic business corporation proposing to convert to an unincorporated entity may abandon the transaction without shareholder approval, even though it has been previously approved by the shareholders. Whether or not the conversion of an unincorporated entity to a domestic business corporation may be abandoned is determined by the law under which the unincorporated entity is organized, except that the rule of this section will apply to the extent provided in section 9.50(c).

CHAPTER 10

Amendment of Articles of Incorporation and Bylaws

Subchapter A.

AMENDMENT OF ARTICLES OF INCORPORATION

Subchapter B.

AMENDMENT OF BYLAWS

Subchapter A.

AMENDMENT OF ARTICLES OF INCORPORATION

§ 10.01. AUTHORITY TO AMEND

(a) A corporation may amend its articles of incorporation at any time to add or change a provision that is required or permitted in the articles of incorporation as of the effective date of the amendment or to delete a provision that is not required to be contained in the articles of incorporation.

(b) A shareholder of the corporation does not have a vested property right resulting from any provision in the articles of incorporation, including provisions relating to management, control, capital structure, dividend entitlement, or purpose or duration of the corporation.

CROSS-REFERENCES

Amendment:

before issuance of shares, see § 10.02.

by board of directors and shareholders, see § 10.03.

by board of directors, see § 10.05.

pursuant to court reorganization, see § 10.08.

Appraisal rights, see ch. 13.

Articles of incorporation, see § 2.02.

Effective date of amendment, see § 1.23.

Powers of corporation, see § 3.02.

Procedure for amendment, see §§ 10.02–10.07.

Purposes of corporation, see § 3.01.

Restatement of articles, see § 10.07.

Share transfer restrictions, see § 6.27.

Voting by voting groups, see §§ 7.25, 7.26, & 10.04.

"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 10.01(a) authorizes a corporation to amend its articles of incorporation by adding a new provision to its articles of incorporation, modifying an existing provision, or deleting a provision in its entirety. The sole test for the validity of an amendment is whether the provision could lawfully have been included in (or in the case of a deletion, omitted from) the articles of incorporation as of the effective date of the amendment.

The power of amendment must be exercised pursuant to the procedures set forth in chapter 10. Section 10.03 requires most amendments to be approved by a majority of the votes cast on the proposed amendment at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast is present. This requirement is supplemented by section 10.04, which governs voting by voting groups on amendments that directly affect a single class or series of shares, and by section 7.27, which governs amendments that change the voting requirements for future amendments.

Section 10.01(b) restates the policy embodied in earlier versions of the Act and in all modern state corporation statutes, that a shareholder "does not have a vested property right" in any provision of the articles of incorporation. Under section 1.02, corporations and their shareholders are also subject to amendments of the governing statute.

Section 10.01 should be construed liberally to achieve the fundamental purpose of this chapter of permitting corporate adjustment and change by majority vote. Section 10.01(b) rejects decisions by a few courts that have applied a vested right or property right doctrine to restrict or invalidate amendments to articles of incorporation because they modified particular rights conferred on shareholders by the original articles of incorporation.

Under general corporation law and under the Act, a provision in the articles of incorporation is subject to amendment under section 10.01 even though the provision is described, referred to, or stated in a share certificate, information statement, or other document issued by the corporation that reflects provisions of the articles of incorporation. The only exception to this unlimited power of amendment is section 6.27, which provides that without the consent of the holder, amendments cannot impose share transfer restrictions on previously issued shares.

However, section 10.01 does not concern obligations of a corporation to its shareholders based upon contracts independent of the articles of incorporation. An amendment permitted by this section may constitute a breach of such a contract or of a contract between the shareholders themselves. A shareholder with contractual rights (or who otherwise is concerned about possible onerous amendments) may obtain complete protection against these amendments by establishing procedures in the articles of incorporation or bylaws that limit the power of amendment without the shareholder's consent. In appropriate cases, a shareholder may be able to enjoin an amendment that constitutes a breach of a contract.

Minority shareholders are protected from the power of the majority to impose onerous or objectionable amendments in several ways. First, such shareholders may have the right to vote on amendments by separate voting groups (section 10.04). Second, a decision by a majority shareholder or a control group to exercise the powers granted by this section in a way that may breach a duty to minority or noncontrolling interests may be reviewable by a court under its inherent equity power to review transactions for good faith and fair dealing to the minority shareholders. *McNulty v. W. & J. Sloane*, 184 Misc. 835, 54 N.Y.S.2d 253 (Sup. Ct. 1945); *Kamena v. Janssen Dairy Corp.*, 133 N.J. Eq. 214, 31 A.2d 200, 202 (Ch. 1943), aff'd, 134 N.J. Eq. 359, 35 A.2d 894 (1944) (where the court stated that it "is more a question of fair dealing between the strong and the weak than it is a question of percentages or proportions of the votes favoring the plan"). See also *Teschner v. Chicago Title & Trust Co.*, 59 Ill. 2d 452, 322 N.E.2d 54, 57 (1974), where the court, in upholding a transaction that had a reasonable business purpose, relied partially on the fact that there was "no claim of fraud or deceptive conduct . .. [or] that the exchange offer was unfair or that the price later offered for the shares was inadequate."

Because of the broad power of amendment contained in this section, it is unnecessary to make any reference to, or reserve, an express power to amend in the articles of incorporation.

§ 10.02. AMENDMENT BEFORE ISSUANCE OF SHARES

If a corporation has not yet issued shares, its board of directors, or its incorporators if it has no board of directors, may adopt one or more amendments to the corporation's articles of incorporation.

CROSS-REFERENCES

Articles of amendment, see § 10.06.

Effective date of amendment, see § 1.23.

Incorporators, see § 2.01.

Initial directors, see § 2.02.

Organization of corporation, see § 2.05.

Restated articles of incorporation, see § 10.07.

OFFICIAL COMMENT

Section 10.02 provides that, before any shares are issued, amendments may be made by the persons empowered to complete the organization of the corporation. Under section 2.04 the organizers may be either the incorporators or the initial directors named in the articles of incorporation.

§ 10.03. AMENDMENT BY BOARD OF DIRECTORS AND SHAREHOLDERS

If a corporation has issued shares, an amendment to the articles of incorporation shall be adopted in the following manner:

(a) The proposed amendment must be adopted by the board of directors.

(b) Except as provided in sections 10.05, 10.07, and 10.08, after adopting the proposed amendment the board of directors must submit the amendment to the shareholders for their approval. The board of directors must also transmit to the shareholders a recommendation that the shareholders approve the amendment, unless the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation, in which case the board of directors must transmit to the shareholders the basis for that determination.

(c) The board of directors may condition its submission of the amendment to the shareholders on any basis.

(d) If the amendment is required to be approved by the shareholders, and the approval is to be given at a meeting, the corporation must notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the amendment is to be submitted for approval. The notice must state that the purpose, or one of the purposes, of the meeting is to consider the amendment and must contain or be accompanied by a copy of the amendment.

(e) Unless the articles of incorporation, or the board of directors acting pursuant to subsection (c), requires a greater vote or a greater number of shares to be present, approval of the amendment requires the approval of the shareholders at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast on the amendment exists, and, if any class or series of shares is entitled to vote as a separate group on the amendment, except as provided in section 10.04(c), the approval of each such separate voting group at a meeting at which a quorum of the voting group consisting of at least a majority of the votes entitled to be cast on the amendment by that voting group exists.

CROSS-REFERENCES

Appraisal rights, see § 13.02.

Articles of amendment, see § 10.06.

Director standards of conduct, see § 8.30.

"Notice" defined, see § 1.41.

Notice of shareholders' meeting, see § 7.05.

Quorum at shareholders' meeting, see § 7.25.

Restatement of articles of incorporation, see § 10.07.

Supermajority quorum and voting requirements for shareholders, see § 7.27.

Voting by voting group, see §§ 7.25, 7.26 & 10.04.

Voting entitlement of shareholders generally, see § 7.21.

"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

1. In General

Under section 10.03, if a corporation has issued shares, a proposed amendment to the articles of incorporation must be adopted by the board. Thereafter, the board must submit the amendment to the shareholders for their approval, except as provided in sections 10.05, 10.07, and 10.08.

2. Submission to the Shareholders

Section 10.03 requires the board of directors, after having adopted an amendment, to submit the amendment to the shareholders for approval except as otherwise provided by sections 10.05, 10.07, and 10.08. When submitting the amendment, the board of directors must make a recommendation to the shareholders that the amendment be approved, unless the board of directors makes a determination that because of conflicts of interest or other special circumstances it should make no recommendation. For example, the board of directors may make such a determination where there is not a sufficient number of directors free of a conflicting interest to approve the amendment or because the board of directors is evenly divided as to the merits of an amendment but is able to agree that shareholders should be permitted to consider the amendment. If the board of directors makes such a determination, it must describe the conflict of interest or special circumstances, and communicate the basis for the determination, when submitting the amendment to the shareholders. The exception for conflicts of interest or other special circumstances is intended to be sparingly available. Generally, shareholders should not be asked to act on an amendment in the absence of a recommendation by the board of directors. The exception is not intended to relieve the board of directors of its duty to consider carefully the amendment and the interests of shareholders.

Section 10.03(c) permits the board of directors to condition its submission of an amendment on any basis. Among the conditions that a board might impose are that the amendment will not be deemed approved (i) unless it is approved by a specified vote of the shareholders, or by one or more specified classes or series of shares, voting as a separate voting group, or by a specified percentage of disinterested shareholders, or (ii) if shareholders holding more than a specified fraction of outstanding shares assert appraisal rights. The board of directors is not limited to conditions of these types.

3. Quorum and Voting

Section 10.03(e) provides that approval of an amendment requires approval of the shareholders at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast on the amendment exists, including, if any class or series of shares is entitled to vote as a separate group on the amendment, the approval of each such separate group, at a meeting at which a similar quorum of the voting group exists. If a quorum exists, then under sections 7.25 and 7.26 the amendment will be approved if more votes are cast in favor of the amendment than against it by the voting group or separate voting groups entitled to vote on the plan. This represents a change from the Act's previous voting rule for amendments, which required approval by a majority of votes cast, with no minimum quorum, for some amendments, and approval by a majority of the votes entitled to be cast by a voting group, for others.

If an amendment would affect the voting requirements on future amendments, it must also be approved by the vote required by section 7.27.

§ 10.04. VOTING ON AMENDMENTS BY VOTING GROUPS

(a) If a corporation has more than one class of shares outstanding, the holders of the outstanding shares of a class are entitled to vote as a separate voting group (if shareholder voting is otherwise required by this Act) on a proposed amendment to the articles of incorporation if the amendment would:

1. effect an exchange or reclassification of all or part of the shares of the class into shares of another class;

2. effect an exchange or reclassification, or create the right of exchange, of all or part of the shares of another class into shares of the class;

3. change the rights, preferences, or limitations of all or part of the shares of the class;

4. change the shares of all or part of the class into a different number of shares of the same class;

5. create a new class of shares having rights or preferences with respect to distributions or to dissolution that are prior or superior to the shares of the class;

6. increase the rights, preferences, or number of authorized shares of any class that, after giving effect to the amendment, have rights or preferences with respect to distributions or to dissolution that are prior or superior to the shares of the class;

7. limit or deny an existing preemptive right of all or part of the shares of the class; or

8. cancel or otherwise affect rights to distributions that have accumulated but not yet been authorized on all or part of the shares of the class.

(b) If a proposed amendment would affect a series of a class of shares in one or more of the ways described in subsection (a), the holders of shares of that series are entitled to vote as a separate voting group on the proposed amendment.

(c) If a proposed amendment that entitles the holders of two or more classes or series of shares to vote as separate voting groups under this section would affect those two or more classes or series in the same or a substantially similar way, the holders of shares of all the classes or series so affected must vote together as a single voting group on the proposed amendment, unless otherwise provided in the articles of incorporation or required by the board of directors.

(d) A class or series of shares is entitled to the voting rights granted by this section although the articles of incorporation provide that the shares are nonvoting shares.

CROSS-REFERENCES

Authorized shares, see § 6.01.

Classes of shares, see §§ 6.01 & 6.02.

Quorum for shareholders' meeting to amend articles, see § 10.03(e).

Series of shares, see § 6.02.

Share rights and limitations, see § 6.01.

Voting by voting groups generally, see §§ 7.25 & 7.26.

"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 10.04(a) requires separate approval by voting groups for certain types of amendments to the articles of incorporation where the corporation has more than one class of shares outstanding. In general, section 10.04 carries forward provisions of the prior Act, but certain changes have been made. Under the prior Act, approval by a class, voting as a separate voting group, was required for an amendment that would increase or decrease the aggregate number of shares of the class. That provision does not appear in the present Act. Also, in the prior Act approval by a class, voting as a separate voting group, was required for an amendment that would create a new class of shares having rights or preferences with respect to dissolution that would be prior, superior, or substantially equal to the class, and for an amendment that would increase the rights, preferences, or number of authorized shares of any class that, after giving effect to the amendment, would have rights or preferences with respect to distributions or dissolution that would be prior, superior, or substantially equal to the shares of the class. Under the present Act, approval by a class, voting as a separate voting group, is required in these cases only when the new or other class would have rights with respect to distributions or dissolution that would be prior or superior to the class, not when the rights would be substantially equal.

Shares are entitled to vote as separate voting groups under this section even though they are designated as nonvoting shares in the articles of incorporation, or the articles of incorporation purport to deny them entirely the right to vote on the proposal in question, or purport to allow other classes or series of shares to vote as part of the same voting group. However, an amendment that does not require shareholder approval does not trigger the right to vote by voting groups under this section. This would include a determination by the board of directors, pursuant to authority granted in the articles of incorporation, of the preferences, limitations and relative rights of any class prior to the issuance of any shares of that class, or of one or more series within a class before the issuance of any shares of that series (see section 6.02(a)).

The right to vote as a separate voting group provides a major protection for classes or series of shares with preferential rights, or classes or series of limited or nonvoting shares, against amendments that are especially burdensome to that class or series. This section, however, does not make the right to vote by separate voting group dependent on an evaluation of whether the amendment is detrimental to the class or series; if the amendment is one of those described in section 10.04(a), the class or series is automatically entitled to vote as a separate voting group on the amendment. The question whether an amendment is detrimental is often a question of judgment, and approval by the affected class or series is required irrespective of whether the board or other shareholders believe it is beneficial or detrimental to the affected class or series.

Under subsection (a) (4), a class is entitled to vote as a separate voting group on an amendment that would change the shares of all or part of the class into a different number of shares of the same class. An amendment that changes the number of shares owned by one or more shareholders of a class into a fraction of a share, through a "reverse split," falls within subsection (a) (4) and therefore requires approval by the class, voting as a separate voting group, whether or not the fractional share is to be acquired for cash under section 6.04.

Sections 7.25 and 7.26 set forth the mechanics of voting by multiple voting groups.

Subsection (b) extends the privilege of voting by separate voting group to a series of a class of shares if the series has financial or voting provisions unique to the series that are affected in one or more of the ways described in subsection (a). Any significant distinguishing feature of a series, which an amendment affects or alters, should trigger the right of voting by separate voting group for that series. However, under subsection (c) if a proposed amendment that entitles two or more classes or series of shares to vote as separate voting groups would affect those classes or series in the same or a substantially similar way, the shares of all the class or series so affected must vote together, as a single voting group, unless otherwise provided in the articles of incorporation or required by the board of directors.

The application of subsections (b) and (c) may best be illustrated by examples.

First, assume there is a class of shares, with preferential rights, comprised of three series, each with different preferential dividend rights. A proposed amendment would reduce the rate of dividend applicable to the "Series A" shares and would change the dividend right of the "Series B" shares from a cumulative to a noncumulative right. The amendment would not affect the preferential dividend right of the "Series C" shares. Both Series A and B would be entitled to vote as separate voting groups on the proposed amendment; the holders of the Series C shares, not directly affected by the amendment, would not be entitled to vote at all, unless otherwise provided, or unless the shares are voting shares under the articles of incorporation, in which case they would not vote as a separate voting group but in the voting group consisting of all shares with general voting rights under the articles of incorporation.

Second, if the proposed amendment would reduce the dividend right of Series A and change the dividend right of both Series B and C from a cumulative to a noncumulative right, the holders of Series A would be entitled to vote as a single voting group, and the holders of Series B and C would be required to vote together as a single, separate voting group.

Third, assume that a corporation has common stock and two classes of preferred stock. A proposed amendment would create a new class of senior preferred that would have priority in distribution rights over both the common stock and the existing classes of preferred stock. Because the creation of the new senior preferred would affect all three classes of stock in the same or a substantially similar way, all three classes would vote together as a single voting group on the proposed amendment.

Under the prior version of section 10.04(c), series that were affected by an amendment in the same or a substantially similar manner were required to vote together, but classes that were affected by an amendment in the same or a substantially similar manner voted separately. Thus under the prior version of section 10.04(c) if, in the second example, the A, B, and C stock had been denominated as classes rather than series, then the A, B, and C holders would have been required to vote separately rather than together. Similarly, in the third example, under the prior version of section 10.04(c) the Common and existing Preferred would have been required to vote separately rather than together, because each was a separate class. The distinction between classes and series for this purpose seems artificial, and therefore has been eliminated in the current version of section 10.04(c).

Section 10.04(d) makes clear that the right to vote by separate voting groups provided by section 10.04 may not be narrowed or eliminated by the articles of incorporation. Even if a class or series of shares is described as "nonvoting" and the articles purport to make that class or series nonvoting "for all purposes," that class or series nevertheless has the voting right provided by this section. No inference should be drawn from section 10.04(d) as to whether other, unrelated sections of the Act may be modified by provisions in the articles of incorporation.

§ 10.05. AMENDMENT BY BOARD OF DIRECTORS

Unless the articles of incorporation provide otherwise, a corporation's board of directors may adopt amendments to the corporation's articles of incorporation without shareholder approval:

1. to extend the duration of the corporation if it was incorporated at a time when limited duration was required by law;

2. to delete the names and addresses of the initial directors;

3. to delete the name and address of the initial registered agent or registered office, if a statement of change is on file with the secretary of state;

4. if the corporation has only one class of shares outstanding:

   a. to change each issued and unissued authorized share of the class into a greater number of whole shares of that class; or

   b. to increase the number of authorized shares of the class to the extent necessary to permit the issuance of shares as a share dividend;

5. to change the corporate name by substituting the word “corporation,” “incorporated,” “company,” “limited,” or the abbreviation “corp.,” “inc.,” “co.,” or “ltd.,” for a similar word or abbreviation in the name, or by adding, deleting, or changing a geographical attribution for the name;

6. to reflect a reduction in authorized shares, as a result of the operation of section 6.31(b), when the corporation has acquired its own shares and the articles of incorporation prohibit the reissue of the acquired shares;

7. to delete a class of shares from the articles of incorporation, as a result of the operation of section 6.31(b), when there are no remaining shares of the class because the corporation has acquired all shares of the class and the articles of incorporation prohibit the reissue of the acquired shares; or

8. to make any change expressly permitted by section 6.02(a) or (b) to be made without shareholder approval.

CROSS-REFERENCES

Action by board of directors, see §§ 8.20–8.24.

Articles of amendment, see § 10.06.

Classes and series of shares, see §§ 6.01 & 6.02.

Duration of corporate existence, see § 3.02.

Effective date of amendment, see § 1.23.

Initial directors, see § 2.02.

Merger, see ch. 11.

Name of corporation, see ch. 4.

Reacquisition of shares, see § 6.31.

Registered office and agent, see ch. 5.

Restatement of articles, see § 10.07.

Terms of class or series determined by board of directors, see § 6.02.

OFFICIAL COMMENT

The amendments described in clauses (1) through (8) are so routine and “housekeeping” in nature as not to require approval by shareholders. None affects substantive rights in any meaningful way.

Section 10.05(4) (a) authorizes the board of directors to change each issued and unissued share of an outstanding class of shares into a greater number of whole shares if the corporation has only that class of shares outstanding. All shares of the class being changed must be treated identically under this clause. Section 10.05(4)(b) authorizes the board of directors to increase the number of shares of the class to the extent necessary to permit the issuance of shares as a share dividend, if the corporation has only that one class of stock outstanding.

Amendments provided for in this section may be included in restated articles of incorporation under section 10.07 or in articles of merger under chapter 11.

§ 10.06. ARTICLES OF AMENDMENT

After an amendment to the articles of incorporation has been adopted and approved in the manner required by this Act and by the articles of incorporation, the corporation shall deliver to the secretary of state, for filing, articles of amendment, which shall set forth:

1. the name of the corporation;

2. the text of each amendment adopted, or the information required by section 1.20(k)(5);

3. if an amendment provides for an exchange, reclassification, or cancellation of issued shares, provisions for implementing the amendment if not contained in the amendment itself, (which may be made dependent upon facts objectively ascertainable outside the articles of amendment in accordance with section 1.20(k)(5);

4. the date of each amendment's adoption; and

5. if an amendment:

    a. was adopted by the incorporators or board of directors without shareholder approval, a statement that the amendment was duly approved by the incorporators or by the board of directors, as the case may be, and that shareholder approval was not required;

    b. required approval by the shareholders, a statement that the amendment was duly approved by the shareholders in the manner required by this Act and by the articles of incorporation; or

    c. is being filed pursuant to section 1.20(k) (5), a statement to that effect.

CROSS-REFERENCES

Amendment by:

board of directors and shareholders, see § 10.03.

board of directors, see § 10.05.

incorporators or initial directors, see § 10.02.

"Deliver," see § 1.40.

Effective date of amendment, see § 1.23.

Extrinsic facts, see § 1.20(k).

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

Merger, see ch. 11.

Share exchange, see ch. 11.

Voting by voting groups, see §§ 7.25, 7.26 & 10.04.

"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 10.06(3) requires the articles of amendment to contain a statement of the manner in which an exchange, reclassification, or cancellation of issued shares is to be put into effect if not set forth in the amendment itself. This requirement avoids any possible confusion that may arise as to how the amendment is to be put into effect and also permits the amendment itself to be limited to provisions of permanent applicability, with transitional provisions having no long-range effect appearing only in the articles of amendment.

§ 10.07. RESTATED ARTICLES OF INCORPORATION

(a) A corporation's board of directors may restate its articles of incorporation at any time, with or without shareholder approval, to consolidate all amendments into a single document.

(b) If the restated articles include one or more new amendments that require shareholder approval, the amendments must be adopted and approved as provided in section 10.03.

(c) A corporation that restates its articles of incorporation shall deliver to the secretary of state for filing articles of restatement setting forth the name of the corporation and the text of the restated articles of incorporation together with a certificate which states that the restated articles consolidate all amendments into a single document and, if a new amendment is included in the restated articles, which also includes the statements required under section 10.06.

(d) Duly adopted restated articles of incorporation supersede the original articles of incorporation and all amendments thereto.

(e) The secretary of state may certify restated articles of incorporation as the articles of incorporation currently in effect, without including the certificate information required by subsection (c).

CROSS-REFERENCES

Amendment of articles of incorporation:

before issuance of shares, see § 10.02.

by board of directors, see § 10.05.

by board of directors and shareholders, see § 10.03.

Certified copies, see § 1.22.

"Deliver," see § 1.40.

Effective date of restatement, see § 1.23.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

"Notice" defined, see § 1.41.

Notice of shareholders' meeting, see § 7.05.

OFFICIAL COMMENT

Restated articles of incorporation serve the useful purpose of permitting articles of incorporation that have been amended from time to time, or are being concurrently amended, to be consolidated into a single document.

A restatement of a corporation's articles of incorporation is not an amendment of the articles of incorporation, but only a consolidation of amendments into a single document. A corporation that is restating its articles may concurrently amend the articles, and include the new amendments in the restated articles. In such a case, the provisions of this chapter that govern amendments of the articles of incorporation would apply to the new amendments. In case of doubt whether a provision of a restatement of the articles of incorporation might be deemed to be an amendment, rather than a consolidation, the prudent course for the corporation is to treat that provision as an amendment, and follow the procedures that apply to amendments under this chapter.

Where the articles of incorporation are amended at the same time they are restated, a combined articles of amendment and restatement may be filed.

§ 10.08. AMENDMENT PURSUANT TO REORGANIZATION

(a) A corporation's articles of incorporation may be amended without action by the board of directors or shareholders to carry out a plan of reorganization ordered or decreed by a court of competent jurisdiction under the authority of a law of the United States.

(b) The individual or individuals designated by the court shall deliver to the secretary of state for filing articles of amendment setting forth:

1. the name of the corporation;
2. the text of each amendment approved by the court;
3. the date of the court's order or decree approving the articles of amendment;
4. the title of the reorganization proceeding in which the order or decree was entered; and
5. a statement that the court had jurisdiction of the proceeding under federal statute.

(c) This section does not apply after entry of a final decree in the reorganization proceeding even though the court retains jurisdiction of the proceeding for limited purposes unrelated to consummation of the reorganization plan.

CROSS-REFERENCES

"Deliver," see § 1.40.

Effective date of amendment, see § 1.23.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

"Proceeding" defined, see § 1.40.

OFFICIAL COMMENT

Section 10.08 provides a simplified method of conforming corporate documents filed under state law with the federal statutes relating to corporate reorganization. If a federal court confirms a plan of reorganization that requires articles of amendment to be filed, those amendments may be prepared and filed by the persons designated by the court and the approval of neither the shareholders nor the board of directors is required.

This section applies only to amendments in articles of incorporation approved before the entry of a final decree in the reorganization.

§ 10.09. EFFECT OF AMENDMENT

An amendment to the articles of incorporation does not affect a cause of action existing against or in favor of the corporation, a proceeding to which the corporation is a party, or the existing rights of persons other than shareholders of the corporation. An amendment changing a corporation's name does not abate a proceeding brought by or against the corporation in its former name.

CROSS-REFERENCES

Amendment after issuance of shares, see §§ 10.03–10.05.

Amendment before issuance of shares, see § 10.02.

Delayed effective date, see § 1.23.

Effective time and date of filing, see § 1.23.

"Proceeding" defined, see § 1.40.

OFFICIAL COMMENT

Under section 10.09, amendments to articles of incorporation do not interrupt the corporate existence and do not abate a proceeding by or against the corporation even though the amendment changes the name of the corporation.

Amendments are effective when filed unless a delayed effective date is elected. See section 1.23.

Subchapter B. AMENDMENT OF BYLAWS

§ 10.20. AMENDMENT BY BOARD OF DIRECTORS OR SHAREHOLDERS

(a) A corporation's shareholders may amend or repeal the corporation's bylaws.

(b) A corporation's board of directors may amend or repeal the corporation's bylaws, unless:

1. the articles of incorporation, section 10.21 or, if applicable, section 10.22 reserve that power exclusively to the shareholders in whole or part; or

2. the shareholders in amending, repealing, or adopting a bylaw expressly provide that the board of directors may not amend, repeal, or reinstate that bylaw.

CROSS-REFERENCES

Action by:

board of directors, see §§ 8.20–8.24.

shareholders, see §§ 7.0 1–7.04.

Articles of incorporation, see § 2.02, ch. 10A.

Bylaw provisions relating to the election of directors, see § 10.22

Bylaws, see §§ 2.06 & 2.07.

Supermajority requirements for directors, see § 10.21.

OFFICIAL COMMENT

The power to amend or repeal bylaws is shared by the board of directors and the shareholders, unless that power is reserved exclusively to the shareholders by an appropriate provision in the articles of incorporation. Section 10.20(b)(1) provides that the power to amend or repeal the bylaws may be reserved to the shareholders "in whole or part." This language permits the reservation of power to be limited to specific articles or sections of the bylaws or to specific subjects or topics addressed in the bylaws.

Section 10.20(b) (2) permits the shareholders to amend, repeal, or adopt a bylaw and reserve exclusively to themselves the power to amend, repeal, or reinstate that bylaw if the reservation is express.

Section 10.21 limits the power of directors to adopt or amend supermajority provisions in bylaws. See section 10.21 and the Official Comment thereto.

Section 10.22 limits the power of directors to repeal a bylaw adopted by shareholders which opts in to the provisions of that section. See section 10.22 and the Official Comment thereto.

§ 10.21. BYLAW INCREASING QUORUM OR VOTING REQUIREMENT FOR DIRECTORS

(a) A bylaw that increases a quorum or voting requirement for the board of directors may be amended or repealed:

1. if originally adopted by the shareholders, only by the shareholders, unless the bylaw otherwise provides;

2. if adopted by the board of directors, either by the shareholders or by the board of directors.

(b) A bylaw adopted or amended by the shareholders that increases a quorum or voting requirement for the board of directors may provide that it can be amended or repealed only by a specified vote of either the shareholders or the board of directors.

(c) Action by the board of directors under subsection (a) to amend or repeal a bylaw that changes the quorum or voting requirement for the board of directors must meet the same quorum requirement and be adopted by the same vote required to take action under the quorum and voting requirement then in effect or proposed to be adopted, whichever is greater.

CROSS-REFERENCES

Bylaws:

amendment, see § 10.20.

generally, see § 2.06.

Quorum and voting of directors, see § 8.24.

Supermajority quorum and voting requirements for shareholders, see § 7.27.

OFFICIAL COMMENT

Provisions that increase a quorum or voting requirement for the board over the requirement that would otherwise apply under this Act or that was previously set forth in the bylaws ("supermajority requirements") may be placed in the bylaws of the corporation without specific authorization in the articles of incorporation. See section 8.24(a) and (c). Like other bylaw provisions, they may be adopted either by the shareholders or by the board of directors. See section 10.20. Such provisions may be amended or repealed by the board of directors or shareholders as provided in this section.

Section 10.21(a) (1) provides that if a supermajority requirement is imposed by a bylaw adopted by the shareholders, only the shareholders may amend or repeal it. Under section 10.21(b), such a bylaw may impose restrictions on the manner in which it may be thereafter amended or repealed by the shareholders. If a supermajority requirement is imposed in a bylaw adopted by the board of directors, the bylaw may be amended either by the shareholders or the board of directors (see section 10.21(a) (2)). However, if such an amendment is amended by the board of directors, section 10.21(c) requires approval by the supermajority requirement then in effect or proposed to be adopted, whichever is greater. Compare section 7.27.

§ 10.22. BYLAW PROVISIONS RELATING TO THE ELECTION OF DIRECTORS

(a) Unless the articles of incorporation (i) specifically prohibit the adoption of a bylaw pursuant to this section, (ii) alter the vote specified in section 7.28(a), or (iii) provide for cumulative voting, a public corporation may elect in its bylaws to be governed in the election of directors as follows:

1. each vote entitled to be cast may be voted for or against up to that number of candidates that is equal to the number of directors to be elected, or a shareholder may indicate an abstention, but without cumulating the votes;

2. to be elected, a nominee must have received a plurality of the votes cast by holders of shares entitled to vote in the election at a meeting at which a quorum is present, provided that a nominee who is elected but receives more votes against than for election shall serve as a director for a term that shall terminate on the date that is the earlier of (i) 90 days from the date on which the voting results are determined pursuant to section 7.29(b) (5) or (ii) the date on which an individual is selected by the board of directors to fill the office held by such director, which selection shall be deemed to constitute the filling of a vacancy by the board to which section 8.10 applies. Subject to clause (3) of this section, a nominee who is elected but receives more votes against than for election shall not serve as a director beyond the 90-day period referenced above; and

3. the board of directors may select any qualified individual to fill the office held by a director who received more votes against than for election.

(b) Subsection (a) does not apply to an election of directors by a voting group if (i) at the expiration of the time fixed under a provision requiring advance notification of director candidates, or (ii) absent such a provision, at a time fixed by the board of directors which is not more than 14 days before notice is given of the meeting at which the election is to occur, there are more candidates for election by the voting group than the number of directors to be elected, one or more of whom are properly proposed by shareholders. An individual shall not be considered a candidate for purposes of this subsection if the board of directors determines before the notice of meeting is given that such individual's candidacy does not create a bona fide election contest.

(c) A bylaw electing to be governed by this section may be repealed:

1. if originally adopted by the shareholders, only by the shareholders, unless the bylaw otherwise provides;

2. if adopted by the board of directors, by the board of directors or the shareholders.

CROSS REFERENCES

Amendment of bylaws, see § 10.20.

Articles of Incorporation:

amendment, see ch. 10A.

content, see § 2.02.

Cumulative voting, see §§ 7.28(b)–(d).

Inspectors of election, see § 7.29.

"Public corporation" defined, see § 1.40.

Resignation of directors, see § 8.07(b).

Vacancy on board, see § 8.10.

Voting for directors: see § 7.28(a).

Voting for directors by voting group, see § 8.04.

"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 10.22 is effective only if a corporation elects in a bylaw adopted either by shareholders or by the board of directors to be governed by its terms. As provided in section 10.22(b), if such a bylaw is adopted by shareholders, it may be repealed only by shareholders unless the electing bylaw provides otherwise. If adopted by the board of directors, such a bylaw may be repealed by either the board of directors or the shareholders. The provisions of section 10.22 effectively modify the term and holdover provisions of section 8.05 pursuant to a limited exception recognized in that section. Accordingly, a bylaw provision that would seek to alter the term and holdover provision of section 8.05 that varied in any manner from section 10.22 would not be effective.

Only public corporations as defined in section 1.40(18A) may elect to be governed by section 10.22. Also, corporations whose articles of incorporation require cumulative voting (see section 7.28(c)), specifically prohibit the section 10.22 election, or alter the vote specified in section 7.28(a), are not eligible to elect to be governed by section 10.22. Since section 10.22 is a part of the Model Act, if a corporation validly elects in a bylaw to be governed by its provisions, those provisions would supersede any other contrary provisions in the articles of incorporation or bylaws.

1. Section 10.22 (a)

Section 10.22(a) (1) provides that each vote entitled to be cast in an election of directors may be voted for or against up to the number of candidates that is equal to the number of directors to be elected, or a shareholder may indicate an abstention. Application of this rule is straightforward if the nominees for director equal the number of directorships up for election. In that case, and by way of example, the holder of a single share could vote either for or against each director. *In the unusual case that section 10.22 (a) were applicable to a contested election notwithstanding the provisions of section 10.22(b)* (i.e., in the absence of an advance notice bylaw, a contest arises as a result of candidates for director being proposed subsequent to the determination date under section 10.22(b)), the holder of a share would have to choose whether to indicate opposition to a slate by voting in favor of a candidate on an opposing slate or by voting against the candidates on the disfavored slate, or to abstain. Since it would be in the interests of all contestants to explain in their proxy materials that against votes would not affect the result in a contested election, the rational voter in a contested election could be expected to vote in favor of all candidates on the preferred slate to promote a simple plurality victory rather than voting against candidates on the disfavored slate. Nothing in section 10.22 would prevent the holder of more than one share from voting differently with respect to each share held.

Section 10.22(a) specifically contemplates that a corporate ballot for the election of directors would provide for "against" votes. Since "against" votes would have a potential effect with respect to corporations electing to be governed by section 10.22, existing rules of the Securities and Exchange Commission would mandate that a means for voting "against" also be provided in the form of proxy. See SEC Rule 14a-4(b)(2), 17 C.F.R. § 240.14a-4(b)(2) (2005), Instruction 2. While there is no prohibition in the Model Act against a corporation, outside of the context of section 10.22, offering to shareholders the opportunity to vote against candidates, unless section 10.22 is elected or the articles of incorporation are amended to make such a vote meaningful, an "against" vote is given no effect under the Model Act.

Section 10.22(a)(2) does not conflict with or alter the plurality voting default standard. A nominee who receives a plurality vote is still elected even if that nominee receives more votes against election than in favor of election. The term of that director is shortened, however, to a period ending no later than 90 days after the results of an election are determined by inspectors of election pursuant to section 7.29(b)(5), with no right to hold over, such that a vacancy would exist if no action is taken by the board prior to that date. As contemplated by section 8.10, that vacancy may be filled by shareholders or by the board of directors, unless the articles of incorporation provide otherwise. In the alternative, action could be taken by amendment to, or in the manner provided in, the articles of incorporation or bylaws to reduce the size of the board. See section 8.03.

Within the 90-day period immediately following determination of the election results, section 10.22(a) (2) also grants to the board of directors the right to fill the office held by any director who received more votes against than for election. That action would be deemed to constitute the filling of a vacancy, with the result that, under section 8.05(d), the director filling the vacancy would be up for reelection at the next annual meeting, even if the term for that directorship would otherwise have been for more than one year, as in the case of a staggered board.

In the exercise of its power under section 10.22(a)(2), a board can select as a director any qualified person, which could include a director who received more against than for votes. Among other things, this power permits a board to respond to the use of section 10.22(a)(2) as a takeover device or to prevent harm to the corporation resulting from a failed election. As a practical matter, however, and given the directors' consideration of their duties, boards are likely to be hesitant to select such director to fill the vacancy in other contexts. There is also no limitation in section 10.22 or elsewhere in the Model Act on the power of either the board of directors or shareholders to fill a vacancy with the person who held such directorship before the vacancy arose.

2. Section 10.22(b)

Under section 10.22(b), when there are more candidates for election as directors by a voting group (as defined in section 1.40(26)) than seats to be filled, the resulting election contest would not be subject to the voting regime under section 10.22(a) but would be conducted by means of a plurality vote under section 7.28(a). Such plurality voting is appropriate in that circumstance because shareholders will have a choice.

Whether there are more candidates than the number of directors to be elected, and therefore whether the voting regime under section 10.22(a) is inapplicable, is determined, if the corporation has a provision in the articles of incorporation or the bylaws requiring advance notification of director candidates, when the time for such notice expires; otherwise the determination is made no later than 14 days before the notice of meeting is given to the shareholders. This assures that the voting regime that will apply will be known in advance of the giving of notice, and that the disclosure of the voting rules and form of proxy will be clear and reflect the applicable voting regime. The determination of how many candidates there are to fill the number of seats up for election can be made by the board of directors. In addition, section 10.22(b) gives the board the authority to determine that an individual shall not be considered a candidate for purposes of section 10.22(b) if the candidacy does not create a bona fide election contest. This determination must be made before notice of the meeting is given. The board might choose, for example, to exercise this authority to preserve the voting regime under section 10.22(a) when it is clear that an individual has designated himself or herself as a candidate without intending to solicit votes or for the purpose of frustrating the availability of the section 10.22(a) voting regime. A board can be expected to exercise its authority under section 10.22(b) with care so as to give fair effect to the voting policies chosen by the corporation to govern the election of the corporation's directors.

The contested or uncontested nature of the election can change following the date for determining the voting regime that will apply. For example, an election that is contested at that date could become uncontested if a candidate withdraws, possibly as part of a settlement. Conversely, unless an advance notice bylaw has been adopted, an uncontested election could become contested before the vote is taken but after notice of the meeting has been given because in that situation there is nothing limiting the ability of shareholders to nominate candidates for directorships up until the time nominations are closed at the meeting. Section 10.22(b) does not authorize changing the voting regime in these circumstances. In some circumstances, a board, in the exercise of its general authority and if consistent with its duties, might decide to reset the determination date so that the appropriate voting regime applies by renoticing the meeting, either with or without delaying the meeting depending upon the available time, and by providing revised disclosure of the applicable voting regime and a revised form of proxy, if necessary.

3. Inclusion in Articles of Incorporation

As provided in section 2.02(b)(3), an election to have section 10.22 apply also may be included in the articles of incorporation. As with any amendment to the articles of incorporation, its adoption and amendment requires the approval of both the directors and the shareholders. See section 10.03.

CHAPTER 11

Mergers and Share Exchanges

§ 11.01. DEFINITIONS

As used in this chapter:

(a) "Merger" means a business combination pursuant to section 11.02.

(b) "Party to a merger" or "party to a share exchange" means any domestic or foreign corporation or eligible entity that will:

(1) merge under a plan of merger;

(2) acquire shares or eligible interests of another corporation or an eligible entity in a share exchange; or

(3) have all of its shares or eligible interests or all of one or more classes or series of its shares or eligible interests acquired in a share exchange.

(c) "Share exchange" means a business combination pursuant to section 11.03.

(d) "Survivor" in a merger means the corporation or eligible entity into which one or more other corporations or eligible entities are merged. A survivor of a merger may preexist the merger or be created by the merger.

CROSS-REFERENCES

Corporation, see § 1.40.

OFFICIAL COMMENT

1. **In General**

The definition of what constitutes an "eligible entity" in section 1.40(7B) determines the kinds of entities, other than corporations, with which a corporation may merge. The definition of "voting power" in section 1.40 also has important substantive implications, because whether shareholder approval is required for a transaction under chapter 11 depends in part on the proportion of voting power that is carried by shares that would be issued and issuable as a result of the transaction.

2. **Interests**

The term "interests" as defined in section 1.40(13B) includes such interests as general and limited partnership interests in limited partnerships, equity interests in limited liability companies, and any other form of equity or ownership interests in an unincorporated entity, as defined in section 1.40(24A), however denominated. For purposes of this chapter, the definition of "eligible interests" in section 1.40(7C) adds to those types of interests any form of membership in a domestic or foreign nonprofit corporation.

3. **Organic Documents**

The definition of the term "organic documents" which was previously found in section 11.01(c) is now set forth in section 1.40(15A).

4. **Other entity**

For purposes of this chapter, the term "other entity" is defined more broadly in this section than it is in section 1.40(15C).

5. **Survivor**

The term "survivor" is used in chapter 11 as a defined technical term and therefore is not always used in a manner that is equivalent to the ordinary meaning of the term. For example, a corporation may be the "survivor" of a merger within the meaning of section 11.01(d) even if it is created by the merger, and therefore had no existence before the merger.

§ 11.02. MERGER

(a) One or more domestic business corporations may merge with one or more domestic or foreign business corporations or eligible entities pursuant to a plan of merger, or two or more foreign business corporations or domestic or foreign eligible entities may merge into a new domestic business corporation to be created in the merger in the manner provided in this chapter.

(b) A foreign business corporation, or a foreign eligible entity, may be a party to a merger with a domestic business corporation, or may be created by the terms of the plan of merger, only if the merger is permitted by the foreign business corporation or eligible entity.

(b.1) If the organic law of a domestic eligible entity does not provide procedures for the approval of a merger, a plan of merger may be adopted and approved, the merger effectuated, and appraisal rights exercised in accordance with the procedures in this chapter and chapter 13. For the purposes of applying this chapter and chapter 13:

(1) the eligible entity, its members or interest holders, eligible interests and organic documents taken together shall be deemed to be a domestic business corporation, shareholders, shares and articles of incorporation, respectively and vice versa as the context may require; and

(2) if the business and affairs of the eligible entity are managed by a group of persons that is not identical to the members or interest holders, that group shall be deemed to be the board of directors.

(c) The plan of merger must include:

(1) the name of each domestic or foreign business corporation or eligible entity that will merge and the name of the domestic or foreign business corporation or eligible entity that will be the survivor of the merger;

(2) the terms and conditions of the merger;

(3) the manner and basis of converting the shares of each merging domestic or foreign business corporation and eligible interests of each merging domestic or foreign eligible entity into shares or other securities, eligible interests, obligations, rights to acquire shares, other securities or eligible interests, cash, other property, or any combination of the foregoing;

(4) the articles of incorporation of any domestic or foreign business or nonprofit corporation, or the organic documents of any domestic or foreign unincorporated entity, to be created by the merger, or if a new domestic or foreign business or nonprofit corporation or unincorporated entity is not to be created by the merger, any amendments to the survivor's articles of incorporation or organic documents; and

(5) any other provisions required by the laws under which any party to the merger is organized or by which it is governed, or by the articles of incorporation or organic document of any such party.

(d) Terms of a plan of merger may be made dependent on facts objectively ascertainable outside the plan in accordance with section 1.20(k).

(e) The plan of merger may also include a provision that the plan may be amended prior to filing articles of merger, but if the shareholders of a domestic corporation that is a party to the merger are required or permitted to vote on the plan, the plan must provide that subsequent to approval of the plan by such shareholders the plan may not be amended to change:

(1) the amount or kind of shares or other securities, eligible interests, obligations, rights to acquire shares, other securities or eligible interests, cash, or other property to be received under the plan by the shareholders of or owners of eligible interests in any party to the merger;

(2) the articles of incorporation of any corporation, or the organic documents of any unincorporated entity, that will survive or be created as a result of the merger, except for changes permitted by section 10.05 or by comparable provisions of the organic laws of any such foreign corporation or domestic or foreign unincorporated entity; or

(3) any of the other terms or conditions of the plan if the change would adversely affect such shareholders in any material respect.

(f) Property held in trust or for charitable purposes under the laws of this state by a domestic or foreign eligible entity shall not be diverted by a merger from the objects for which it was donated, granted or devised, unless and until the eligible entity obtains an order of [court] [the attorney general] specifying the disposition of the property to the extent required by and pursuant to [cite state statutory cy pres or other nondiversion statute].

CROSS-REFERENCES

Abandonment of merger, see § 11.08.

Amendment of articles of incorporation, see § 11.06(a) (2).

Amendment of articles by board of directors, see § 10.05.

Appraisal rights, see ch. 13.

Approval of plan, see § 11.03.

Articles of merger, see § 11.06.

Effect of merger, see § 11.07.

"Eligible entity" defined, see § 1.40.

Extrinsic facts, see § 1.20(k).

Merger between parent and subsidiary or between subsidiaries, see § 11.05.

"Other entity" defined, see § 11.01(d).

Share exchange, see § 11.03.

OFFICIAL COMMENT

1. In General

Section 11.02 authorizes mergers between one or more domestic corporations, or between one or more domestic corporations and one or more foreign corporations or domestic or foreign other entities. Upon the effective date of the merger the survivor becomes vested with all the assets of the corporations or other entities that merge into the survivor and becomes subject to their liabilities, as provided in section 11.07.

2. Applicability

A merger of a domestic corporation with a foreign corporation or a foreign other entity is authorized by chapter 11 only if the merger is permitted by the laws under which the foreign corporation or other entity is organized, and in effecting the merger the foreign corporation or other entity complies with such laws. Whether and on what terms a foreign corporation or a foreign other entity is authorized to merge with a domestic corporation is a matter that is governed by the laws under which that corporation or other entity is organized or by which it is governed, not by chapter 11.

Nevertheless, certain provisions of chapter 11 have an indirect effect on a foreign corporation or foreign other entity that proposes to or does merge with a domestic corporation, because they set conditions concerning the effectiveness and effect of the merger. For example, section 11.02(c) sets forth certain requirements for the contents of a plan of merger. This section is directly applicable only to domestic corporations, but has an indirect effect on a foreign corporation or foreign other entity that is a party to a proposed merger with a domestic corporation.

In some cases, the impact of chapter 11 on a foreign corporation or foreign other entity is more direct. For example, section 11.07(d) provides that upon a merger becoming effective, a foreign corporation or foreign other entity that is the survivor of the merger is deemed to appoint the secretary of state as its agent for service of process in a proceeding to enforce the rights of shareholders of each domestic corporation that is a party to the merger to exercise appraisal rights and to agree that it will promptly pay to such shareholders the amount, if any, to which they are entitled under chapter 13.

If the law under which a domestic other entity is organized does not expressly authorize it to merge with a domestic business corporation, it is intended that section 11.02(a) will provide the necessary authority. Until such time as the various laws governing the organization of each form of other entity have been amended to provide procedures for adopting and approving a plan of merger, subsection (b.1) provides those procedures by reference to the provisions of this subchapter applicable to domestic business corporations.

3. Terms and Conditions of Merger

Chapter 11 imposes virtually no restrictions or limitations on the terms or conditions of a merger, except for those set forth in section 11.02(e) concerning provisions in a plan of merger for amendment of the plan after it has been approved by shareholders. Owners of shares or interests in a party to the merger that merges into the survivor may receive shares or other securities of the survivor, shares or other securities of a party other than the survivor, interests, obligations, rights to acquire shares or other securities, cash, or other property. The capitalization of the survivor may be restructured in the merger, and its articles or organizational documents may be amended by the articles of merger, in any way deemed appropriate.

Although chapter 11 imposes virtually no restrictions or limitations on the terms or conditions of a merger, section 11.02(c) requires that the terms and conditions be set forth in the plan of merger. The present Act clarifies that the plan of merger need not be set forth in the articles of merger that are to be delivered to the secretary of state for filing after the merger has been adopted and approved. See section 11.06.

Section 11.02(c) (4) provides that a plan of merger must set forth the articles of incorporation of any corporation, and the organizational documents of any other entity, to be created by the merger, or if a new corporation or other entity is not to be created by the merger, any amendments to the survivor's articles of incorporation or organizational documents. If a domestic corporation is merged into an existing domestic or foreign corporation or other entity, section 11.02(c) does not require that the survivor's articles of incorporation or organizational documents be included in the plan of merger. However, if approval of the plan of merger by the shareholders of a domestic corporation to be merged into another party to the merger is required under section 11.04, section 11.04(d) requires that the shareholders be furnished with a copy or summary of those articles of incorporation or organizational documents in connection with voting on approval of the merger.

The list in section 11.02(c) of required provisions in a plan of merger is not exhaustive and the plan may include any other provisions that may be desired.

4. **Amendments of Articles of Incorporation**

Under section 11.02, a corporation's articles of incorporation may be amended by a merger. Under section 11.02(c) (4), a plan of merger must include any amendments to the survivor's articles of incorporation or organizational documents. If the plan of merger is approved, the amendments will be effective.

5. **Adoption and Approval; Abandonment**

A merger must be adopted and approved as set forth in sections 11.04 and 11.05. Under section 11.08, the board of directors may abandon a merger before its effective date even if the plan of merger has already been approved by the corporation's shareholders.

6. **Effective Date of Merger**

A merger takes effect on the date the articles of merger are filed, unless a later date, not more than 90 days after filing, is specified in the articles. See section 11.06 and the Official Comment thereto.

7. **Appraisal Rights**

Shareholders of a domestic corporation that is a party to a merger may have appraisal rights. See chapter 13.

8. **Protection of Restricted Property**

This section permits a nonprofit corporation or unincorporated nonprofit association to merge into a for-profit corporation or unincorporated entity. The laws of some states governing the nondiversion of charitable and trust property to other uses may not be worded in a fashion that will cover a merger under section 11.02. To prevent a merger from being used to avoid restrictions on the use of property held by nonprofit entities, optional section 11.02(f) may be used to require approval of mergers by the appropriate arm of government having supervision of nonprofit entities.

§ 11.03. SHARE EXCHANGE

(a) Through a share exchange:

(1) a domestic corporation may acquire all of the shares of one or more classes or series of shares of another domestic or foreign corporation, or all of the interests

of one or more classes or series of interests of a domestic or foreign other entity, in exchange for shares or other securities, interests, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing, pursuant to a plan of share exchange, or

(2) all of the shares of one or more classes or series of shares of a domestic corporation may be acquired by another domestic or foreign corporation or other entity, in exchange for shares or other securities, interests, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing, pursuant to a plan of share exchange.

(b) A foreign corporation or eligible entity, may be a party to a share exchange only if the share exchange is permitted by the corporation or other entity is organized or by which it is governed.

(b.1) If the organic law of a domestic other entity does not provide procedures for the approval of a share exchange, a plan of share exchange may be adopted and approved, and the share exchange effectuated, in accordance with the procedures, if any, for a merger. If the organic law of a domestic other entity does not provide procedures for the approval of either a share exchange or a merger, a plan of share exchange may be adopted and approved, the share exchange effectuated, and appraisal rights exercised, in accordance with the procedures in this chapter and chapter 13. For the purposes of applying this chapter and chapter 13:

(1) the other entity, its interest holders, interests and organic documents taken together shall be deemed to be a domestic business corporation, shareholders, shares and articles of incorporation, respectively and vice versa as the context may require; and

(2) if the business and affairs of the other entity are managed by a group of persons that is not identical to the interest holders, that group shall be deemed to be the board of directors.

(c) The plan of share exchange must include:

(1) the name of each corporation or other entity whose shares or interests will be acquired and the name of the corporation or other entity that will acquire those shares or interests;

(2) the terms and conditions of the share exchange;

(3) the manner and basis of exchanging shares of a corporation or interests in an other entity whose shares or interests will be acquired under the share exchange into shares or other securities, interests, obligations, rights to acquire shares, other securities, or interests, cash, other property, or any combination of the foregoing; and

(4) any other provisions required by the laws under which any party to the share exchange is organized or by the articles of incorporation or organic document of any such party.

(d) Terms of a plan of share exchange may be made dependent on facts objectively ascertainable outside the plan in accordance with section 1.20(k).

(e) The plan of share exchange may also include a provision that the plan may be amended prior to filing articles of share exchange, but if the shareholders of a domestic corporation that is a party to the share exchange are required or permitted to vote on the plan, the plan must provide that subsequent to approval of the plan by such shareholders the plan may not be amended to change:

(1) the amount or kind of shares or other securities, interests, obligations, rights to acquire shares, other securities or interests, cash, or other property to be issued by the corporation or to be received under the plan by the shareholders of or owners of interests in any party to the share exchange; or

(2) any of the other terms or conditions of the plan if the change would adversely affect such shareholders in any material respect.

(f) Section 11.03 does not limit the power of a domestic corporation to acquire shares of another corporation or interests in another entity in a transaction other than a share exchange.

CROSS-REFERENCES

Abandonment of share exchange, see § 11.08.

Appraisal rights, see ch. 13.

Approval of plan, see § 11.04.

Articles of share exchange, see § 11.06.

Classes of shares, see § 6.01.

Effect of share exchange, see § 11.07.

“Eligible entity” defined, see § 1.40.

Extrinsic facts, see § 1.20(k).

“Other entity” defined, see § 11.01(d).

Series of shares, see § 6.02.

OFFICIAL COMMENT

1. In General

It is often desirable to structure a corporate combination so that the separate existence of one or more parties to the combination does not cease although another corporation or other entity obtains ownership of the shares or interests of those parties. This objective is often particularly important in the formation of insurance and bank holding companies, but is not limited to those contexts. In the absence of the procedure authorized in section 11.03, this kind of result often can be accomplished only by a reverse triangular merger, which involves the formation by a corporation, A, of a new subsidiary, followed by a merger of that subsidiary into another party to the merger, B, effected through the exchange of A's securities for securities of B. Section 11.03 authorizes a more straightforward procedure to accomplish the same result.

Under section 11.03, the acquiring corporation in a share exchange must acquire all of the shares or interests of the class or series of shares or interests that is being acquired. The shares or interests of one or more other classes or series of the acquired corporation or other entity may be excluded from the share exchange or may be included on different bases. After the plan of share exchange is adopted and approved as required by section 11.04, it is binding on all holders of the class or series to be acquired. Accordingly, a share exchange may operate in a mandatory fashion on some holders of the class or series of shares or interests acquired.

Section 11.03(f) makes clear that the authorization of share exchange combinations under section 11.03 does not limit the power of corporations to acquire shares or interests without using the share-exchange procedure, either as part of a corporate combination or otherwise.

In contrast to mergers, the articles of incorporation of a party to a share exchange may not be amended by a plan of share exchange. Such an amendment may, however, be effected under chapter 10 as a separate element of a corporate combination that involves a share exchange.

2. Applicability

Whether and on what terms a foreign corporation or a foreign other entity is authorized to enter into a share exchange with a domestic corporation is a matter that is governed by the laws under which that corporation or other entity is organized or by which it is governed, not by chapter 11. Therefore, for example, section 11.04, which governs the manner in which a plan of share exchange must be adopted, applies only to adoption of a plan of share exchange by a domestic corporation.

Nevertheless, certain provisions of chapter 11 have an indirect effect on a foreign corporation or foreign other entity that proposes to or does engage in a share exchange with a domestic corporation, because they set conditions concerning the effectiveness and effect of the share exchange. For example, section 11.03(c) sets forth certain requirements for the contents of a plan of share exchange. This section is directly applicable only to domestic corporations, but has an indirect effect on a foreign corporation or foreign other entity that is a party to a proposed share exchange with a domestic corporation.

If the law under which a domestic other entity is organized does not expressly authorize it to participate in a share (or interest) exchange with a domestic business corporation, it is intended that section 11.03(a) will provide the necessary authority. Until such time as the various laws governing the organization of each form of other entity have been amended to provide procedures for adopting and approving a plan of share (or interest) exchange, subsection (b.1) provides those procedures by reference to the provisions of this subchapter applicable to domestic business corporations.

3. **Terms and Conditions of Share Exchange**

Chapter 11 imposes virtually no restrictions or limitations on the terms or conditions of a share exchange, except for those contained in section 11.03(e) concerning provisions in a plan of share exchange for amendment of the plan after it has been approved by shareholders, and the requirement in section 11.03(a) that the acquiring party must acquire all the shares of the acquired class or series of stock or interests. Owners of shares or interests in a party whose shares are acquired under section 11.03(a) (2) may receive securities or interests of the acquiring party, securities or interests of a party other than the acquiring party, or cash or other property.

Although chapter 11 imposes virtually no restrictions or limitations on the terms or conditions of a share exchange, section 11.03(c) requires that the terms and conditions be set forth in the plan of share exchange. The present Act clarifies that the plan of share exchange need not be set forth in the articles of share exchange that are to be delivered to the secretary of state for filing after the share exchange has been adopted and approved. See section 11.06.

The list in section 11.03(c) of required provisions in a plan of share exchange is not exhaustive and the plan may include any other provisions that may be desired.

4. **Adoption and Approval; Abandonment**

A share exchange must be adopted and approved as set forth in section 11.04. Under section 11.08, the board of directors may abandon a share exchange before its effective date even if the plan of share exchange has already been approved by the corporation's shareholders.

5. **Effective Date of Share Exchange**

A share exchange takes effect on the date the articles of share exchange are filed, unless a later date, not more than 90 days after filing, is specified in the articles. See section 11.06 and the Official Comment thereto.

6. **Appraisal Rights**

Holders of a class or series of shares of a domestic corporation that is acquired in a share exchange may have appraisal rights. See chapter 13.

§ 11.04. ACTION ON A PLAN OF MERGER OR SHARE EXCHANGE

In the case of a domestic corporation that is a party to a merger or share exchange:

(a) The plan of merger or share exchange must be adopted by the board of directors.

(b) Except as provided in subsection (g) and in section 11.05, after adopting the plan of merger or share exchange the board of directors must submit the plan to the shareholders for their approval. The board of directors must also transmit to the shareholders a recommendation that the shareholders approve the plan, unless the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation, in which case the board of directors must transmit to the shareholders the basis for that determination.

(c) The board of directors may condition its submission of the plan of merger or share exchange to the shareholders on any basis.

(d) If the plan of merger or share exchange is required to be approved by the shareholders, and if the approval is to be given at a meeting, the corporation must notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the plan is to be submitted for approval. The notice must state that the purpose, or one of the purposes, of the meeting is to consider the plan and must contain or be accompanied by a copy or summary of the plan. If the corporation is to be merged into an existing corporation or other entity, the notice shall also include or be accompanied by a copy or summary of the articles of incorporation or organizational documents of that corporation or other entity. If the corporation is to be merged into a corporation or other entity that is to be created pursuant to the merger, the notice shall include or be accompanied by a copy or a summary of the articles of incorporation or organizational documents of the new corporation or other entity.

(e) Unless the articles of incorporation, or the board of directors acting pursuant to subsection (c), requires a greater vote or a greater number of votes to be present, approval of the plan of merger or share exchange requires the approval of the shareholders at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast on the plan exists, and, if any class or series of shares is entitled to vote as a separate group on the plan of merger or share exchange, the approval of each such separate voting group at a meeting at which a quorum of the voting group consisting of at least a majority of the votes entitled to be cast on the merger or share exchange by that voting group is present.

(f) Separate voting by voting groups is required:

(1) on a plan of merger, by each class or series of shares that:

(i) are to be converted under the plan of merger into other securities, interests, obligations, rights to acquire shares, other securities or interests, cash, other property, or any combination of the foregoing; or

(ii) would be entitled to vote as a separate group on a provision in the plan that, if contained in a proposed amendment to articles of incorporation, would require action by separate voting groups under section 10.04;

(2) on a plan of share exchange, by each class or series of shares included in the exchange, with each class or series constituting a separate voting group; and

(3) on a plan of merger or share exchange, if the voting group is entitled under the articles of incorporation to vote as a voting group to approve a plan of merger or share exchange.

(g) Unless the articles of incorporation otherwise provide, approval by the corporation's shareholders of a plan of merger or share exchange is not required if:

(1) the corporation will survive the merger or is the acquiring corporation in a share exchange;

(2) except for amendments permitted by section 10.05, its articles of incorporation will not be changed;

(3) each shareholder of the corporation whose shares were outstanding immediately before the effective date of the merger or share exchange will hold the same number of shares, with identical preferences, limitations, and relative rights, immediately after the effective date of change; and

(4) the issuance in the merger or share exchange of shares or other securities convertible into or rights exercisable for shares does not require a vote under section 6.21(f).

(h) If as a result of a merger or share exchange one or more shareholders of a domestic corporation would become subject to owner liability for the debts, obligations or liabilities of any other person or entity, approval of the plan of merger or share exchange shall require the execution, by each such shareholder, of a separate written consent to become subject to such owner liability.

CROSS-REFERENCES

Abandonment of merger or share exchange, see § 11.08.

Amendment of articles by board of directors, see § 10.05.

Appraisal rights, see ch. 13.

Director standards of conduct, see § 8.30.

Director standards of liability, see § 8.31.

"Distribution" defined, see § 1.40.

Distributions generally, see § 6.40.

"Notice" defined, see § 1.41.

Notice of shareholders' meeting, see § 7.05.

Share exchange, see § 11.03.

Share issuances requiring shareholder approval, see § 6.21(f).

Supermajority quorum and voting requirements for shareholders, see § 7.27.

Unanimous consent of shareholders see § 7.04.

Voting by voting groups generally, see §§ 7.25 & 7.26.

Voting by voting group on amendment of articles of incorporation, see § 10.04.

Voting entitlement of shareholders generally, see § 7.21.

"Voting group" defined, see § 1.40.

"Voting power" defined, see § 1.40.

OFFICIAL COMMENT

1. In General

Under section 11.04, a plan of merger or share exchange must be adopted by the board. Thereafter, the board must submit the plan to the shareholders for their approval, unless the conditions stated in section 11.04(g) or section 11.05 are satisfied. A plan of share exchange must always be approved by the shareholders of the class or series that is being acquired in a share exchange. Similarly, a plan of merger must always be approved by the shareholders of a corporation that is merged into another party in a merger, unless the corporation is a subsidiary and the merger falls within section 11.05. However, under section 11.04(g) approval of a plan of merger or share exchange by the shareholders of a surviving corporation in a merger or of an acquiring corporation in a share exchange is not required if the conditions stated in that section, including the fundamental rule of section 6.21(f), are satisfied.

Section 11.04(f) provides that a class or series has a right to vote on a plan of merger as a separate voting group if, pursuant to the merger, the class or series would be converted into other securities, interests, obligations, rights to acquire shares, other securities or interests, cash, or other property. A class or series also is entitled to vote as a separate voting group if the class or series would be entitled to vote as a separate group on a provision in the plan that, if contained in an amendment to the articles of incorporation, would require approval by that class or series, voting as a separate voting group, under section 10.04. Under this latter requirement, a class or series will be entitled to vote as a separate voting group if the terms of that class or series are being changed or the shares of that class or series are being converted into shares of any other class or series. Where the surviving entity is a foreign business corporation, it is not intended that immaterial changes in the terms of a class or series that conform to the usage of the laws of the foreign jurisdiction will alone create an entitlement to vote as a separate group.

Under section 10.04, and therefore under section 11.04(f), if a change that requires voting by separate voting groups affects two or more classes or two or more series in the same or a substantially similar way, the relevant classes or series vote together, rather than separately, on the change. If separate voting by voting groups is required for a merger or a share exchange under section 11.04(f), it will not be excused by section 11.04(g). For the mechanics of voting where voting by voting groups is required under section 11.04(f), see sections 7.25 and 7.26 and the Official Comments thereto.

If a merger would amend the articles of incorporation in such a way as to affect the voting requirements on future amendments, the transaction must also be approved by the vote required by section 7.27.

2. Submission to the Shareholders

Section 11.04(b) requires the board of directors, after having adopted the plan of merger or share exchange, to submit the plan of merger or share exchange to the shareholders for approval, except as provided in subsection (g) and section 11.05. When submitting the plan of merger or share exchange the board of directors must make a recommendation to the shareholders that the plan be approved, unless the board of directors makes a determination that because of conflicts of interest or other special circumstances it should make no recommendation. For example, the board or directors may make such a determination where there is not a sufficient number of directors free of a conflicting interest to approve the transaction or because the board of directors is evenly divided as to the merits of a transaction but is able to agree that shareholders should be permitted to consider the transaction. If the board of directors makes such a determination, it must describe the conflict of interest or special circumstances, and communicate the basis for the determination, when submitting the plan of merger or share exchange to the shareholders. The exception for conflicts of interest or other special circumstances is intended to be sparingly available. Generally, shareholders should not be asked to act on a merger or share exchange in the absence of a recommendation by the board of directors. The exception is not intended to relieve the board of directors of its duty to consider carefully the proposed transaction and the interests of shareholders.

Section 11.04(c) permits the board of directors to condition its submission of a plan of merger or share exchange on any basis. Among the conditions that a board might impose are that the plan will not be deemed approved (i) unless it is approved by a specified vote of the shareholders, or by one or more specified classes or series of shares, voting as a separate voting group, or by a specified percentage of disinterested shareholders or (ii) if shareholders holding more than a specified fraction of the outstanding shares assert appraisal rights. The board of directors is not limited to conditions of these types.

Section 11.04(d) provides that if the plan of merger or share exchange is required to be approved by the shareholders, and if the approval is to be given at a meeting, the corporation must notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the plan is to be submitted. Requirements concerning the timing and content of a notice of meeting are set out in section 7.05. Section 11.04(d) does not itself require that notice be given to nonvoting shareholders where the merger is approved, without a meeting, by unanimous consent. However, that requirement is imposed by section 7.04(d).

3. Quorum and Voting

Section 11.04(e) provides that approval of a plan of merger or share exchange requires approval of the shareholders at a meeting at which a quorum consisting of a majority of the votes entitled to be cast on the plan exists and, if any class or series of shares are entitled to vote as a separate group on the plan, the approval of each such separate group at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast on the plan by that class or series exists. If a quorum is present, then under sections 7.25 and 7.26 the plan will be approved if more votes are cast in favor of the plan than against it by the voting group or separate voting groups entitled to vote on the plan. This represents a change from the Act's previous voting rule for mergers and share exchanges, which required approval by a majority of outstanding shares.

In lieu of approval at a shareholders' meeting, approval can be given by shareholder consent under the procedures set forth in section 7.04.

4. Abandonment of Merger or Share Exchange

Under section 11.08, the board of directors may abandon a merger or share exchange before its effective date even if the plan of merger or share exchange has already been approved by the corporation's shareholders.

5. Personal Liability of Shareholders

Section 11.04(h) applies only in situations where a shareholder is becoming subject to "owner liability" as defined in section 1.40(15C), for example, where a corporation is merging into a general partnership. Where another entity whose interest holders have owner liability, such as a general partnership, is merging into a corporation, the effect of the transaction on the owner liability of the interest holders in the other entity will be determined by section 11.07(e).

§ 11.05. MERGER BETWEEN PARENT AND SUBSIDIARY OR BETWEEN SUBSIDIARIES

(a) A domestic parent corporation that owns shares of a domestic or foreign subsidiary corporation that carry at least 90% of the voting power of each class and series of the outstanding shares of the subsidiary that have voting power may merge the subsidiary into itself or into another such subsidiary, or merge itself into the subsidiary, without the approval of the board of directors or shareholders of the subsidiary, unless the articles of incorporation of any of the corporations otherwise provide, and unless, in the case of a foreign subsidiary, approval by the subsidiary's board of directors or shareholders is required by the laws under which the subsidiary is organized.

(b) If under subsection (a) approval of a merger by the subsidiary's shareholders is not required, the parent corporation shall, within 10 days after the effective date of the merger, notify each of the subsidiary's shareholders that the merger has become effective.

(c) Except as provided in subsections (a) and (b), a merger between a parent and a subsidiary shall be governed by the provisions of chapter 11 applicable to mergers generally.

CROSS-REFERENCES

Appraisal rights, see ch. 13.

Articles of merger, see § 11.06.

Director standards of conduct, see § 8.30.

Director standards of liability, see § 8.31.

"Voting power" defined, see § 1.40.

OFFICIAL COMMENT

Under section 11.05, if a parent owns 90% of the voting power of each class and series of the outstanding shares of a subsidiary that have voting power, the subsidiary may be merged into the parent or another such subsidiary, or the parent may be merged into the subsidiary, without the approval of the subsidiary's shareholders or board of directors, subject to certain informational and notice requirements. Approval by the subsidiary's shareholders is not required partly because if a parent already owns 90% or more of the voting power of each class and series of a subsidiary's shares, approval of a merger by the subsidiary's shareholders would be a foregone conclusion, and partly to facilitate the simplification of corporate structure where only a very small fraction of stock is held by outside shareholders. Approval by the subsidiary's board of directors is not required because if the parent owns 90% or more of the voting power of each class and series of the subsidiary's outstanding shares, the subsidiary's directors cannot be expected to be independent of the parent, so that the approval by the subsidiary's board of directors would also be a foregone conclusion. In other respects, mergers between parents and 90%-owned subsidiaries are governed by the provisions of chapter 11.

Section 11.05 dispenses with approval by the board of directors or the shareholders of a subsidiary that is merged into the parent or another subsidiary if the conditions of the section are met. Section 11.05 does not in itself dispense with approval by the shareholders of the parent. Under section 11.04(g), a merger of the kind described in section 11.05 in which the subsidiary is merged upstream into the parent would usually not require approval of the parent's shareholders, because in such cases the parent's articles of incorporation are usually not affected by the merger and the parent usually does not issue stock carrying more than 20% of its voting power. If, however, a parent is merged downstream into the subsidiary, approval by the parent's shareholders would be required under section 11.04.

§ 11.06. ARTICLES OF MERGER OR SHARE EXCHANGE

(a) After a plan of merger or share exchange has been adopted and approved as required by this Act, articles of merger or share exchange shall be executed on behalf of each party to the merger or share exchange by any officer or other duly authorized representative. The articles shall set forth:

(1) the names of the parties to the merger or share exchange;

(2) if the articles of incorporation of the survivor of a merger are amended, or if a new corporation is created as a result of a merger, the amendments to the

survivor's articles of incorporation or the articles of incorporation of the new corporation;

(3) if the plan of merger or share exchange required approval by the shareholders of a domestic corporation that was a party to the merger or share exchange, a statement that the plan was duly approved by the shareholders and, if voting by any separate voting group was required, by each such separate voting group, in the manner required by this Act and the articles of incorporation;

(4) if the plan of merger or share exchange did not require approval by the shareholders of a domestic corporation that was a party to the merger or share exchange, a statement to that effect; and

(5) as to each foreign corporation or eligible entity that was a party to the merger or share exchange, a statement that the participation of the foreign corporation or eligible entity was duly authorized as required by the organic law of the corporation or eligible entity.

(b) Articles of merger or share exchange shall be delivered to the secretary of state for filing by the survivor of the merger or the acquiring corporation in a share exchange, and shall take effect at the effective time provided in section 1.23. Articles of merger or share exchange filed under this section may be combined with any filing required under the organic law of any domestic eligible entity involved in the transaction if the combined filing satisfies the requirements of both this section and the other organic law.

CROSS-REFERENCES

Approval of merger or share exchange, see § 11.04.

"Deliver" defined, see § 1.40.

"Eligible entity" defined, see § 1.40.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

"Organic law" defined, see § 1.40.

Short form merger, see § 11.05.

Voting by voting group, see §§ 7.25 & 7.26.

"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

The filing of articles of merger or share exchange makes the transaction a matter of public record. The requirements of filing are set forth in section 1.20. The effective date of the articles is the effective date of their filing, unless otherwise specified. Under section 1.23, a document may specify a delayed effective time and date, and if it does so the document becomes effective at the time and date specified, except that a delayed effective date may not be later than the 90th day after the date the document is filed.

If a merger or share exchange involves a domestic eligible entity whose organic law also requires a filing to effectuate the transaction, section 11.06(b) permits the filings under that organic law and this section to be combined so that only one document need be filed with the secretary of state.

§ 11.07. EFFECT OF MERGER OR SHARE EXCHANGE

(a) When a merger becomes effective:

(1) the corporation or eligible entity that is designated in the plan of merger as the survivor continues or comes into existence, as the case may be;

(2) the separate existence of every corporation or eligible entity that is merged into the survivor ceases;

(3) all property owned by, and every contract right possessed by, each corporation or eligible entity that merges into the survivor is vested in the survivor without reversion or impairment;

(4) all liabilities of each corporation or eligible entity that is merged into the survivor are vested in the survivor;

(5) the name of the survivor may, but need not be, substituted in any pending proceeding for the name of any party to the merger whose separate existence ceased in the merger;

(6) the articles of incorporation or organic documents of the survivor are amended to the extent provided in the plan of merger;

(7) the articles of incorporation or organic documents of a survivor that is created by the merger become effective; and

(8) the shares of each corporation that is a party to the merger, and the interests in an eligible entity that is a party to a merger, that are to be converted under the plan of merger into shares, eligible interests, obligations, rights to acquire securities, other securities, or eligible interests, cash, other property, or any combination of the foregoing, are converted, and the former holders of such shares or eligible interests are entitled only to the rights provided to them in the plan of merger or to any rights they may have under chapter 13 or the organic law of the eligible entity.

(b) When a share exchange becomes effective, the shares of each domestic corporation that are to be exchanged for shares or other securities, interests, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing, are entitled only to the rights provided to them in the plan of share exchange or to any rights they may have under chapter 13.

(c) A person who becomes subject to owner liability for some or all of the debts, obligations or liabilities of any entity as a result of a merger or share exchange shall have owner liability only to the extent provided in the organic law of the entity and only for those debts, obligations and liabilities that arise after the effective time of the articles of merger or share exchange.

(d) Upon a merger becoming effective, a foreign corporation, or a foreign eligible entity, that is the survivor of the merger is deemed to:

(1) appoint the secretary of state as its agent for service of process in a proceeding to enforce the rights of shareholders of each domestic corporation that is a party to the merger who exercise appraisal rights, and

(2) agree that it will promptly pay the amount, if any, to which such shareholders are entitled under chapter 13.

(e) The effect of a merger or share exchange on the owner liability of a person who had owner liability for some or all of the debts, obligations or liabilities of a party to the merger or share exchange shall be as follows:

(1) The merger or share exchange does not discharge any owner liability under the organic law of the entity in which the person was a shareholder or interest holder to the extent any such owner liability arose before the effective time of the articles of merger or share exchange.

(2) The person shall not have owner liability under the organic law of the entity in which the person was a shareholder or interest holder prior to the merger or share exchange for any debt, obligation or liability that arises after the effective time of the articles of merger or share exchange.

(3) The provisions of the organic law of any entity for which the person had owner liability before the merger or share exchange shall continue to apply to the collection or discharge of any owner liability preserved by paragraph (1), as if the merger or share exchange had not occurred.

(4) The person shall have whatever rights of contribution from other persons are provided by the organic law of the entity for which the person had owner liability with respect to any owner liability preserved by paragraph (1), as if the merger or share exchange had not occurred.

CROSS-REFERENCES

Appraisal rights, see ch. 13.

Effective time and date of merger or share exchange, see § 1.23.

“Organic law” defined see § 1.40.

“Owner liability” defined see § 1.40.

“Proceeding” defined, see § 1.40.

OFFICIAL COMMENT

Under section 11.07(a), in the case of a merger the survivor and the parties that merge into the survivor become one. The survivor automatically becomes the owner of all real and personal property and becomes subject to all the liabilities, actual or contingent, of each party that is merged into it. A merger is not a conveyance, transfer, or assignment. It does not give rise to claims of reverter or impairment of title based on a prohibited conveyance, transfer, or assignment. It does not give rise to a claim that a contract with a party to the merger is no longer in effect on the ground of nonassignability, unless the contract specifically provides that it does not survive a merger. All pending proceedings involving either the survivor or a party whose separate existence ceased as a result of the merger are continued. Under section 11.07(a) (5), the name of the survivor may be, but need not be, substituted in any pending proceeding for the name of a party to the merger whose separate existence ceased as a result of the merger. The substitution may be made whether the survivor is a complainant or a respondent, and may be made at the instance of either the survivor or an opposing party. Such a substitution has no substantive effect, because whether or not the survivor’s name is substituted it succeeds to the claims of, and is subject to the liabilities of, any party to the merger whose separate existence ceased as a result of the merger.

In contrast to a merger, a share exchange does not in and of itself affect the separate existence of the parties, vest in the acquiring corporation the assets of the corporation whose stock is to be acquired, or render the acquiring corporation liable for the liabilities of the corporation whose stock the acquiring corporation acquires.

Under section 11.07(a)(8), on the effective date of a merger the former shareholders of a corporation that is merged into the survivor are entitled only to the rights provided in the plan of merger (which would include any rights they have as holders of the consideration they acquire) or to any rights they may have under chapter 13. Similarly, under section 11.07(b), on the effective date of a share exchange the former shareholders of a corporation whose shares are acquired are entitled only to the rights provided in the plan of share exchange (which would include any rights they have as holders of the consideration they acquire) or to any rights they may have under chapter 13. These provisions are not intended to preclude an otherwise proper question concerning the merger’s validity, or to override or otherwise affect any provisions of chapter 13 concerning the exclusiveness of rights under that chapter.

Under section 11.07(d), when a merger becomes effective a foreign corporation, or a foreign other entity, that is the survivor of the merger is deemed to appoint the secretary of state as its agent for service of process in a proceeding to enforce the rights of any shareholders of each domestic corporation that is a party to the merger who exercise appraisal rights, and to agree that it will promptly pay the amount, if any, to which such shareholders are entitled under chapter 13. This result is based on the implied consent of such a foreign corporation, or foreign other entity, to the terms of chapter 11 by virtue of entering into an agreement that is governed by this chapter.

Section 11.07(e) preserves liability only for owner liabilities to the extent they arise before the merger or share exchange. Owner liability is not preserved for subsequent changes in an underlying liability, regardless of whether a change is voluntary or involuntary.

Under section 11.04(h), a merger cannot have the effect of making any shareholder of a domestic corporation subject to owner liability for the debts, obligations or liabilities of any other person or entity unless each such shareholder has executed a separate written consent to become subject to such owner liability.

This section does not address the issue that could arise in a merger where a person who had authority to bind a party to the merger loses that authority because of the merger and yet purports to act to bind the survivor of the merger. For example, in a merger of a general partnership into a corporation, a person who is a general partner but does not become an officer of the corporation will lose the authority of a general partner to bind the business to obligations incurred in the ordinary course, but might purport to commit the corporation to such an obligation in dealing with a person who does not have knowledge of the merger. Instances in which this occurs are rare and, in the limited instances in which it does occur, general principles of agency law are sufficient to resolve the problems created.

§ 11.08. ABANDONMENT OF A MERGER OR SHARE EXCHANGE

(a) Unless otherwise provided in a plan of merger or share exchange or in the laws under which a foreign business corporation or a domestic or foreign eligible entity that is a party to a merger or a share exchange is organized or by which it is governed, after the plan has been adopted and approved as required by this chapter, and at any time before the merger or share exchange has become effective, it may be abandoned by a domestic business corporation that is a party thereto without action by its shareholders in accordance with any procedures set forth in the plan of merger or share exchange or, if no such procedures are set forth in the plan, in the manner determined by the board of directors, subject to any contractual rights of other parties to the merger or share exchange.

(b) If a merger or share exchange is abandoned under subsection (a) after articles of merger or share exchange have been filed with the secretary of state but before the merger or share exchange has become effective, a statement that the merger or share exchange has been abandoned in accordance with this section, executed on behalf of a party to the merger or share exchange by an officer or other duly authorized representative, shall be delivered to the secretary of state for filing prior to the effective date of the merger or share exchange. Upon filing, the statement shall take effect and the merger or share exchange shall be deemed abandoned and shall not become effective.

CROSS-REFERENCES

Approval of merger or share exchange, see § 11.04.

"Deliver," see § 1.40.

Effective time and date of filing, see § 1.23.

Filing requirements, see § 1.20.

OFFICIAL COMMENT

Under section 11.08, unless otherwise provided in the plan of merger or share exchange, a domestic business corporation that is a party to a merger or share exchange may abandon the transaction without shareholder approval, even though the transaction has been previously approved by the shareholders. The power under section 11.08 to abandon a transaction without shareholder approval does not affect any contract rights that other parties may have. The power of a foreign business corporation or a domestic or foreign eligible entity to abandon a transaction will be determined by the organic law of the corporation or eligible entity, except as provided in sections 11.02(b.1) and 11.03(b.1).

CHAPTER 12

Disposition of Assets

§ 12.01. DISPOSITION OF ASSETS NOT REQUIRING SHAREHOLDER APPROVAL

No approval of the shareholders of a corporation is required, unless the articles of incorporation otherwise provide:

(1) to sell, lease, exchange, or otherwise dispose of any or all of the corporation's assets in the usual and regular course of business;

(2) to mortgage, pledge, dedicate to the repayment of indebtedness (whether with or without recourse), or otherwise encumber any or all of the corporation's assets, whether or not in the usual and regular course of business;

(3) to transfer any or all of the corporation's assets to one or more corporations or other entities all of the shares or interests of which are owned by the corporation; or

(4) to distribute assets pro rata to the holders of one or more classes or series of the corporation's shares.

CROSS-REFERENCES

Articles of incorporation, see § 2.02, ch. 10A.
Director standards of conduct, see § 8.30.
Dissolution, see ch. 14.
"Distribution" defined, see § 1.40.
Distributions to shareholders, see § 6.40.
Shareholder approval of certain dispositions, see § 12.02.

OFFICIAL COMMENT

Section 12.01 provides that no approval of the shareholders is required for dispositions of assets of the types described therein, unless the articles of incorporation otherwise provide. Dispositions other than those described in section 12.01 require shareholder approval if they fall within section 12.02.

Under subsection (1), shareholder approval is not required for a disposition of the corporation's assets in the usual and regular course of business, regardless of the size of the transaction. Examples of such dispositions would include the sale of a building that was the corporation's only major asset where the corporation was formed for the purpose of constructing and selling that building, or the sale by a corporation of its only major business where the corporation was formed to buy and sell businesses and the proceeds of the sale are to be reinvested in the purchase of a new business, or an open- or closed-end investment company whose portfolio turns over many times in short periods.

Subsection (3) provides that no approval of shareholders is required to transfer any or all of the corporation's assets to a wholly owned subsidiary or other entity. This provision may not be used as a device to avoid a vote of shareholders by a multi-step transaction.

Subsection (4) provides that no approval of the shareholders is required to distribute assets pro rata to the holders of one or more classes of the corporation's shares. A traditional spin-off-that is, a pro rata distribution of the shares of a subsidiary to the holders of one or more classes of shares-falls within this subsection. A split-off-that is, a non pro rata distribution of shares of a subsidiary to some or all shareholders in exchange for some of their shares-would require shareholder approval if the disposition left the parent without a significant continuing business activity under subsection 12.02(a). A split-up that is, a distribution of the shares of two or more subsidiaries in complete liquidation to shareholders would be governed by section 14.02 (dissolution), not by chapter 12. In each of the foregoing situations, the subsidiary or subsidiaries could be historical or newly created.

§ 12.02. SHAREHOLDER APPROVAL OF CERTAIN DISPOSITIONS

(a) A sale, lease, exchange, or other disposition of assets, other than a disposition described in section 12.01, requires approval of the corporation's shareholders if the disposition would leave the corporation without a significant continuing business activity. If a corporation retains a business activity that represented at least 25% of total assets at the end of the most recently completed fiscal year, and 25% of either income from continuing operations before taxes or revenues from continuing operations for that fiscal year, in each case of the corporation and its subsidiaries on a consolidated basis, the corporation will conclusively be deemed to have retained a significant continuing business activity.

(b) A disposition that requires approval of the shareholders under subsection (a) shall be initiated by a resolution by the board of directors authorizing the disposition. After adoption of such a resolution, the board of directors shall submit the proposed disposition to the shareholders for their approval. The board of directors shall also transmit to the shareholders a recommendation that the shareholders approve the proposed disposition, unless the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation, in which case the board of directors shall transmit to the shareholders the basis for that determination.

(c) The board of directors may condition its submission of a disposition to the shareholders under subsection (b) on any basis.

(d) If a disposition is required to be approved by the shareholders under subsection (a), and if the approval is to be given at a meeting, the corporation shall notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the disposition is to be submitted for approval. The notice shall state that the purpose, or one of the purposes, of the meeting is to consider the disposition and shall contain a description of the disposition, including the terms and conditions thereof and the consideration to be received by the corporation.

(e) Unless the articles of incorporation or the board of directors acting pursuant to subsection (c) requires a greater vote, or a greater number of votes to be present, the approval of a disposition by the shareholders shall require the approval of the shareholders at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast on the disposition exists.

(f) After a disposition has been approved by the shareholders under subsection (b), and at any time before the disposition has been consummated, it may be abandoned by the corporation without action by the shareholders, subject to any contractual rights of other parties to the disposition.

(g) A disposition of assets in the course of dissolution under chapter 14 is not governed by this section.

(h) The assets of a direct or indirect consolidated subsidiary shall be deemed the assets of the parent corporation for the purposes of this section.

CROSS-REFERENCES

Appraisal rights, see ch. 13.
Director standards of conduct, see § 8.30.
Disposition of assets not requiring shareholder approval, see § 12.01.
Dissolution, see ch. 14.
"Notice" defined, see § 1.41.
Notice of shareholders' meeting, see § 7.05.
Supermajority quorum and voting requirements for shareholders, see § 7.27.
Voting entitlement of shareholders generally, see § 7.21.

OFFICIAL COMMENT

1. In General

Section 12.02(a) requires shareholder approval for a sale, lease, exchange or other disposition by a corporation that would leave the corporation without a significant continuing business activity. The test employed in section 12.02(a) for whether a disposition of assets requires shareholder approval differs verbally from the test employed in past versions of the Model Act, which centered on whether a sale involves "all or substantially all" of a corporation's assets. The "all or substantially all" test has also been used in most corporate statutes. In practice, however, courts interpreting these statutes have commonly employed a test comparable to that embodied in 12.02(a). For example, in *Gimbel v. Signal Cos.,* 316 A.2d 599 (Del. Ch.), aff'd, 316 A.2d 619 (Del. 1974), the court stated that "While it is true that [the all or substantially all] test does not lend itself to a strict mathematical standard to be applied in every case, the qualitative factor can be defined to some degree…. If the sale is of assets quantitatively vital to the operation of the corporation and is out of the ordinary [course] and substantially affects the existence and purpose of the corporation then it is beyond the power of the Board of Directors." In *Thorpe v. Cerbco, Inc.,* 676 A.2d 436 (Del. 1996), a major issue was whether the sale by a corporation, CERBCO, of one of its subsidiaries, East, would have been a sale of all or substantially all of the corporation's assets, and therefore would have required shareholder approval under the Delaware statute. The court, quoting *Oberly v. Kirby,* 592 A.2d 445 (Del. 1991), stated:

> "[T]he rule announced in Gimbel v. Signal Cos., Del. Ch., 316 A.2d 599, aff'd, Del. Supr., 316 A.2d 619 (1974), makes it clear that the need for shareholder. . . approval is to be measured not by the size of a sale alone, but also by its qualitative effect upon the corporation. Thus, it is relevant to ask whether a transaction is out of the ordinary and substantially affects the existence and purpose of the corporation. [Gimbel, 316 A.2d] at 606."

In the opinion below, the Chancellor determined that the sale of East would constitute a radical transformation of CERBCO. In addition, CERBCO's East stock accounted for 68% of CERBCO's assets in 1990 and this stock was its primary income generating asset. We therefore affirm the decision that East stock constituted "substantially all" of CERBCO's assets as consistent with Delaware law.

See also *Katz v. Bregman*, 431 A.2d 1274 (Del. Ch.), appeal refused sub nom. *Plant Industries, Inc. v. Katz*, 435 A.2d 1044 (Del. 1981); *Stiles v. Aluminum Products Co.*, 338 Ill. App. 48, 86 N.E.2d 887 (1949); *Campbell v. Vose*, 515 F.2d 256 (10th Cir. 1975); *South End Improvement Group, Inc. v. Mulliken*, 602 So. 2d 1327 (Fla. App. 1992); *Schwadel v. Uchitel*, 455 So. 2d 401 (Fla. App. 1984).

Whether a disposition leaves a corporation with a significant continuing business activity, within the meaning of section 12.02(a), depends primarily on whether the corporation will have a remaining business activity that is significant when compared to the corporation's business prior to the disposition. The addition of a safe harbor, embodied in the second sentence of section 12.02(a), under which a significant business activity exists if the continuing business activity represented at least 25% of the total assets and 25% of either income from continuing operations before income taxes or revenues from continuing operations, in each case of the company and its subsidiaries on a consolidated basis for the most recent full fiscal year, the corporation will conclusively be deemed to have retained a significant continuing business activity, represents a policy judgment that a greater measure of certainty than is provided by interpretations of the current case law is highly desirable. The application of this bright-line safe-harbor test should, in most cases, produce a reasonably clear result substantially in conformity with the approaches taken in the better case law developing the "quantitative" and "qualitative" analyses. The test is to be applied to assets, revenue, and income for the most recent fiscal year ended immediately before the decision by the board of directors to make the disposition in question.

If a corporation disposes of assets for the purpose of reinvesting the proceeds of the disposition in substantially the same business in a somewhat different form (for example, by selling the corporation's only plant for the purpose of buying or building a replacement plant), the disposition and reinvestment should be treated together, so that the transaction should not be deemed to leave the corporation without a significant continuing business activity.

In determining whether a disposition would leave a corporation without a significant continuing business activity, the term "the corporation" includes subsidiaries that are or should be consolidated with the parent under generally accepted accounting principles. Accordingly, if, for example, a corporation's only significant business is owned by a wholly or almost wholly owned subsidiary, a sale of that business requires approval of the parent's shareholders under section 12.02. See *Schwadel v. Uchitel*, 455 So. 2d 401 (Fla. App. 1984). Correspondingly, if a corporation owns one significant business directly, and several other significant businesses through one or more wholly or almost wholly owned subsidiaries, a sale by the corporation of the single business it owns directly does not require shareholder approval under section 12.02.

If all or a large part of a corporation's assets are held for investment, the corporation actively manages those assets, and it has no other significant business, for purposes of the statute the corporation should be considered to be in the business of investing in such assets, so that a sale of most of those assets without a reinvestment should be considered a sale that would leave the corporation without a significant continuing business activity. In applying the 25% tests of section 12.02(a), an issue could arise if a corporation had more than one business activity, one or more of which might be traditional operating activities such as manufacturing or distribution, and another of which might be considered managing investments in other securities or enterprises. If the activity constituting the management of investments is to be a continuing business activity as a result of the active engagement of the management of the corporation in that process, and the 25% tests were met upon the disposition of the other businesses, shareholder approval would not be required.

As under section 6.40(d) (determination of whether a dividend is permissible), and for the same reasons, the board of directors may base a determination that a retained continuing business falls within the 25% bright-line tests of the safe harbor embodied in the second sentence of section 12.02(a) either on accounting principles and practices that are reasonable in the circumstances or (in applying the asset test) on a fair valuation or other method that is reasonable in the circumstances. See section 6.40(d) and Comment 4 thereto.

The utilization of the term "significant," and the specific 25% safe harbor test for purposes of this section, should not be read as implying a standard for the test of significance or materiality for any other purposes under the Act or otherwise.

2. Submission to Shareholders

Section 12.02(b) requires the board of directors, after having adopted a resolution authorizing a disposition that requires shareholder approval, to submit the disposition to the shareholders for approval. When submitting the disposition to the shareholders, the board of directors must make a recommendation to the shareholders that the disposition be approved, unless the board makes a determination that because of conflicts of interests or other special circumstances it should make no recommendation. For example, the board of directors may make such a determination where there is not a sufficient number of directors free of a conflicting interest to approve the transaction or because the board of directors is evenly divided as to the merits of a transaction but is able to agree that shareholders should be permitted to consider the transaction. If the board of directors makes such a determination, it must describe the conflicts of interests or special circumstances, and communicate the basis for the determination, when submitting the disposition to the shareholders. The exception for conflicts of interest or other special circumstances is intended to be sparingly available. Generally, shareholders should not be asked to act on a disposition in the absence of a recommendation by the board of directors. The exception is not intended to relieve the board of directors of its duty to consider carefully the proposed transaction and the interests of shareholders.

Section 12.02(c) permits the board of directors to condition its submission of a proposed disposition to the shareholders. Among the conditions that board might impose are that the disposition will not be deemed approved: (i) unless it is approved by a specified percentage of the shareholders, or by one or more specified classes or series of shares, voting as a separate voting group, or by a specified percentage of disinterested shareholders, or (ii) if shareholders holding more than a specified fraction of the outstanding shares assert appraisal rights. The board of directors is not limited to conditions of these types.

3. Quorum and Voting

Section 12.02(e) provides that approval of a plan of merger or share exchange requires approval of the shareholders at a meeting at which at least a majority of the votes entitled to be cast on the plan is present. This represents a change from the Act's previous voting rule, which required approval by a majority of outstanding shares.

In lieu of approval at a shareholders' meeting, approval can be by shareholder consent under the procedures set forth in section 7.04.

4. Appraisal Rights

Shareholders of a domestic corporation that engages in a disposition that requires shareholder approval under section 12.02 may have appraisal rights. See chapter 13.

5. Subsidiaries

The term "subsidiary" or "subsidiaries," as used in section 12.02, includes both corporate and noncorporate subsidiaries. Accordingly, for example, a limited liability company or a partnership may be a subsidiary for purposes of section 12.02.

CHAPTER 13

Appraisal Rights

Subchapter A.
RIGHT TO APPRAISAL AND PAYMENT FOR SHARES

Subchapter B.
PROCEDURE FOR EXERCISE OF APPRAISAL RIGHTS

Subchapter C.
JUDICIAL APPRAISAL OF SHARES

Subchapter D.
OTHER REMEDIES

Subchapter A.
RIGHT TO APPRAISAL AND PAYMENT FOR SHARES

§ 13.01. DEFINITIONS

In this chapter:

(1) "Affiliate" means a person that directly or indirectly through one or more intermediaries controls, is controlled by, or is under common control with another person or is a senior executive thereof. For purposes of section 13.02(b)(4), a person is deemed to be an affiliate of its senior executives.

(2) "Beneficial shareholder" means a person who is the beneficial owner of shares held in a voting trust or by a nominee on the beneficial owner's behalf.

(3) "Corporation" means the issuer of the shares held by a shareholder demanding appraisal and, for matters covered in sections 13.22-13.31, includes the surviving entity in a merger.

(4) "Fair value" means the value of the corporation's shares determined:

(i) immediately before the effectuation of the corporate action to which the shareholder objects;

(ii) using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and

(iii) without discounting for lack of marketability or minority status except, if appropriate, for amendments to the articles pursuant to section 13.02(a)(5).

(5) "Interest" means interest from the effective date of the corporate action until the date of payment, at the rate of interest on judgments in this state on the effective date of the corporate action.

(5.1) "Interested transaction" means a corporate action described in section 13.02(a), other than a merger pursuant to section 11.05, involving an interested person in which any of the shares or assets of the corporation are being acquired or converted. As used in this definition:

(i) "Interested person" means a person, or an affiliate of a person, who at any time during the one-year period immediately preceding approval by the board of directors of the corporate action:

(A) was the beneficial owner of 20% or more of the voting power of the corporation, other than as owner of excluded shares;

(B) had the power, contractually or otherwise, other than as owner of excluded shares, to cause the appointment or election of 25% or more of the directors to the board of directors of the corporation; or

(C) was a senior executive or director of the corporation or a senior executive of any affiliate thereof, and that senior executive or director will receive, as a result of the corporate action, a financial benefit not generally available to other shareholders as such, other than:

(I) employment, consulting, retirement, or similar benefits established separately and not as part of or in contemplation of the corporate action; or

(II) employment, consulting, retirement, or similar benefits established in contemplation of, or as part of, the corporate action that are not more favorable than those existing before the corporate action or, if more favorable, that have been approved on behalf of the corporation in the same manner as is provided in section 8.62; or

(III) in the case of a director of the corporation who will, in the corporate action, become a director of the acquiring entity in the corporate action or one of its affiliates, rights and benefits as a director that are provided on the same basis as those afforded by the acquiring entity generally to other directors of such entity or such affiliate.

(ii) "Beneficial owner" means any person who, directly or indirectly, through any contract, arrangement, or understanding, other than a revocable proxy, has or shares the power to vote, or to direct the voting of, shares; except that a member of a national securities exchange is not deemed to be a beneficial owner of securities held directly or indirectly by it on behalf of another person solely because the member is the record holder of the securities if the member is precluded by the rules of the exchange from voting without instruction on contested matters or matters that may affect substantially the rights or privileges of the holders of the securities to be voted. When two or more persons agree to act together for the purpose of voting their shares of the corporation, each member of the group formed thereby is deemed to have acquired beneficial ownership, as of the date of the agreement, of all voting shares of the corporation beneficially owned by any member of the group.

(iii) "Excluded shares" means shares acquired pursuant to an offer for all shares having voting power if the offer was made within one year prior to the corporate action for consideration of the same kind and of a value equal to or less than that paid in connection with the corporate action;

(6) "Preferred shares" means a class or series of shares whose holders have preference over any other class or series with respect to distributions.

(7) "Record shareholder" means the person in whose name shares are registered in the records of the corporation or the beneficial owner of shares to the extent of the rights granted by a nominee certificate on file with the corporation.

(8) "Senior executive" means the chief executive officer, chief operating officer, chief financial officer, and anyone in charge of a principal business unit or function.

(9) "Shareholder" means both a record shareholder and a beneficial shareholder.

CROSS-REFERENCES

Act definitions, see § 1.40.

Directors' action, see § 8.62.

Merger and share exchange, see ch. 11.

OFFICIAL COMMENT

1. Overview

Chapter 13 deals with the tension between the desire of the corporate leadership to be able to enter new fields, acquire new enterprises, and rearrange investor rights, and the desire of investors to adhere to the rights and the risks on the basis of which they invested. Contemporary corporation statutes in the United States attempt to resolve this tension through a combination of two devices. On the one hand, through their approval of an amendment to the articles of incorporation, a merger, share exchange or disposition of assets, the majority may change the nature and shape of the enterprise and the rights of all its shareholders. On the other hand, shareholders who object to these changes may withdraw the fair value of their investment in cash through their exercise of appraisal rights.

The traditional accommodation has been sharply criticized from two directions. From the viewpoint of investors who object to the transaction, the appraisal process is criticized for providing little help to the ordinary investor because its technicalities make its use difficult, expensive, and risky. From the viewpoint of the corporate leadership, the appraisal process is criticized because it fails to protect the corporation from demands that are motivated by the hope of a nuisance settlement or by fanciful conceptions of value. See generally Bayless Manning, "The Shareholders' Appraisal Remedy: An Essay for Frank Coker," 72 YALE L.J. 223 (1962).

Chapter 13 is a compromise between these opposing points of view. It is designed to increase the frequency with which assertion of appraisal rights leads to economical and satisfying solutions, and to decrease the frequency with which such assertion leads to delay, expense, and dissatisfaction. It seeks to achieve these goals primarily by simplifying and clarifying the appraisal process, as well as by motivating the parties to settle their differences in private negotiations without resort to judicial appraisal proceedings.

Chapter 13 proceeds from the premise that judicial appraisal should be provided by statute only when two conditions co-exist. First, the proposed corporate action as approved by the majority will result in a fundamental change in the shares to be affected by the action. Second, uncertainty concerning the fair value of the affected shares may cause reasonable persons to differ about the fairness of the terms of the corporate action. Uncertainty is greatly reduced, however, in the case of publicly-traded shares. This explains both the market exception described below and the limits provided to the exception.

Appraisal rights in connection with mergers and share exchanges under chapter 11 and dispositions of assets requiring shareholder approval under chapter 12 are provided when these two conditions co-exist. Each of these actions will result in a fundamental change in the shares that a disapproving shareholder may feel was not adequately compensated by the terms approved by the majority. Except for shareholders of a subsidiary corporation that is merged under section 11.05 (the "short-form" merger), only those shareholders who are entitled to vote on a transaction are entitled to appraisal rights. The linkage between voting and appraisal rights is justified because the right to a shareholder vote is a good proxy for assessing the seriousness of the change contemplated by the corporate action. This is especially true where the action triggers group-voting provisions.

Notwithstanding this linkage, amended chapter 13 eliminates appraisal for voting shareholders in several instances where it would have been available under the 1984 Act. Shareholders who are entitled to vote on a corporate action, whether because such shareholders have general voting rights or because group voting provisions are triggered, are not entitled to appraisal if the change will not alter the terms of the class or series of securities that they hold. Thus, statutory appraisal rights are not available for shares of any class of the surviving corporation in a merger or any class of shares that is not included in a share exchange. Appraisal is also not triggered by a voluntary dissolution under chapter 14 because that action does not affect liquidation rights—the only rights that are relevant following a shareholder vote to dissolve.

With the exception of reverse stock splits that result in cashing out some of the shares of a class or series, amended chapter 13 also eliminates appraisal in connection with all amendments to the articles of incorporation. This change in amended chapter 13 does not reflect a judgment that an amendment changing the terms of a particular class or series may not have significant economic effects. Rather, it reflects a judgment that distinguishing among different types of amendments for the purposes of statutory appraisal is necessarily arbitrary and thus may not accurately reflect the actual demand of shareholders for appraisal in specific instances. Instead, amended chapter 13 permits a high degree of private-ordering by delineating a list of transactions for which the corporation may voluntarily choose to provide appraisal and by permitting a provision in the articles of incorporation that eliminates, in whole or in part, statutory appraisal rights for preferred shares.

Chapter 13 also is unique in its approach to appraisal rights for publicly-traded shares. Approximately half of the general corporation statutes in the United States provide exceptions to appraisal for publicly-traded shares, on the theory that it is not productive to expose the corporation to the time, expense and cash drain imposed by appraisal demands when shareholders who are dissatisfied with the consideration offered in an appraisal-triggering transaction could sell their shares and obtain cash from the market. This exception to appraisal is generally known as the "market-out" and is referred to here as the "market exception."

Opponents of the market exception argue that it results in unfairness where neither the consideration offered in connection with the transaction nor the market price reflects the fair value of the shares, particularly if the corporate decision-makers have a conflict of interest.

Chapter 13 seeks to accommodate both views by providing a market exception that is limited to those situations where shareholders are likely to receive fair value when they sell their shares in the market after the announcement of an appraisal-triggering transaction. For the market exception to apply under chapter 13, there must first be a liquid market. Second, unique to chapter 13, the market exception does not apply in specified circumstances where the appraisal-triggering action is deemed to be a conflict-of-interest transaction.

2. Definitions

Section 13.01 contains specialized definitions applicable only to chapter 13.

BENEFICIAL SHAREHOLDER

The definition of "beneficial shareholder" means a person who owns the beneficial interest in shares; "shares" is defined in section 1.40(22) to include, without limitation, a holder of a depository receipt for shares. Similar definitions are found in section 7.40(2) (derivative proceedings) and section 16.02(f) (inspection of records by a shareholder). In the context of chapter 13, beneficial shareholder means a person having a direct economic interest in the shares. The definition is not intended to adopt the broad definition of beneficial ownership in SEC Rule 13d-2, which includes persons with a right to vote or dispose of the shares even though they have no economic interest in them. However, section 13.02(b)(5) includes the concept of the right to vote in determining whether the event represents a conflict transaction that renders the market exception unavailable.

CORPORATION

The definition of "corporation" in section 13.01(3) includes, for purposes of the post-transaction matters covered in section 13.22 through 13.31, a successor entity in a merger where the corporation is not the surviving entity. The definition does not include a domestic acquiring corporation in a share exchange or disposition of assets because the corporation whose shares or assets were acquired continues in existence in both of these instances and remains responsible for the appraisal obligations. Whether a foreign corporation or other form of domestic or foreign entity is subject to appraisal rights in connection with any of these transactions depends upon the corporation or other applicable law of the relevant jurisdiction.

FAIR VALUE

Subsection (i) of the definition of "fair value" in section 13.01(4) makes clear that fair value is to be determined immediately before the effectuation of the corporate action, rather than, as is the case under most state statutes that address the issue, the date of the shareholders' vote. This comports with the purpose of this chapter to preserve the shareholder's prior rights as a shareholder until the effective date of the corporate action, rather than leaving the shareholder in an ambiguous state with neither rights as a shareholder nor perfected appraisal rights. The corporation and, as relevant, its shares are valued as they exist immediately before the effectuation of the corporate action requiring appraisal. Accordingly, section 13.01(4) permits consideration of changes in the market price of the corporation's shares in anticipation of the transaction, to the extent such changes are relevant. Similarly, in a two-step transaction culminating in a merger, the corporation is valued immediately before the second step merger, taking into account any interim changes in value. Cf. *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289 (Del. 1996).

The definition of "fair value" in section 13.01(4) makes several changes from the prior version. The 1984 Model Act's definition of "fair value" was silent on how fair value was to be determined, except for a concluding clause that excluded from the valuation "any appreciation or depreciation in anticipation of the corporate action, unless exclusion would be inequitable." The Official Comment provided that the section left to the courts "the details by which 'fair value' is to be determined within the broad outlines of the definition." While the logic of the prior Official Comment continues to apply, the exclusionary clause in the prior Model Act definition, including the qualification for cases where the exclusion would be inequitable, has been deleted. Those provisions have not been susceptible to meaningful judicial interpretation and have been set aside in favor of the broader concept in subsection (ii).

The new formulation in paragraph (ii), which is patterned on section 7.22 of the Principles of Corporate Governance promulgated by the American Law Institute, directs courts to keep the methodology chosen in appraisal proceedings consistent with evolving economic concepts and adopts that part of section 7.22 which provides that fair value should be determined using "customary valuation concepts and techniques generally employed . . . for similar businesses in the context of the transaction requiring appraisal." Subsection (ii) adopts the accepted view that different transactions and different contexts may warrant different valuation methodologies. Customary valuation concepts and techniques will typically take into account numerous relevant factors, including assigning a higher valuation to corporate assets that would be more productive if acquired in a comparable transaction but excluding any element of value attributable to the unique synergies of the actual purchaser of the corporation or its assets. For example, if the corporation's assets include undeveloped real estate that is located in a prime commercial area, the court should consider the value that would be attributed to the real estate as commercial development property in a comparable transaction. The court should not, however, assign any additional value based upon the specific plans or special use of the actual purchaser.

Modern valuation methods will normally result in a range of values, not a particular single value. When a transaction falls within that range, "fair value" has been established. Absent unusual circumstances, it is expected that the consideration in an arm's-length transaction will fall within the range of "fair value" for purposes of section 13.01(4). Section 7.22 of the ALI Principles of Corporate Governance also provides that in situations that do not involve certain types of specified conflicts of interest, "the aggregate price accepted by the board of directors of the subject corporation should be presumed to represent the fair value of the corporation, or of the assets sold in the case of an asset sale, unless the plaintiff can prove otherwise by clear and convincing evidence." That presumption has not been included in the definition of "fair value" in section 13.01(4) because the framework of defined types of conflict transactions which is a predicate for the ALI's presumption is not contained in the Model Act. Nonetheless, under section 13.01(4), a court determining fair value should give great deference to the aggregate consideration accepted or approved by a disinterested board of directors for an appraisal-triggering transaction.

Subsection (iii) of the definition of "fair value" establishes that valuation discounts for lack of marketability or minority status are inappropriate in most appraisal actions, both because most transactions that trigger appraisal rights affect the corporation as a whole and because such discounts give the majority the opportunity to take advantage of minority shareholders who have been forced against their will to accept the appraisal-triggering transaction. Subsection (iii), in conjunction with the lead-in language to the definition, is also designed to adopt the more modern view that appraisal should generally award a shareholder his or her proportional interest in the corporation after valuing the corporation as a whole, rather than the value of the shareholder's shares when valued alone. If, however, the corporation voluntarily grants appraisal rights for transactions that do not affect the entire corporation—such as certain amendments to the articles of incorporation—the court should use its discretion in applying discounts if appropriate. As the introductory clause of section 13.01 notes, the definition of "fair value" applies only to chapter 13. See the Official Comment to section 14.34 which recognizes that a minority discount may be appropriate under that section.

INTEREST

The definition of "interest" in section 13.01(5) is included to apprise the parties of their respective rights and obligations. The right to receive interest is based on the elementary consideration that the corporation, rather than the shareholder demanding appraisal, has the use of the shareholder's money from the effective date of the corporate action (when those shareholders who do not demand appraisal rights have the right to receive their consideration from the transaction) until the date of payment. Section 13.01(5) thus requires interest to be paid at the rate of interest on judgments from the effective date of the corporate action until the date of payment. The specification of the rate of interest on judgments, rather than a more subjective rate, eliminates a possible issue of contention and should facilitate voluntary settlements. Each state determines whether interest is compound or simple.

INTERESTED TRANSACTION

The term "interested transaction" addresses two groups of conflict transactions: those in section 13.01(5.1)(i)(A) and (B), which involve controlling shareholders; and those in section 13.01(5.1)(i)(C), which involve senior executives and directors. Regardless of which type of interested transaction may be involved, when a transaction fits within the definition of an interested transaction there are two consequences: the market out will not be applicable in situations where it would otherwise apply, and the exclusion of other remedies under section 13.40 will not be applicable unless certain disinterested approvals have been obtained.

Section 13.01(5.1)(i)(A) covers the acquisition or exchange of shares or assets of the corporation by a shareholder or an affiliate of the shareholder that could be considered controlling by virtue of ownership of a substantial amount of voting stock (20%). Section 13.01(5.1)(i)(B) covers the acquisition or exchange of shares or assets of the corporation by an individual or group, or by an affiliate of such individual or group, that has the ability to exercise control, through contract, stock ownership, or some other means, over at least one fourth of the board's membership. The definition of "beneficial owner" in section 13.01(5.1)(ii) serves to identify possible conflict situations by deeming each member of a group that agrees to vote in tandem to be a beneficial owner of all the voting shares owned by the group. In contrast, the term "beneficial shareholder," as defined in section 13.01(2), is used to identify those persons entitled to appraisal rights. The exclusions of "excluded shares," as defined in subsection (5.1)(iii), in subsections (5.1)(i)(A) and (B) recognize that an acquisition effected in two steps (a tender offer followed by a merger) within one year, where the two steps are either on the same terms or the second step is on terms that are more favorable to target shareholders, is properly considered a single transaction for purposes of identifying conflict transactions, regardless of whether the second-step merger is governed by sections 11.04 or 11.05.

A reverse split in which small shareholders are cashed out will constitute an interested transaction if there is a shareholder who satisfies the test in section 13.01(5.1)(i)(A) or (B). In that case, the corporation itself will be an affiliate of the large shareholder and thus within the concept of an "interested person," such that when the corporation acquires the shares of the small shareholders being cashed out the acquisition will be an interested transaction.

Section 13.01(5.1)(i)(C) covers the acquisition or exchange of shares or assets of the corporation by a person, or an affiliate of a person, who is, or in the year leading up to the transaction was, a senior executive or director of the corporation. It applies to management buyouts because participation in the buyout group is itself "a financial benefit not available to other shareholders as such." It also applies to transactions involving other types of economic benefits (in addition to benefits afforded to shareholders generally, as such) afforded to senior executives (as defined in section 13.01(8)) and directors in specified conflict situations, unless specific objective or procedural standards are met. Finally, it will apply to less common situations, such as where the vote of a director is manipulated by providing the director with special consideration to secure his or her vote in favor of the transaction. Section 13.01(1) specifically defines the term "affiliate" to include an entity of which a person is a senior executive. Due to this specialized definition, if a senior executive of the corporation is to continue and is to receive enumerated employment and other financial benefits after the transaction, exempting the transaction from the category of "interested transactions" will depend on meeting one of the three conditions specified in clauses (I), (II) and (III) of section 13.01(5.1)(i)(C):

- First, under section 13.01(5.1)(i)(C)(I), a transaction will not be considered an interested transaction if financial benefits that result from the transaction consist of employment, consulting, retirement or similar benefits established separately and not in contemplation of the transaction. For example, if an individual has an arrangement under which benefits will be triggered on a "change of control," such as accelerated vesting of options, retirement benefits, deferred compensation and similar items, or is afforded the opportunity to retire or leave the employ of the enterprise with more favorable economic results than would be the case absent a change of control, the existence of these arrangements would not mean that the transaction is an interested transaction if the arrangements had been established as a general condition of the individual's employment or continued employment, rather than in contemplation of the particular transaction.

- Second, under section 13.01(5.1)(i)(C)(II), if such arrangements are established as part of, or as a condition of, the transaction, the transaction will still not be considered an interested transaction if the arrangements are either not more favorable than those already in existence or, if more favorable, are approved by "qualified" directors (i.e., meeting the standard of disinterestedness specified in section 1.43), in the same manner as provided for conflicting interest transactions generally with the corporation under section 8.62. This category would include arrangements with the corporation that have been negotiated as part of, or as a condition of, the transaction or arrangements with the acquiring company or one or more of its other subsidiaries.

- The third situation, delineated in section 13.01(5.1)(1)(C)(III), addresses a person who is a director of the issuer and, in connection with the transaction, is to become a director of the acquiring entity or its parent, or to continue as a director of the corporation when it becomes a subsidiary of the acquiring entity. In this situation, the transaction will not be considered an interested transaction as long as that person will not be treated more favorably as a director than are other persons who are serving in the same director positions.

SENIOR EXECUTIVE

The definition of "senior executive" in section 13.01(8) encompasses the group of individuals in control of corporate information and the day-to-day operations. An employee of a subsidiary organization is a "senior executive" of the parent if the employee is "in charge of a principal business unit or function" of the parent and its subsidiaries on a combined or consolidated basis.

SHAREHOLDER

The definition of "shareholder" in section 13.01(9) for purposes of chapter 13 differs from the definition of that term used elsewhere in the Model Act. Section 1.40(21) defines "shareholder" as used generally in the Act to mean only a "record shareholder"; that term is specifically defined in section 13.01(7). Section 13.01(9), on the other hand, defines "shareholder" to include not only a "record shareholder" but also a "beneficial shareholder," a term that is itself defined in section 13.01(2). The specially defined terms "record shareholder" and "beneficial shareholder" appear primarily in section 13.03, which establishes the manner in which beneficial shareholders, and record shareholders who are acting on behalf of beneficial shareholders, perfect appraisal rights. The word "shareholder" is used generally throughout chapter 13 in order to permit both record and beneficial shareholders to take advantage of the provisions of this chapter, subject to their fulfilling the applicable requirements of this chapter.

§ 13.02. RIGHT TO APPRAISAL

(a) A shareholder is entitled to appraisal rights, and to obtain payment of the fair value of that shareholder's shares, in the event of any of the following corporate actions:

(1) consummation of a merger to which the corporation is a party (i) if shareholder approval is required for the merger by section 11.04 and the shareholder is

entitled to vote on the merger, except that appraisal rights shall not be available to any shareholder of the corporation with respect to shares of any class or series that remain outstanding after consummation of the merger, or (ii) if the corporation is a subsidiary and the merger is governed by section 11.05;

(2) consummation of a share exchange to which the corporation is a party as the corporation whose shares will be acquired if the shareholder is entitled to vote on the exchange, except that appraisal rights shall not be available to any shareholder of the corporation with respect to any class or series of shares of the corporation that is not exchanged;

(3) consummation of a disposition of assets pursuant to section 12.02 if the shareholder is entitled to vote on the disposition;

(4) an amendment of the articles of incorporation with respect to a class or series of shares that reduces the number of shares of a class or series owned by the shareholder to a fraction of a share if the corporation has the obligation or right to repurchase the fractional share so created;

(5) any other amendment to the articles of incorporation, merger, share exchange or disposition of assets to the extent provided by the articles of incorporation, bylaws or a resolution of the board of directors;

(6) consummation of a domestication if the shareholder does not receive shares in the foreign corporation resulting from the domestication that have terms as favorable to the shareholder in all material respects, and represent at least the same percentage interest of the total voting rights of the outstanding shares of the corporation, as the shares held by the shareholder before the domestication;

(7) consummation of a conversion of the corporation to nonprofit status pursuant to subchapter 9C; or

(8) consummation of a conversion of the corporation to an unincorporated entity pursuant to subchapter 9E.

(b) Notwithstanding subsection (a), the availability of appraisal rights under subsections (a)(1), (2), (3), (4), (6) and (8) shall be limited in accordance with the following provisions:

(1) Appraisal rights shall not be available for the holders of shares of any class or series of shares which is:

(i) a covered security under section 18(b)(1)(A) or (B) of the Securities Act of 1933, as amended; or

(ii) traded in an organized market and has at least 2,000 shareholders and a market value of at least $20 million (exclusive of the value of such shares held by the corporation's subsidiaries, senior executives, directors and beneficial shareholders owning more than 10% of such shares); or

(iii) issued by an open end management investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 and may be redeemed at the option of the holder at net asset value.

(2) The applicability of subsection (b)(1) shall be determined as of:

(i) the record date fixed to determine the shareholders entitled to receive notice of, and to vote at, the meeting of shareholders to act upon the corporate action requiring appraisal rights; or

(ii) the day before the effective date of such corporate action if there is no meeting of shareholders.

(3) Subsection (b)(1) shall not be applicable and appraisal rights shall be available pursuant to subsection (a) for the holders of any class or series of shares who are required by the terms of the corporate action requiring appraisal rights to accept for such shares anything other than cash or shares of any class or any series of shares of any corporation, or any other proprietary interest of any other entity, that satisfies the standards set forth in subsection (b)(1) at the time the corporate action becomes effective.

(4) Subsection (b)(1) shall not be applicable and appraisal rights shall be available pursuant to subsection (a) for the holders of any class or series of shares where the corporate action is an interested transaction.

CROSS-REFERENCES

Amendment of articles of incorporation, see ch. 10A.

Bylaws, see § 2.05, ch. 10B.

Disposition of assets, see ch. 12.

Domestication, see § 9.24.

Entity conversion, see § 9.52.

"Interested transaction" defined, see § 13.01(5.1).

Fractional shares, see § 6.04.

Merger and share exchange, see ch. 11.

Merger of subsidiary, see § 11.05.

Nonprofit conversion, see § 9.34.

"Person" defined, see § 1.40.

Redemption of shares, see §§ 6.01 & 6.31.

Share dividends, see § 6.23.

Share preferences, see §§ 6.01 & 6.02.

"Voting power" defined, see § 1.40.

Voting rights generally, see § 7.21.

OFFICIAL COMMENT

1. Transactions Requiring Appraisal Rights

Section 13.02(a) establishes the scope of appraisal rights by identifying those transactions which afford this right. In view of the significant degree of private ordering permitted by section 13.02(a)(5), the scope of statutory appraisal provided is somewhat narrower than that provided in the 1984 Model Act. As discussed in the first section of the Official Comment to section 13.01, statutory appraisal is made available only for corporate actions that will result in a fundamental change in the shares to be affected by the action and then only when uncertainty concerning the fair value of the affected shares may cause reasonable differences about the fairness of the terms of the corporate action. The transactions that satisfy both of these criteria are:

(1) A merger pursuant to section 11.04 or a short-form merger pursuant to section 11.05. Holders of any class or series that is to be exchanged or converted in connection with a merger under section 11.04 are entitled both to a vote under section 11.04(f) and to appraisal under section 13.02(a)(1). Although shareholders of a subsidiary that is a party to a merger under section 11.05 are not entitled to a vote, they are entitled to appraisal under 13.02(a)(1) because their interests will be extinguished by the merger. Section 13.02(a)(1)(i) denies appraisal rights to any class or series of shares in the surviving corporation if such class or series remains outstanding.

(2) A share exchange under section 11.03 if the corporation is a party whose shares are being acquired in the exchange. Consistent with the treatment in section 13.02(a)(1) of mergers requiring shareholder approval, subsection (2) provides appraisal only for those shares that will be exchanged.

(3) A disposition of assets requiring shareholder approval under section 12.02. Minimally, shareholders of all classes or series of the corporation that are generally entitled to vote on matters requiring shareholder approval will be entitled to assert appraisal rights. Whether shares of a class or series that do not have general voting rights will be entitled to vote on the asset disposition and thus become entitled to appraisal rights depends on the form of the transaction disposing of the corporation's assets. In the usual form of this transaction, which is governed by chapter 12, the acquirer purchases substantially all of

the assets and assumes substantially all of the liabilities of the corporation, which then liquidates pursuant to a plan of dissolution approved by the shareholders as part of the transaction and distributes the consideration received from the acquirer to its shareholders. If the transaction provides a nonvoting class of preferred with its liquidation preference, there is no change in the contractual terms of the preferred and it is entitled neither to vote nor to appraisal rights. By the same token, a preferred class cannot be required to accept any consideration different from that called for in its liquidation preference without amending the terms of the class. For example, a plan that called for the preferred to accept securities of the acquirer in lieu of its cash liquidation preference would trigger both group voting and appraisal rights on behalf of the class. In the unusual event that the asset disposition plan contemplated that the corporation would continue in existence, the terms of a nonvoting class would not have been changed as a result of the transaction, and appraisal rights would not be available. As provided in section 12.02(g), a disposition of assets by a corporation in the course of dissolution under chapter 14 is governed by that chapter, not chapter 12, and thus does not implicate appraisal rights.

(4) Amendments to the articles of incorporation that effectuate a reverse stock split which reduces the number of shares that a shareholder owns of a class or series to a fractional share if the corporation has the obligation or right to repurchase the fractional share so created. The reasons for granting appraisal rights in this situation are similar to those granting such rights in cases of cash-out mergers, as both transactions could compel affected shareholders to accept cash for their investment in an amount established by the corporation. Appraisal is afforded only for those shareholders of a class or series whose interest is so affected.

(5) Any other merger, share exchange, disposition of assets or amendment to the articles to the extent the articles, bylaws, or a resolution of the board of directors grants appraisal rights to a particular class or series of stock. A corporation may voluntarily wish to grant to the holders of one or more of its classes or series of shares appraisal rights in connection with these important transactions whenever the Act does not provide statutory appraisal rights. The grant of appraisal rights may satisfy shareholders who might, in the absence of appraisal rights, seek other remedies. Moreover, in situations where the existence of appraisal rights may otherwise be disputed, the voluntary offer of those rights under this section may avoid litigation. Obviously, an express grant of voluntary appraisal rights under section 13.02(a)(5) is intended to override any of the exceptions to the availability of appraisal rights in section 13.02(a). Any voluntary grant of appraisal rights by the corporation to the holders of one or more of its classes or series of shares will thereby automatically make all of the provisions of chapter 13 applicable to the corporation and such holders regarding this corporate action.

(6) A domestication in which the shares held by a shareholder are reclassified in a manner that results in the shareholder holding shares either with terms that are not as favorable in all materials respects or representing a smaller percentage of the total outstanding voting rights in the corporation as those held before the domestication. Appraisal rights are not provided if the shares of a shareholder are otherwise reclassified so long as the foregoing restrictions are satisfied.

(7) A conversion to nonprofit status pursuant to subchapter 9C. Such a conversion involves such a fundamental change in the nature of the corporation that appraisal rights are provided to all of the shareholders.

(8) A conversion of the corporation to an unincorporated entity pursuant to subchapter 9E. As with the previous type of transaction, this form of conversion is so fundamental that appraisal rights are provided to all of the shareholders.

2. Market Out to Appraisal Rights

Chapter 13 provides a limited exception to appraisal rights for those situations where shareholders can either accept the appraisal-triggering corporate action or can sell their shares in a liquid and reliable market or an equivalent transaction. This provision, the so-called market out, is predicated on the theory that where an efficient market exists, the market price will be an adequate proxy for the fair value of the corporation's shares, thus making appraisal unnecessary. Furthermore, after the corporation announces an appraisal-triggering action which is a transaction such as a merger, the market operates at maximum efficiency with respect to the corporation's shares because interested parties and market professionals evaluate the proposal and competing proposals may be generated if the original proposal is deemed inadequate. Moreover, the market out reflects an evaluation that the uncertainty, costs and time commitment involved in any appraisal proceeding are not warranted where shareholders can sell their shares in an efficient, fair and liquid market.

For purposes of this chapter, the market out is provided for a class or series of shares if two criteria are met: the market in which the shares are traded must be "liquid" and the value of the shares established by the appraisal-triggering event must be "reliable." Except as provided in section 13.02(b)(1)(iii), liquidity is addressed in section 13.02(b)(1) and requires the class or series of stock to satisfy either one of two requirements: (1) The class or series must be a covered security under section 18 (a)(1)(A) or (B) of the Securities Act of 1933. This means that it must be listed on the New York Stock Exchange or the American Stock Exchange, or on the NASDAQ Global Select Market or the NASDAQ Global Market (successors to the NASDAQ National Market), or on certain other markets having comparable listing standards as determined by the Securities and Exchange Commission. (2) If not in these categories, the class or series must be traded in an organized market and have at least 2,000 record or beneficial shareholders (provided that using both concepts does not result in duplication) and have a market value of at least \$20 million, excluding the value of shares held by the corporation's subsidiaries, senior executives, directors and beneficial shareholders owning more than 10% of the class or series.

Shares issued by an open end management investment company registered under the Investment Company Act of 1940 that may be redeemed at the option of the holder at net asset value provide an equivalent quality of liquidity and reliability, and are also included in the market out.

Because section 13.02(b)(3) excludes from the market those transactions that require shareholders to accept anything other than cash or securities that also meet the liquidity tests of section 13.02(b)(1), shareholders are assured of receiving either appraisal rights, cash from the transaction, or shares or other proprietary interests in the survivor entity that are liquid. Section

13.02(b)(2) provides that the corporation generally must satisfy the requirements of section 13.02(b)(1) on the record date for a shareholder vote on the appraisal-triggering transaction. For purposes of subsection 13.02(a)(1)(ii), the requirements of section 13.02(b)(1) must be met as of the day before the corporate action becomes effective.

3. Appraisal Rights in Conflict Transactions

The premise of the market out is that the market must be liquid and the valuation assigned to the relevant shares must be "reliable." Section 13.02(b)(1) is designed to assure liquidity. For purposes of these provisions, section 13.02(b)(4) is designed to assure reliability by recognizing that the market price of, or consideration for, shares of a corporation that proposes to engage in a section 13.02(a) transaction may be subject to influences where a corporation's management, controlling shareholders or directors have conflicting interests that could, if not dealt with appropriately, adversely affect the consideration that otherwise could have been expected. Section 13.02(b)(4) thus provides that the market out will not apply in those instances where the transaction constitutes an interested transaction (as defined in section 13.01(5.1)).

4. Elimination of Appraisal Rights for Preferred Shares

Section 13.02(c) permits the corporation to eliminate or limit appraisal rights for the holders of one or more series or classes of preferred shares. The operative provisions may be set forth in the corporation's articles of incorporation as originally filed or in any amendment thereto, but any such amendment will not become effective for one year with respect to outstanding shares or shares which the corporation is or may be required to issue or sell at some later date pursuant to any rights outstanding prior to such amendment becoming effective. Shareholders who have not yet acquired, or do not have a right to acquire from the corporation, any shares of preferred stock, should have the ability either not to acquire any shares of preferred stock or to have appraisal rights granted or restored for such shares, if such shareholders so desire, before purchasing them. In contrast, because the terms of common shares are rarely negotiated, section 13.02 does not permit the corporation to eliminate or limit the appraisal rights of common shares.

§ 13.03. ASSERTION OF RIGHTS BY NOMINEES AND BENEFICIAL OWNERS

(a) A record shareholder may assert appraisal rights as to fewer than all the shares registered in the record shareholder's name but owned by a beneficial shareholder only if the record shareholder objects with respect to all shares of the class or series owned by the beneficial shareholder and notifies the corporation in writing of the name and address of each beneficial shareholder on whose behalf appraisal rights are being asserted. The rights of a record shareholder who asserts appraisal rights for only part of the shares held of record in the record shareholder's name under this subsection shall be determined as if the shares as to which the record shareholder objects and the record shareholder's other shares were registered in the names of different record shareholders.

(b) A beneficial shareholder may assert appraisal rights as to shares of any class or series held on behalf of the shareholder only if such shareholder:

(1) submits to the corporation the record shareholder's written consent to the assertion of such rights no later than the date referred to in section 13.22(b)(2)(ii); and

(2) does so with respect to all shares of the class or series that are beneficially owned by the beneficial shareholder.

CROSS-REFERENCES

"Beneficial shareholder" defined, see § 13.01.

Notice to the corporation, see § 1.41.

"Person" defined, see § 1.40.

"Record shareholder" defined, see § 13.01.

"Shareholder" defined, see §§ 1.40 & 13.01.

Shares held by nominee, see § 7.23.

Voting agreements, see § 7.31.

Voting trusts, see § 7.30.

OFFICIAL COMMENT

Section 13.03 addresses the relationship between those who are entitled to assert appraisal rights and the widespread practice of nominee or street name ownership of publicly-held shares. Generally, a shareholder must demand appraisal for all the shares of a class or series which the shareholder owns. If a record shareholder is a nominee for several beneficial shareholders, some of whom wish to demand appraisal and some of whom do not, section 13.03(a) permits the record shareholder to assert appraisal rights with respect to a portion of the shares held of record by the record shareholder but only with respect to all the shares beneficially owned by a single person. This limitation is necessary to prevent abuse by a single beneficial shareholder who is not fundamentally opposed to the proposed corporate action but who may wish to speculate on the appraisal process, as to some of that shareholder's shares, on the possibility of a high payment. On the other hand, a shareholder who owns shares in more than one class or series may assert appraisal rights for only some but not all classes or series that the shareholder owns. This is permitted because fair treatment of one class or series does not guarantee fair treatment of other classes or series.

Section 13.03(a) also requires a record shareholder who demands appraisal with respect to a portion of the shares held by the record shareholder to notify the corporation of the name and address of the beneficial owner on whose behalf the record shareholder has demanded appraisal rights.

Section 13.03(b) permits a beneficial shareholder to assert appraisal rights directly if the beneficial shareholder submits the record shareholder's written consent. Although generally the record shareholder is treated as the owner of shares, this section recognizes that sometimes the record shareholders are holding shares on behalf of beneficial shareholders. It would be foreign to the premises underlying nominee and street name ownership to require these record shareholders to forward demands and participate in litigation on behalf of their clients. In order to make appraisal rights effective without burdening record shareholders, beneficial shareholders should be allowed to assert their own claims as provided in this subsection. The beneficial shareholder is required to submit, no later than the date specified in section 13.22(b)(2)(ii), a written consent by the record shareholder to the assertion of appraisal rights to verify the beneficial shareholder's entitlement and to permit the protection of any security interest in the shares. In practice, a broker's customer who wishes to assert appraisal rights may request the broker to supply the customer with the name of the record shareholder (which may be a house nominee or a nominee of the Depository Trust Company), and a form of consent signed by the record shareholder. At the same time, the customer may want to obtain certificates for the shares so that they may be deposited pursuant to section 13.23. After the corporation has received the form of consent, the corporation must deal with the beneficial shareholder.

Subchapter B.
PROCEDURE FOR EXERCISE OF APPRAISAL RIGHTS

§ 13.20. NOTICE OF APPRAISAL RIGHTS

(a) Where any corporate action specified in section 13.02(a) is to be submitted to a vote at a shareholders' meeting, the meeting notice must state that the corporation has concluded that the shareholders are, are not or may be entitled to assert appraisal rights under this chapter. If the corporation concludes that appraisal rights are or may be available, a copy of this chapter must accompany the meeting notice sent to those record shareholders entitled to exercise appraisal rights.

(b) In a merger pursuant to section 11.05, the parent corporation must notify in writing all record shareholders of the subsidiary who are entitled to assert appraisal rights that the corporate action became effective. Such notice must be sent within 10 days after the corporate action became effective and include the materials described in section 13.22.

(c) Where any corporate action specified in section 13.02(a) is to be approved by written consent of the shareholders pursuant to section 7.04:

(1) written notice that appraisal rights are, are not or may be available must be given to each record shareholder from whom a consent is solicited at the time consent of such shareholder is first solicited and, if the corporation has concluded that appraisal rights are or may be available, must be accompanied by a copy of this chapter; and

(2) written notice that appraisal rights are, are not or may be available must be delivered together with the notice to nonconsenting and nonvoting shareholders required by sections 7.04(e) and (f), may include the materials described in section 13.22 and, if the corporation has concluded that appraisal rights are or may be available, must be accompanied by a copy of this chapter.

(d) Where corporate action described in section 13.02(a) is proposed, or a merger pursuant to section 11.05 is effected, the notice referred to in subsection (a) or (c), if the corporation concludes that appraisal rights are or may be available, and in subsection (b) of this section 13.20 shall be accompanied by:

(1) the annual financial statements specified in section 16.20(a) of the corporation that issued the shares that may be subject to appraisal, which shall be as of a date ending not more than 16 months before the date of the notice and shall comply with section 16.20(b); provided that, if such annual financial statements are not reasonably available, the corporation shall provide reasonably equivalent financial information; and

(2) the latest available quarterly financial statements of such corporation, if any.

(e) The right to receive the information described in subsection (d) may be waived in writing by a shareholder before or after the corporate action.

CROSS-REFERENCES

Meeting notice, see § 7.05.

Merger of subsidiary, see § 11.05.

"Notice" defined, see § 1.41.

"Record shareholder" defined, see § 13.01.

Right to appraisal rights, see § 13.02.

Shareholder action without a meeting, see § 7.04.

"Shareholder" defined, see § 13.01.

Shareholders' meetings, see §§ 7.01–7.03.

OFFICIAL COMMENT

Before a vote at a meeting is taken on a corporate action, the corporation is required by section 13.20(a) to notify shareholders that a transaction is proposed and that the corporation has concluded either that appraisal rights are or are not available; alternatively, if the corporation is unsure about the availability of appraisal rights, it may state that appraisal rights may be available. Notice of appraisal rights is needed because many shareholders do not know what appraisal rights they may have or how to assert them.

Section 13.20(b) provides that notice be given by the parent corporation within 10 days after the effective date of a merger of its subsidiary under section 11.05.

Section 13.20(d) specifies certain disclosure requirements for corporate actions for which appraisal rights are provided. Because appraisal is an "opt in" remedy, shareholders otherwise entitled to an appraisal of their shares by reason of corporate actions specified in section 13.02 must elect whether to seek that remedy or accept the results of that action. Because an election is needed, the common law duty of disclosure articulated by some states, notably Delaware, has required the corporation to disclose all material facts available to it that would enable affected shareholders to make an informed decision whether or not to demand appraisal. See, e.g., *Turner v. Bernstein*, 776 A.2d 530 (Del. Ch. 2000). That duty may include the obligation to provide financial information relating to the value of the company, where such information is relevant to the decision. See, e.g., *Gilliland v. Motorola, Inc.*, 859 A.2d 80 (Del. Ch. 2004). The board of directors typically will have relied upon such information before approving the corporate action and before determining that the consideration offered constitutes fair value for the shares being surrendered or exchanged. Such financial information will normally include the company's financial statements, and it may also include financial expert valuation analyses of the company or summaries of such analyses. See, e.g., *In re Pure Resources Inc. Shareholders Litig.*, 808

A.2d 421 (Del. Ch. 2002). Section 13.20(d) specifies certain financial information disclosure requirements. Disclosure of additional information may be necessary depending upon applicable case law. See Official Comment 3, section 8.30(c).

By specifying certain disclosure requirements, section 13.20(d) reduces the risk, in the transactions to which it applies, of an uninformed shareholder decision whether or not to exercise appraisal rights. Section 13.20(e) permits a shareholder to waive the right to receive the information. The objective served by specifying these disclosure requirements is to facilitate a shareholder's decision whether to exercise appraisal rights. Section 13.20(d) does not address remedies, including those, if any, that shareholders might have against persons other than the corporation, as a result of the failure to provide the required information. Section 13.31(b)(1) provides that a corporation may be liable for the fees and expenses of counsel and experts for the respective parties for failure to comply substantially with section 13.20, as well as the related section 13.24.

Although the information requirements of section 13.20 would not apply to transactions for which there are no appraisal rights because of the market exception under section 13.02(b), the corporations to which the market exception applies are public companies which in most cases are subject to federal disclosure requirements.

§ 13.21. NOTICE OF INTENT TO DEMAND PAYMENT AND CONSEQUENCES OF VOTING OR CONSENTING

(a) If a corporate action specified in section 13.02(a) is submitted to a vote at a shareholders' meeting, a shareholder who wishes to assert appraisal rights with respect to any class or series of shares:

(1) must deliver to the corporation, before the vote is taken, written notice of the shareholder's intent to demand payment if the proposed action is effectuated; and

(2) must not vote, or cause or permit to be voted, any shares of such class or series in favor of the proposed action.

(b) If a corporate action specified in section 13.02(a) is to be approved by less than unanimous written consent, a shareholder who wishes to assert appraisal rights with respect to any class or series of shares must not execute a consent in favor of the proposed action with respect to that class or series of shares.

(c) A shareholder who fails to satisfy the requirements of subsection (a) or (b) is not entitled to payment under this chapter.

CROSS-REFERENCES

Appraisal rights as exclusive remedy, see § 13.02.

"Deliver," see § 1.40.

Effective date of notice, see § 1.41.

"Notice" defined, see § 1.41.

Shareholder action without a meeting, see § 7.04.

OFFICIAL COMMENT

Section 13.21 applies to all transactions requiring appraisal, except short-form mergers under section 11.05. In the latter case, shareholders of the subsidiary do not vote on the transaction but are nevertheless entitled to appraisal.

Section 13.21(a) requires the shareholder to give notice of an intent to demand payment before the vote on the corporate action is taken. This notice enables the corporation to determine how much of a cash payment may be required. It also serves to limit the number of persons to whom the corporation must give further notice during the remainder of the appraisal process.

In order for a shareholder to remain eligible to demand payment, section 13.21(a)(2) mandates that the shareholder must not vote (or, in the case of a beneficial shareholder, cause or permit to be voted) any shares of any class or series for which the shareholder is demanding appraisal in favor of the proposal.

§ 13.22. APPRAISAL NOTICE AND FORM

(a) If a corporate action requiring appraisal rights under section 13.02(a) becomes effective, the corporation must deliver a written appraisal notice and form required by subsection (b)(1) to all shareholders who satisfy the requirements of section 13.21(a) or section 13.21(b). In the case of a merger under section 11.05, the parent must deliver a written appraisal notice and form to all record shareholders who may be entitled to assert appraisal rights.

(b) The appraisal notice must be sent no earlier than the date the corporate action specified in section 13.02(a) became effective, and no later than 10 days after such date, and must:

(1) supply a form that (i) specifies the first date of any announcement to shareholders made prior to the date the corporate action became effective of the principal terms of the proposed corporate action, and (ii) if such announcement was made, requires the shareholder asserting appraisal rights to certify whether beneficial ownership of those shares for which appraisal rights are asserted was acquired before that date, and (iii) requires the shareholder asserting appraisal rights to certify that such shareholder did not vote for or consent to the transaction;

(2) state:

(i) where the form must be sent and where certificates for certificated shares must be deposited and the date by which those certificates must be deposited, which date may not be earlier than the date for receiving the required form under subsection (2)(ii);

(ii) a date by which the corporation must receive the form, which date may not be fewer than 40 nor more than 60 days after the date the subsection (a) appraisal notice and form are sent, and state that the shareholder shall have waived the right to demand appraisal with respect to the shares unless the form is received by the corporation by such specified date;

(iii) the corporation's estimate of the fair value of the shares;

(iv) that, if requested in writing, the corporation will provide, to the shareholder so requesting, within 10 days after the date specified in subsection (2)(ii) the number of shareholders who return the forms by the specified date and the total number of shares owned by them; and

(v) the date by which the notice to withdraw under section 13.23 must be received, which date must be within 20 days after the date specified in subsection (2)(ii); and

(3) be accompanied by a copy of this chapter.

CROSS-REFERENCES

After-acquired shares, see § 13.25.

Certificateless shares, see § 6.26.

"Deliver" defined, see § 1.40.

Effective date of notice, see § 1.41.

Merger of subsidiary, see § 11.05.

"Notice" defined, see § 1.41.

Shareholder action without a meeting, see § 7.04.

OFFICIAL COMMENT

The purpose of section 13.22 is to require the corporation to provide shareholders with information and a form for perfecting appraisal rights. The content of this notice and form are spelled out in detail to ensure that they accomplish this purpose.

The appraisal notice must be sent only to those shareholders who satisfy the requirements of section 13.21(a) or section 13.21(b). In a short-form merger under section 11.05, the notice must be sent to all persons who may be eligible for appraisal rights no earlier than the effective date of the merger and no later than 10 days thereafter. In either case, the notice must be accompanied by a copy of this chapter.

The notice must supply a form to be used by the person asserting appraisal rights in order to complete the exercise of those rights. Under section 13.22(b)(2)(ii), the notice must specify the date by which the shareholder's executed form must be received by the corporation, which date must be at least 40 days but not more than 60 days after the appraisal notice is sent.

Under section 13.22(b)(2)(i), the notice must also specify where and when share certificates must be deposited; the time for deposit may not be set at a date earlier than the date for receiving the required form under section 13.22(b)(2)(ii).

Section 13.22(b)(1) requires the corporation to specify the date of the first announcement of the terms of the proposed corporate action. This is the critical date for determining the rights of shareholder-transferees: persons who became shareholders prior to that date are entitled to full appraisal rights, while persons who became shareholders on or after that date are entitled only to the more limited rights provided by section 13.25. See the Official Comments to sections 13.23 and 13.25. The date the principal terms of the transaction were announced by the corporation to shareholders may be the day the terms were communicated directly to the shareholders, included in a public filing with the Securities and Exchange Commission, published in a newspaper of general circulation that can be expected to reach the financial community, or any earlier date on which such terms were first announced by any other person or entity to such persons or sources. Any announcement to news media or to shareholders that relates to the proposed transaction but does not contain the principal terms of the transaction to be authorized at the shareholders' meeting is not considered to be an announcement for the purposes of section 13.22. If a corporation does not make a public announcement of the terms of a proposed corporation action, the requirement of section 13.22(b)(1) is not applicable.

Sections 13.22(b)(2)(iii) and (b)(2)(iv) require the corporation to state its estimate of the fair value of the shares and how shareholders may obtain the number of shareholders and number of shares demanding appraisal rights. The information required by sections 13.22(b)(2)(iii) and (b)(2)(iv) is intended to help shareholders assess whether they wish to demand payment or to withdraw their demand for appraisal, but the information under section 13.22(b)(2)(iv) is required to be sent only to those shareholders from whom the corporation has received a written request. If such request is received, the corporation must respond within 10 days after forms are due pursuant to section 13.22(b)(2)(ii). Finally, section 13.22(b)(2)(v) requires the corporation to specify the date by which the shareholder's notice to withdraw under section 13.23 must be received.

§ 13.23. PERFECTION OF RIGHTS; RIGHT TO WITHDRAW

(a) A shareholder who receives notice pursuant to section 13.22 and who wishes to exercise appraisal rights must sign and return the form sent by the corporation and, in the case of certificated shares, deposit the shareholder's certificates in accordance with the terms of the notice by the date referred to in the notice pursuant to section 13.22(b)(2)(ii). In addition, if applicable, the shareholder must certify on the form whether the beneficial owner of such shares acquired beneficial ownership of the shares before the date required to be set forth in the notice pursuant to section 13.22(b)(1). If a shareholder fails to make this certification, the corporation may elect to treat the shareholder's shares as after-acquired shares under section 13.25. Once a shareholder deposits that shareholder's certificates or, in the case of uncertificated shares, returns the signed forms, that shareholder loses all rights as a shareholder, unless the shareholder withdraws pursuant to subsection (b).

(b) A shareholder who has complied with subsection (a) may nevertheless decline to exercise appraisal rights and withdraw from the appraisal process by so notifying the corporation in writing by the date set forth in the appraisal notice pursuant to section 13.22(b)(2)(v). A shareholder who fails to so withdraw from the appraisal process may not thereafter withdraw without the corporation's written consent.

(c) A shareholder who does not sign and return the form and, in the case of certificated shares, deposit that shareholder's share certificates where required, each by the date set forth in the notice described in section 13.22(b), shall not be entitled to payment under this chapter.

CROSS-REFERENCES

After-acquired shares, see § 13.25.

Appraisal notice, see § 13.22.

Effective date of notice, see § 1.41.

Other remedies, see § 13.40.

OFFICIAL COMMENT

Section 13.23 permits shareholders to perfect their appraisal rights under subsection (a), subject to their right to withdraw under subsection (b). In the case of a transaction involving a vote by shareholders, returning the signed form and, in the case of certificated shares, depositing the shares are the shareholder's confirmation of the shareholder's intention expressed earlier under section 13.21(a) to pursue appraisal rights; in the case of a merger of a subsidiary under section 11.05, it is the shareholder's first statement of this position.

If required, the shareholder should include on the appraisal form a certification as to whether the date on which the beneficial shareholder acquired beneficial ownership of the shares was before (or on or after) the date the transaction was announced. See section 13.22(b)(1). This information permits the corporation to exercise its right under section 13.25 to defer payment of compensation for certain shares. The corporation may elect to proceed under section 13.25 with respect to those shareholders who were required to make the certification but did not do so.

Section 13.23(a) also requires persons with certificated shares who file the required form to deposit their share certificates as directed by the corporation in its appraisal notice. Once a shareholder deposits that shareholder's shares, that shareholder loses all rights as a shareholder unless the shareholder withdraws from the appraisal process pursuant to section 13.23(b).

With respect to certificated shares, this provision differs from many statutes in that the certificates are deposited for retention, rather than "submitted for notation." This difference reflects the requirement in section 13.22(b)(2)(i) for deposit only after the corporate action became effective; in contrast, many state statutes require shareholders to send in their certificates in anticipation of the effectuation of the proposed corporate action.

Alternatively, under section 13.23(b), a shareholder may withdraw from the appraisal process by so notifying the corporation in writing by the deadline set forth in the appraisal notice. After that date, however, a shareholder who has complied with the requirements to sign and return the form and, in the case of certificated shares, deposit the share certificates may not withdraw from the process without the corporation's written consent.

Under section 13.23(c), a shareholder who fails to sign and return the form with respect to the shares of a class or series for which the shareholder is demanding appraisal or does not deposit that shareholder's share certificates as required by section 13.23(a) loses all rights to pursue appraisal and obtain payment under this chapter. If a beneficial shareholder wishes to assert appraisal rights in place of the record shareholder, the beneficial shareholder must also comply with section 13.03(b).

§ 13.24. PAYMENT

(a) Except as provided in section 13.25, within 30 days after the form required by section 13.22(b)(2)(ii) is due, the corporation shall pay in cash to those shareholders who complied with section 13.23(a) the amount the corporation estimates to be the fair value of their shares, plus interest.

(b) The payment to each shareholder pursuant to subsection (a) must be accompanied by:

(1) (i) the annual financial statements specified in section 16.20(a) of the corporation that issued the shares to be appraised, which shall be of a date ending not more than 16 months before the date of payment and shall comply with section 16.20(b); provided that, if such annual financial statements are not reasonably available, the corporation shall provide reasonably equivalent financial information, and (ii) the latest available quarterly financial statements of such corporation, if any;

(2) a statement of the corporation's estimate of the fair value of the shares, which estimate must equal or exceed the corporation's estimate given pursuant to section 13.22(b)(2)(iii);

(3) a statement that shareholders described in subsection (a) have the right to demand further payment under section 13.26 and that if any such shareholder does not do so within the time period specified therein, such shareholder shall be deemed to have accepted such payment in full satisfaction of the corporation's obligations under this chapter.

CROSS-REFERENCES

After-acquired shares, see § 13.25.

"Fair value" defined, see § 13.01.

"Interest" defined, see § 13.01.

Notice, see § 13.22.

Payment demand, see § 13.23.

Rejection of corporation's estimate of fair value, see § 13.26.

OFFICIAL COMMENT

Section 13.24 is applicable both to shareholders who have complied with section 13.23(a), as well as to shareholders who are described in section 13.25(a) if the corporation so chooses. The corporation must, however, elect to treat all shareholders described in section 13.25(a) either under section 13.24 or under section 13.25; it may not elect to treat some shareholders from this group under section 13.24 but treat others under section 13.25. Considerations of simplicity and harmony may prompt the corporation to elect to treat all shareholders under section 13.24.

Section 13.24 changes the relative balance between the corporation and shareholders demanding appraisal by requiring the corporation to pay in cash within 30 days after the required form is due the corporation's estimate of the fair value of the stock plus interest. Section 13.24(b)(2) requires that estimate to at least equal the corporation's estimate of fair value given pursuant to section 13.22(b)(2)(iii). Since under section 13.23(a) all rights as a shareholder are terminated with the deposit of that shareholder's shares, the former shareholder should have immediate use of such money. A difference of opinion over the total amount to be paid should not delay payment of the amount that is undisputed. Thus, the corporation must pay its estimate of fair value, plus interest from the effective date of the corporate action, without waiting for the conclusion of the appraisal proceeding.

Since the former shareholder must decide whether or not to accept the payment in full satisfaction, the corporation must at this time furnish the former shareholder with the information specified in section 13.24(b), with a reminder of the former shareholder's further rights and liabilities.

Even though the specified information was previously furnished under section 13.20(d) at the time notice of appraisal rights was given, it must still be furnished under section 13.24(b) at the time of payment. Sometimes that information will have to be updated to satisfy the requirements of section 13.24(b), for example, because the annual financial statements are more than 16 months old or there are new quarterly financial statements.

§ 13.25. AFTER-ACQUIRED SHARES

(a) A corporation may elect to withhold payment required by section 13.24 from any shareholder who was required to, but did not certify that beneficial ownership of all of the shareholder's shares for which appraisal rights are asserted was acquired before the date set forth in the appraisal notice sent pursuant to section 13.22(b)(1).

(b) If the corporation elected to withhold payment under subsection (a), it must, within 30 days after the form required by section 13.22(b)(2)(ii) is due, notify all shareholders who are described in subsection (a):

(1) of the information required by section 13.24(b)(1);

(2) of the corporation's estimate of fair value pursuant to section 13.24(b)(2);

(3) that they may accept the corporation's estimate of fair value, plus interest, in full satisfaction of their demands or demand appraisal under section 13.26;

(4) that those shareholders who wish to accept such offer must so notify the corporation of their acceptance of the corporation's offer within 30 days after receiving the offer; and

(5) that those shareholders who do not satisfy the requirements for demanding appraisal under section 13.26 shall be deemed to have accepted the corporation's offer.

(c) Within 10 days after receiving the shareholder's acceptance pursuant to subsection (b), the corporation must pay in cash the amount it offered under subsection (b)(2) to each shareholder who agreed to accept the corporation's offer in full satisfaction of the shareholder's demand.

(d) Within 40 days after sending the notice described in subsection (b), the corporation must pay in cash the amount it offered to pay under subsection (b)(2) to each shareholder described in subsection (b)(5).

CROSS-REFERENCES

"Fair value" defined, see § 13.01.

"Interest" defined, see § 13.01.

Rejection of corporation's offer, see § 13.26.

OFFICIAL COMMENT

If a public announcement of the proposed corporate action is made, section 13.25(a) gives the corporation the option to treat differently shares acquired on or after the date of that announcement. The date of any public announcement is required to be specified by the corporation in its appraisal notice under section 13.22(b)(1). At the corporation's option, holders of shares acquired on or after this date, or shareholders who are required to but do not certify otherwise under section 13.23(a), are not entitled to immediate payment under section 13.24. Instead, shareholders described in subsection (a) may receive only an offer of payment which is conditioned on their agreement to accept it in full satisfaction of their claim. If the right of unconditional immediate payment were granted as to all after-acquired shares, speculators and others might be tempted to buy shares merely for the purpose of demanding appraisal. Since the function of appraisal rights is to protect investors against unforeseen changes, there is no need to give equally favorable treatment to purchasers who knew or should have known about the proposed changes.

The date used as a cut-off for determining the application of this section is when "the principal terms" of the transaction are first announced to shareholders or to a newspaper of general circulation that can be expected to reach the financial community or included in a public filing with the Securities and Exchange Commission. The cut-off should not be set at an earlier date, such as when the first public statement that the corporate action was under consideration was made, because the goal of this section is to prevent use of appraisal rights as a speculative device after the terms of the transaction are announced. See the Official Comment to section 13.22.

Section 13.25(b) requires the corporation to furnish specified information to all shareholders described in subsection (a) and offer them the option of accepting the corporation's estimate of fair value plus interest, in full satisfaction of their claims, provided that such shareholders so accept and notify the corporation within 10 days of receiving this offer. Within 10 days after receiving a shareholder's acceptance, the corporation must pay that shareholder in cash the stated fair value plus interest.

A shareholder may accept the offered payment in full satisfaction of that shareholder's claim; alternatively, a shareholder may reject the corporation's offer and demand a judicial determination under section 13.26 and payment of the amount so determined at the termination of the proceeding. A shareholder who does not satisfy the requirements of section 13.26 shall be deemed to have accepted the corporation's offer.

§ 13.26. PROCEDURE IF SHAREHOLDER DISSATISFIED WITH PAYMENT OR OFFER

A shareholder paid pursuant to section 13.24 who is dissatisfied with the amount of the payment must notify the corporation in writing of that shareholder's estimate of the fair value of the shares and demand payment of that estimate plus interest (less any payment under section 13.24). A shareholder offered payment under section 13.25 who is dissatisfied with that offer must reject the offer and demand payment of the shareholder's stated estimate of the fair value of the shares plus interest.

A shareholder who fails to notify the corporation in writing of that shareholder's demand to be paid the shareholder's stated estimate of the fair value plus interest under subsection (a) within 30 days after receiving the corporation's payment or offer of payment under section 13.24 or section 13.25, respectively, waives the right to demand payment under this section and shall be entitled only to the payment made or offered pursuant to those respective sections.

CROSS-REFERENCES

After-acquired shares, see § 13.25.

"Deliver," see § 1.40.

Effective date of notice, see § 1.41.

"Fair value" defined, see § 13.01.

"Interest" defined, see § 13.01.

Judicial appraisal, see § 13.30.

"Notice" defined, see § 1.41.

Offer of payment for after-acquired shares, see § 13.25.

Other remedies, see § 13.40.

Payment for shares, see § 13.24.

OFFICIAL COMMENT

A shareholder who is not content with the corporation's remittance under section 13.24, or offer of remittance under section 13.25, and wishes to pursue appraisal rights further must state in writing the amount the shareholder is willing to accept. A shareholder whose demand is deemed arbitrary, unreasonable or not in good faith, however, runs the risk of being assessed litigation expenses under section 13.31. These provisions are designed to encourage settlement without a judicial proceeding.

A shareholder to whom the corporation has made payment (or who has been offered payment under section 13.25) must make a supplemental demand within 30 days after receipt of the payment or offer of payment in order to permit the corporation to make an early decision on initiating appraisal proceedings. A failure to make such demand causes the shareholder to relinquish under section 13.26(b) anything beyond the amount the corporation paid or offered to pay.

Subchapter C.
JUDICIAL APPRAISAL OF SHARES

§ 13.30. COURT ACTION

(a) If a shareholder makes demand for payment under section 13.26 which remains unsettled, the corporation shall commence a proceeding within 60 days after receiving the payment demand and petition the court to determine the fair value of the shares and accrued interest. If the corporation does not commence the proceeding within the 60-day period, it shall pay in cash to each shareholder the amount the shareholder demanded pursuant to section 13.26 plus interest.

(b) The corporation shall commence the proceeding in the appropriate court of the county where the corporation's principal office (or, if none, its registered office) in this state is located. If the corporation is a foreign corporation without a registered office in this state, it shall commence the proceeding in the county in this state where the principal office or registered office of the domestic corporation merged with the foreign corporation was located at the time of the transaction.

(c) The corporation shall make all shareholders (whether or not residents of this state) whose demands remain unsettled parties to the proceeding as in an action against their shares, and all parties must be served with a copy of the petition. Nonresidents may be served by registered or certified mail or by publication as provided by law.

(d) The jurisdiction of the court in which the proceeding is commenced under subsection (b) is plenary and exclusive. The court may appoint one or more persons as appraisers to receive evidence and recommend a decision on the question of fair value. The appraisers shall have the powers described in the order appointing them, or in any amendment to it. The shareholders demanding appraisal rights are entitled to the same discovery rights as parties in other civil proceedings. There shall be no right to a jury trial.

(e) Each shareholder made a party to the proceeding is entitled to judgment (i) for the amount, if any, by which the court finds the fair value of the shareholder's shares, plus interest, exceeds the amount paid by the corporation to the shareholder for such shares or (ii) for the fair value, plus interest, of the shareholder's shares for which the corporation elected to withhold payment under section 13.25.

CROSS-REFERENCES

After-acquired shares, see § 13.25.

"Fair value" defined, see § 13.01.

"Interest" defined, see § 13.01.

"Person" defined, see § 1.40.

“Principal office”:

defined, see § 1.40.

designated in annual report, see § 16.21.

“Proceeding” defined, see § 1.40.

Registered office:

designated in annual report, see § 16.21.

required, see §§ 2.02 & 5.01.

OFFICIAL COMMENT

Section 13.30 retains the concept of judicial appraisal as the ultimate means of determining fair value. The proceeding is to be commenced by the corporation within 60 days after a timely demand for payment under section 13.26 was received. If the proceeding is not commenced within this period, the corporation must pay the additional amounts demanded by the shareholders under section 13.26. See the Official Comment to section 13.26.

All demands for payment made under section 13.26 are to be resolved in a single proceeding brought in the county in the state where the corporation’s principal office is located or, if it is a foreign corporation, where its registered office is located, or if it has no registered office, where the principal office of the corporation which issued the shares to be appraised was located. All shareholders making section 13.26 demands must be made parties, with service by publication authorized if necessary. Appraisers may be appointed within the discretion of the court. Since the nature of the proceeding is similar to a proceeding in equity or for an accounting, section 13.30(d) provides that there is no right to a jury trial. The final judgment establishes not only the fair value of the shares in the abstract but also determines how much each shareholder who made a section 13.26 demand should actually receive.

§ 13.31. COURT COSTS AND EXPENSES

(a) The court in an appraisal proceeding commenced under section 13.30 shall determine all court costs of the proceeding, including the reasonable compensation and expenses of appraisers appointed by the court. The court shall assess the court costs against the corporation, except that the court may assess court costs against all or some of the shareholders demanding appraisal, in amounts which the court finds equitable, to the extent the court finds such shareholders acted arbitrarily, vexatiously, or not in good faith with respect to the rights provided by this chapter.

(b) The court in an appraisal proceeding may also assess the expenses of the respective parties in amounts the court finds equitable:

(1) against the corporation and in favor of any or all shareholders demanding appraisal if the court finds the corporation did not substantially comply with the requirements of sections 13.20, 13.22, 13.24, or 13.25; or

(2) against either the corporation or a shareholder demanding appraisal, in favor of any other party, if the court finds the party against whom expenses are assessed acted arbitrarily, vexatiously, or not in good faith with respect to the rights provided by this chapter.

(c) If the court in an appraisal proceeding finds that the expenses incurred by any shareholder were of substantial benefit to other shareholders similarly situated and that such expenses should not be assessed against the corporation, the court may direct that such expenses be paid out of the amounts awarded the shareholders who were benefited.

(d) To the extent the corporation fails to make a required payment pursuant to sections 13.24, 13.25, or 13.26, the shareholder may sue directly for the amount owed, and to the extent successful, shall be entitled to recover from the corporation all expenses of the suit.

CROSS-REFERENCES

Appraisers, see § 13.30.

"Expenses" defined, see § 1.40.

"Proceeding" defined, see § 1.40.

OFFICIAL COMMENT

Section 13.31(a) provides a general rule that the court costs of the appraisal proceeding should be assessed against the corporation. Nevertheless, the court is authorized to assess these court costs, in whole or in part, against all or some of the shareholders demanding appraisal if it concludes they acted arbitrarily, vexatiously, or not in good faith regarding the rights provided by this chapter. Under section 13.31(b), the court may assess expenses against the corporation or against all or some of the shareholders demanding appraisal for the reasons stated in the subsection. Under section 13.31(c), if the corporation is not required to pay the expenses incurred by any shareholder demanding appraisal, the court may require that all the shareholders who benefited to share in the payment of such expenses. The purpose of all these grants of discretion with respect to expenses is to increase the incentives of both sides to proceed in good faith under this chapter to attempt to resolve their disagreement without the need of a formal judicial appraisal of the value of shares.

While subsections (a)–(c) allocate court costs and expenses in an appraisal proceeding, subsection (d) covers the situation where the corporation was obligated to make payment and did not meet this obligation. In that event, the shareholder may sue the corporation directly for the amount owed. In such an action, subsection (d) requires the court, to the extent the shareholder was successful, to impose all court costs and the shareholder's expenses on the corporation.

Subchapter D.
OTHER REMEDIES

§ 13.40. OTHER REMEDIES LIMITED

(a) The legality of a proposed or completed corporate action described in section 13.02(a) may not be contested, nor may the corporate action be enjoined, set aside or rescinded, in a legal or equitable proceeding by a shareholder after the shareholders have approved the corporate action.

(b) Subsection (a) does not apply to a corporate action that:

(1) was not authorized and approved in accordance with the applicable provisions of:

(i) chapter 9, 10, 11, or 12,

(ii) the articles of incorporation or bylaws, or

(iii) the resolution of the board of directors authorizing the corporate action;

(2) was procured as a result of fraud, a material misrepresentation, or an omission of a material fact necessary to make statements made, in light of the circumstances in which they were made, not misleading;

(3) is an interested transaction, unless it has been recommended by the board of directors in the same manner as is provided in section 8.62 and has been approved by the shareholders in the same manner as is provided in section 8.63 as if the interested transaction were a director's conflicting interest transaction; or

(4) is approved by less than unanimous consent of the voting shareholders pursuant to section 7.04 if:

(i) the challenge to the corporate action is brought by a shareholder who did not consent and as to whom notice of the approval of the corporate action was not effective at least 10 days before the corporate action was effected; and

(ii) the proceeding challenging the corporate action is commenced within 10 days after notice of the approval of the corporate action is effective as to the shareholder bringing the proceeding.

CROSS REFERENCES

Act definitions, see § 1.40.

Directors' action, see § 8.62.

"Director's conflicting interest transaction" defined, see § 8.60(1).

"Interested transaction" defined, see § 13.01(5.1).

Shareholder action without a meeting, see § 7.04.

Shareholders' action, see § 8.63.

OFFICIAL COMMENT

With four exceptions, section 13.40 provides that a corporate action described in section 13.02(a) may not be contested, nor may the corporate action be enjoined, set aside or rescinded, in a proceeding by a shareholder after the shareholders have approved the action. The theory underlying this section generally is that when a majority of shareholders has approved a corporate change, the corporation should be permitted to proceed even if a minority considers the change unwise or disadvantageous. The existence of the appraisal remedy recognizes that shareholders may disagree about the financial consequences that a corporate action may have and some may hold such strong views that they will want to vindicate them in a judicial proceeding. Since a judicial proceeding is insulated from the dynamics of an actual negotiation, it is not surprising that the two processes could produce different valuations. Accordingly, if such a proceeding results in an award of additional consideration to the shareholders who pursued appraisal, no inference should be drawn that the judgment of the majority was wrong or that compensation is now owed to shareholders who did not seek appraisal. The limitations are not confined to cases where appraisal is available. The liquidity and reliability considerations that justify the market out justify imposing the same limitation on post-shareholder approval remedies that apply when appraisal is available.

Section 13.40 permits proceedings contesting the legality of a transaction, or seeking to enjoin, rescind or set aside the corporate action after the action has been approved by shareholders under four circumstances:

(1) Situations where there are fundamental flaws in the process by which the corporate action was approved. Thus section 13.40(b)(1) permits challenges to procedural defects in approving the action, such as a failure to obtain the votes required by statute or by the corporation's own articles, bylaws, or board resolution authorizing the transaction.

(2) Situations where the corporate action was procured by fraud, material misrepresentation, or an omission that makes statements made misleading. Section 13.40(b)(2).

(3) A corporate action that is an interested transaction. The same reasoning that supports the provision of appraisal rights for interested transactions in situations where the market out would otherwise apply under 13.02(b) supports the decision in section 13.40(b)(3) not to preclude judicial review or relief in connection with such transactions, unless other strong safeguards are present. Those safeguards are drawn from the treatment of director conflicting interest transactions in sections 8.60 through 8.63. There a conflict of interest transaction may be protected if either qualified director or disinterested shareholder approval is obtained after required disclosure. Here, the protection is made available only if both those requirements are met. Absent compliance with those safeguards, the standard of review to be applied (such as entire fairness), and the extent of the relief that may be available is not addressed by this section. Subsection (b)(3) rejects, however, the

doctrine of *Kahn v. Lynch Communications Systems*, 638 A.2d 1110 (Del. 1994), holding that an interested transaction involving a merger is subject to entire fairness review even when the transaction has been approved by disinterested directors and disinterested shareholders.

(4) Finally, in those cases where a transaction is approved by less than unanimous consent and the nonconsenting shareholders are not given notice of the transaction before it is consummated, and thus do not have the chance to challenge the transaction before its consummation, section 13.40(b)(4) preserves essentially the same opportunity for those shareholders to challenge the transaction as they would have had if they had received notice.

The scope of section 13.40(b) is limited and does not otherwise affect applicable state law. Section 13.40(b) does not create any cause of action; it merely removes the bar to the types of post-transaction claims provided in section 13.40(a). Even then, whether the specific facts of a transaction subject to section 13.40(b) warrant invalidation or rescission is left to the discretion of the court. Similarly section 13.40 leaves to applicable state law the question of remedies, such as injunctive relief, that may be available before the corporate action is approved by shareholders in light of other remedies that may be available after the transaction is approved or completed. Where post-shareholder approval claims outside the scope of section 13.40 are asserted, the availability of judicial review, the remedies (such as damages) that shareholders may have, and questions relating to election of remedies, will be determined by applicable state law. Section 13.40 addresses challenges only to the corporate action and does not address remedies, if any, that shareholders may have against directors or other persons as a result of the corporate action, even where subsection (b)(4) applies. See section 8.31 and the related Official Comment and the Introductory Official Comment to Subchapter F of Chapter 8 under the heading "Scope of Subchapter F."

CHAPTER 14

Dissolution

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Subchapter A. VOLUNTARY DISSOLUTION

§ 14.01. DISSOLUTION BY INCORPORATORS OR INITIAL DIRECTORS

A majority of the incorporators or initial directors of a corporation that has not issued shares or has not commenced business may dissolve the corporation by delivering to the secretary of state for filing articles of dissolution that set forth:

(1) the name of the corporation;

(2) the date of its incorporation;

(3) either (i) that none of the corporation's shares has been issued or (ii) that the corporation has not commenced business;

(4) that no debt of the corporation remains unpaid;

(5) that the net assets of the corporation remaining after winding up have been distributed to the shareholders, if shares were issued; and

(6) that a majority of the incorporators or initial directors authorized the dissolution.

CROSS-REFERENCES

Claims against dissolved corporation, see § 14.06 & 14.07.

"Deliver' see § 1.40.

Dissolution by board of directors and shareholders, see § 14.02.

Effective date of dissolution, see § 14.03.

Effect of dissolution, see § 14.05.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

Incorporators, see § 2.01.

Initial directors, see § 2.05.

Revocation of dissolution, see § 14.04.

OFFICIAL COMMENT

Section 14.01 provides a simple method of voluntary dissolution for a corporation that has not issued shares or commenced business. These provisions are alternative: a corporation may utilize section 14.01 if it has not issued shares (even though it has commenced business) or if it has issued shares but has not commenced business. Dissolution may be accomplished in either of these situations simply by a majority vote of the incorporators or initial directors. (See section 2.05 and its Official Comment for a discussion of the roles of "incorporators" or "initial directors" in the organization of a corporation.)

This simple method of dissolution is likely to be used by name-holding corporations or by corporations formed for the initiation of a new venture when the reasons for the initial creation of the corporation have been completely realized or will never come to fruition.

The form of articles of dissolution provided in section 14.01 takes account of the fact that a corporation may utilize this section even though it has received capital from the issuance of shares or has incurred liabilities either from the commencement of business without issuing shares or from its organization; hence the articles must state that no debts remain unpaid, and that the net assets of the corporation remaining after winding up have been distributed to the shareholders.

§ 14.02. DISSOLUTION BY BOARD OF DIRECTORS AND SHAREHOLDERS

(a) A corporation's board of directors may propose dissolution for submission to the shareholders.

(b) For a proposal to dissolve to be adopted:

(1) The board of directors must recommend dissolution to the shareholders unless the board of directors determines that because of conflict of interest or other special circumstances it should make no recommendation and communicate the basis for its determination to the shareholders; and

(2) The shareholders entitled to vote must approve the proposal to dissolve as provided in subsection (e).

(c) The board of directors may condition its submission of the proposal for dissolution on any basis.

(d) The corporation shall notify each shareholder, whether or not entitled to vote, of the proposed shareholders' meeting. The notice must also state that the purpose, or one of the purposes, of the meeting is to consider dissolving the corporation.

(e) Unless the articles of incorporation or the board of directors acting pursuant to subsection (c) require a greater vote, a greater number of shares to be present, or a vote by voting groups, adoption of the proposal to dissolve shall require the approval of the shareholders at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast exists.

CROSS-REFERENCES

Director standards of conduct, see § 8.30.

Dissolution by unanimous consent of shareholders, see § 7.04.

Effect of dissolution, see § 14.05.

"Notice" defined, see § 1.41.

Notice of shareholders' meeting, see § 7.05.

Quorum at shareholders' meeting, see § 7.25.

Revocation of dissolution, see § 14.04.

Shareholder action without a meeting, see § 7.04

Supermajority quorum and voting requirements, see § 7.27.

Voting by voting group, see § 7.25 & 7.26.

Voting entitlement of shareholders generally, see § 7.21.

"Voting group" defined, see § 1.40.

OFFICIAL COMMENT

Section 14.02(b) requires the board of directors, after approving a proposal to dissolve, to submit the proposal to the shareholders for their approval. When submitting the proposal the board of directors must make a recommendation to the shareholders that the plan be approved, unless the board of directors makes a determination that because of conflicts of interest or other special circumstances it should make no recommendation. For example, the board or directors may make such a determination where there is not a sufficient number of directors free of a conflicting interest to approve the proposal or because the board of directors is evenly divided as to the merits of the proposal but is able to agree that shareholders should be permitted to consider dissolution. If the board of directors makes such a determination, it must describe the conflict of interest or special circumstances, and communicate the basis for the determination, when submitting the proposal to dissolve to the shareholders. The exception for conflicts of interest or other special circumstances is intended to be sparingly available. Generally, shareholders should not be asked to act on a proposal for dissolution in the absence of a recommendation by the board of directors. The exception is not intended to relieve the board of directors of its duty to consider carefully the proposed dissolution and the interests of shareholders.

Section 14.02(c) permits the board of directors to condition its submission of a proposal for dissolution on any basis. Among the conditions that a board might impose are that the proposal will not be deemed approved unless it is approved by a specified vote of the shareholders, or by one or more specified classes or series of shares, voting as a separate voting group, or by a specified percentage of disinterested shareholders. The board of directors is not limited to conditions of these types.

Section 14.02(d) provides that if the approval is to be given at a meeting, the corporation must notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the proposal is to be submitted. Requirements concerning the timing and content of a notice of meeting are set out in section 7.05. Section 14.02(d) does not itself require that notice be given to nonvoting shareholders where the proposal is approved, without a meeting, by shareholder consent. However, that requirement is imposed by section 7.04(e).

Section 14.02(e) provides that approval of a proposal for dissolution requires approval of the shareholders at a meeting at which a quorum consisting of a majority of the votes entitled to be cast on the proposal exists. If a quorum is present, then under sections 7.25 and 7.26 the proposal will be approved if more votes are cast in favor of the proposal than against it by the voting group or separate voting groups entitled to vote on the proposal. This represents a change from the Act's previous voting rule for dissolution, which required approval by a majority of outstanding shares.

The Act does not mandate separate voting by voting groups or appraisal rights in relation to dissolution proposals on the theory that, upon dissolution, the rights or all classes or series of shares are fixed by the articles of incorporation. Of course, group voting rights may be conferred by the articles of incorporation or by the board of directors, acting pursuant to subsection (c).

§ 14.03. ARTICLES OF DISSOLUTION

(a) At any time after dissolution is authorized, the corporation may dissolve by delivering to the secretary of state for filing articles of dissolution setting forth:

(1) the name of the corporation;

(2) the date dissolution was authorized; and

(3) if dissolution was approved by the shareholders, a statement that the proposal to dissolve was duly approved by the shareholders in the manner required by this Act and by the articles of incorporation.

(b) A corporation is dissolved upon the effective date of its articles of dissolution.

(c) For purposes of this subchapter, "dissolved corporation" means a corporation whose articles of dissolution have become effective and includes a successor entity to which the remaining assets of the corporation are transferred subject to its liabilities for purposes of liquidation.

CROSS-REFERENCES

"Deliver' see § 1.40.

Dissolution by board of directors and shareholders, see § 14.02.

Effect of dissolution, see § 14.05.

Effective time and date of filing, see § 1.23.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

Revocation of dissolution, see § 14.04.

Shareholder action without a meeting, see § 7.04

Voting by voting group, see § 7.25 & 7.26.

“Voting group" defined, see § 1.40.

OFFICIAL COMMENT

The act of filing the articles of dissolution makes the decision to dissolve a matter of public record and establishes the time when the corporation must begin the process of winding up and cease carrying on its business except to the extent necessary for winding up. If dissolution was approved by the shareholders, the articles of dissolution must state that dissolution was duly approved by the shareholders in the manner required by the Act and the articles of incorporation of the corporation.

Under the Model Act, articles of dissolution may be filed at the commencement of winding up or at any time thereafter. This is the only filing required for voluntary dissolution; no filing is required to mark the completion of winding up since the existence of the corporation continues for certain purposes even after the business is wound up and the assets remaining after satisfaction of all creditors are distributed to the shareholders. No time limit for filing the articles is specified, and it often may be desirable to postpone filing until winding up is far along or even complete.

A corporation is dissolved on the date the articles of dissolution are effective. After this date the corporation is referred to as a "dissolved corporation' although its existence continues under section 14.05 for purposes of winding up.

Subsection (c) defines "dissolved corporation" for purposes of subchapter A to include successor entities to which assets are transferred subject to liabilities for purposes of liquidation. This provision covers the situation where a liquidating trust or other successor entity is used to complete the liquidation.

§ 14.04. REVOCATION OF DISSOLUTION

(a) A corporation may revoke its dissolution within 120 days of its effective date.

(b) Revocation of dissolution must be authorized in the same manner as the dissolution was authorized unless that authorization permitted revocation by action of the board of directors alone, in which event the board of directors may revoke the dissolution without shareholder action.

(c) After the revocation of dissolution is authorized, the corporation may revoke the dissolution by delivering to the secretary of state for filing articles of revocation of dissolution, together with a copy of its articles of dissolution, that set forth:

(1) the name of the corporation;

(2) the effective date of the dissolution that was revoked;

(3) the date that the revocation of dissolution was authorized;

(4) if the corporation's board of directors (or incorporators) revoked the dissolution, a statement to that effect;

(5) if the corporation's board of directors revoked a dissolution authorized by the shareholders, a statement that revocation was permitted by action by the board of directors alone pursuant to that authorization; and

(6) if shareholder action was required to revoke the dissolution, the information required by section 14.03(a) (3).

(d) Revocation of dissolution is effective upon the effective date of the articles of revocation of dissolution.

(e) When the revocation of dissolution is effective, it relates back to and takes effect as of the effective date of the dissolution and the corporation resumes carrying on its business as if dissolution had never occurred.

CROSS-REFERENCES

Articles of dissolution, see § 14.03.

"Deliver," see § 1.40.

Dissolution by board of directors and shareholders, see § 14.02.

incorporators or initial directors, see § 14.01.

shareholder action without a meeting, see § 7.04.

Effective date of dissolution, see § 14.03.

Effective time and date of filing, see § 1.23.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

OFFICIAL COMMENT

Voluntary dissolution may be revoked within 120 days of the effective date of the dissolution. Because of the importance and finality of dissolution, the decision to revoke dissolution generally requires shareholder authorization (unless the dissolution was approved solely by the initial directors or incorporators under section 14.01). Section 14.04(b), however, contemplates that the board of directors may revoke dissolution if it is granted that authority in advance by the shareholders when approving the dissolution. Such authorization is often included in proposals to dissolve that are contingent upon the effectuation of another transaction, such as a sale of corporate assets not in the ordinary course of business.

Certain other action requiring shareholder approval may be revoked by the board of directors without express shareholder approval. (See sections 11.08 and 12.02). By contrast, dissolution under section 14.04 may not be revoked by the board of directors without approval of the shareholders.

Articles of revocation of dissolution must be filed to reflect the decision to resume the business of the corporation. The information required in these articles parallels the information required in the original articles of dissolution.

The effect of articles of revocation of dissolution is to eliminate the requirement that the corporation cease to conduct its business except as part of the winding-up process and permit it to resume its business without limitation and as if dissolution had never occurred.

§ 14.05. EFFECT OF DISSOLUTION

(a) A dissolved corporation continues its corporate existence but may not carry on any business except that appropriate to wind up and liquidate its business and affairs, including:

(1) collecting its assets;

(2) disposing of its properties that will not be distributed in kind to its shareholders;

(3) discharging or making provision for discharging its liabilities;

(4) distributing its remaining property among its shareholders according to their interests; and

(5) doing every other act necessary to wind up and liquidate its business and affairs.

(b) Dissolution of a corporation does not:

(1) transfer title to the corporation's property;

(2) prevent transfer of its shares or securities, although the authorization to dissolve may provide for closing the corporation's share transfer records;

(3) subject its directors or officers to standards of conduct different from those prescribed in chapter 8;

(4) change quorum or voting requirements for its board of directors or shareholders; change provisions for selection, resignation, or removal of its directors or officers or both; or change provisions for amending its bylaws;

(5) prevent commencement of a proceeding by or against the corporation in its corporate name;

(6) abate or suspend a proceeding pending by or against the corporation on the effective date of dissolution; or

(7) terminate the authority of the registered agent of the corporation.

CROSS-REFERENCES

Administrative dissolution, see § 14.20-14.23.

Amendment of bylaws, see ch. 10B.

Claims against dissolved corporation, see § 14.06 & 14.07.

Deposit with state treasurer, see § 14.40.

Directors:

election, see § 8.03.

removal, see § 8.08 & 8.09.

resignation, see § 8.07.

standards of conduct, see § 8.30.

terms, see § 8.05.

Dissolution by:

board of directors and shareholders, see § 14.02.

incorporators or initial directors, see § 14.01.

"Dissolved corporation' see § 14.03.

Effective date of dissolution, see § 14.03.

Judicial dissolution, see § 14.30-14.34.

Officers:

appointment, see § 8.40.

removal, see § 8.43.

resignation, see § 8.43.

standards of conduct, see § 8.42.

"Proceeding" defined, see § 1.40.

Quorum requirements:

board of directors, see § 8.24.

shareholders, see § 7.25 & 7.26.

Revocation of dissolution, see § 14.04.

Service of process on registered agent, see § 5.04.

Voting requirements:

directors, see § 8.24.

shareholder action without a meeting, see § 7.04

shareholders, see § 7.25 & 7.26.

OFFICIAL COMMENT

Section 14.05(a) provides that 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.

The Model Act uses the term "dissolution" in the specialized sense described above and not to describe the final step in the liquidation of the corporate business. This is made clear by section 14.05(b), which provides that chapter 14 dissolution does not have any of the characteristics of common law dissolution, which treated corporate dissolution as analogous to the death of a natural person and abated lawsuits, vested equitable title to corporate property in the shareholders, imposed the fiduciary duty of trustees on directors who had custody of corporate assets, and revoked the authority of the registered agent. Section 14.05(b) expressly reverses all of these common law attributes of dissolution and makes clear that the rights, powers, and duties of shareholders, the directors, and the registered agent are not affected by dissolution and that suits by or against the corporation are not affected in any way.

§ 14.06. KNOWN CLAIMS AGAINST DISSOLVED CORPORATION

(a) A dissolved corporation may dispose of the known claims against it by notifying its known claimants in writing of the dissolution at any time after its effective date.

(b) The written notice must:

(1) describe information that must be included in a claim;

(2) provide a mailing address where a claim may be sent;

(3) state the deadline, which may not be fewer than 120 days from the effective date of the written notice, by which the dissolved corporation must receive the claim; and

(4) state that the claim will be barred if not received by the deadline.

(c) A claim against the dissolved corporation is barred:

(1) if a claimant who was given written notice under subsection (b) does not deliver the claim to the dissolved corporation by the deadline; or

(2) if a claimant whose claim was rejected by the dissolved corporation does not commence a proceeding to enforce the claim within 90 days from the effective date of the rejection notice.

(d) For purposes of this section, "claim" does not include a contingent liability or a claim based on an event occurring after the effective date of dissolution.

CROSS-REFERENCES

Administrative dissolution, see § 14.21.

Decree of judicial dissolution, see § 14.33.

"Deliver," see § 1.40.

Dissolved corporation, see § 14.03.

Effective date of dissolution, see § 14.03.

Effective date of notice, see § 1.41.

"Notice" defined, see § 1.41.

Notice to the corporation, see § 1.41.

"Proceeding" defined, see § 1.40.

Unknown claims, see § 14.07.

OFFICIAL COMMENT

Sections 14.06 and 14.07 provide a simplified system for handling known and unknown claims against a dissolved corporation, including claims based on events that occur after the dissolution of the corporation. Section 14.06 deals solely with known claims while section 14.07 deals with unknown or subsequently arising claims. A claim can be a "known" claim even if it is unliquidated; a claim that is contingent or has not yet matured or in certain cases has matured but has not been asserted is not a "known" claim (see section 14.06(d)). For example, an unmatured liability under a guarantee, a potential default under a lease, or an unasserted claim based upon a defective product manufactured by the dissolved corporation would not be a "known" claim.

Known claims are handled in section 14.06 through a process of written notice to claimants; the written notice must contain the information described in section 14.06(b). Section 14.06 (c) then provides fixed deadlines by which claims are barred under various circumstances, as follows:

(1) If a claimant was given effective written notice satisfying section 14.06(b) but fails to file the claim by the deadline specified by the dissolved corporation, the claim is barred by section

14.06(c)(1). See section 1.41(e) as to the effectiveness of notice.

(2) If a claimant receives written notice satisfying section 14.06(b) and files the claim as required:

(i) but the dissolved corporation rejects the claim, the claimant must commence a proceeding to enforce the claim within 90 days of the rejection or the claim is barred by section 14.06(c) (2); or

(ii) if the dissolved corporation does not act on the claim or fails to notify the claimant of the rejection, the claimant is not barred by section 14.06(c) until the dissolved corporation notifies the claimant.

(3) If the dissolved corporation publishes notice under section 14.07, a claimant who was not notified in writing is barred unless a proceeding is commenced to enforce the claim within three years after publication of the notice.

(4) If the dissolved corporation does not publish notice, a claimant who was not notified in writing is not barred by section 14.06(c) from pursuing the claim.

These principles, it should be emphasized, do not lengthen statutes of limitation applicable under general state law. Thus, claims that are not barred under the foregoing rules-for example, if the corporation does not act on a claim will nevertheless be subject to the general statute of limitations applicable to claims of that type.

Even though the directors are not trustees of the assets of a dissolved corporation (see section 14.05(b)(3)), they must discharge or make provision for discharging the corporation's liabilities before distributing the remaining assets to the shareholders. See section 14.09.

§ 14.07. OTHER CLAIMS AGAINST DISSOLVED CORPORATION

(a) A dissolved corporation may also publish notice of its dissolution and request that persons with claims against the dissolved corporation present them in accordance with the notice.

(b) The notice must:

(1) be published one time in a newspaper of general circulation in the county where the dissolved corporation's principal office (or, if none in this state, its registered office) is or was last located;

(2) describe the information that must be included in a claim and provide a mailing address where the claim may be sent; and

(3) state that a claim against the dissolved corporation will be barred unless a proceeding to enforce the claim is commenced within three years after the publication of the notice.

(c) If the dissolved corporation publishes a newspaper notice in accordance with subsection (b), the claim of each of the following claimants is barred unless the claimant commences a proceeding to enforce the claim against the dissolved corporation within three years after the publication date of the newspaper notice:

(1) a claimant who was not given written notice under section 14.06;

(2) a claimant whose claim was timely sent to the dissolved corporation but not acted on;

(3) a claimant whose claim is contingent or based on an event occurring after the effective date of dissolution.

(d) A claim that is not barred by section 14.06(b) or section 14.07(c) may be enforced:

(1) against the dissolved corporation, to the extent of its undistributed assets; or

(2) except as provided in section 14.08(d), if the assets have been distributed in liquidation, against a shareholder of the dissolved corporation to the extent of the shareholder's pro rata share of the claim or the corporate assets distributed to the shareholder in liquidation, whichever is less, but a shareholder's total liability for all claims under this section may not exceed the total amount of assets distributed to the shareholder.

CROSS-REFERENCES

Administrative dissolution, see § 14.21.

"Claim" defined, see § 14.06.

Court proceedings, see § 14.08.

Decree of judicial dissolution, see § 14.33.

"Deliver," see § 1.40.

"Dissolved corporation' see § 14.03.

"Distribution" defined, see § 1.40.

Effective date of dissolution, see § 14.03.

Effective date of notice, see § 1.41.

Known claims, see § 14.06.

"Notice" defined, see § 1.41.

Notice to the corporation, see § 1.41.

"Principal office":

defined, see § 1.40.

designated in annual report, see § 16.21.

"Proceeding" defined, see § 1.40.

Registered office:

designated in annual report, see § 16.21.

required, see § 2.02 & 5.01.

OFFICIAL COMMENT

Earlier 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. Most of these claims were based on personal injuries occurring after dissolution but caused by allegedly defective products sold before dissolution. The application of the Model Act provision (and of the state dissolution statutes phrased in different terms) to this problem led to confusing and inconsistent results. The problems raised by these claims are intractable: on the one hand, the application of a mechanical limitation period to a claim for injury that occurs after the period has expired involves obvious injustice to the plaintiff. On the other hand, to permit these suits generally makes it impossible ever to complete the winding up of the corporation, make suitable provision for creditors, and distribute the balance of the corporate assets to the shareholders. Evolving legal rules make estimating future liability for personal injury claims difficult.

In some circumstances successor liability theories have been applied to allow plaintiffs incurring post-dissolution injuries to bring suit against the person that acquired the corporate assets. Some courts have refused to broaden these doctrines, particularly when the purchaser of the corporate assets has not continued the business of the dissolved corporation. In these cases, the remedy of the plaintiff is limited to claims against the dissolved corporation and its shareholders receiving assets pursuant to the dissolution.

The solution adopted in section 14.07 is to continue the liability of a dissolved corporation for subsequent claims for a period of three years after it publishes notice of dissolution. It is recognized that a three year cut-off is itself arbitrary, but it is believed that the bulk of post-dissolution claims that can be estimated will arise during this period. This provision is therefore believed to be a reasonable compromise between the competing considerations of providing a remedy to injured plaintiffs and providing a basis for directors to estimate liabilities so that dissolved corporations may distribute remaining assets free of all claims and shareholders may receive them secure in the knowledge that they may not be reclaimed. The period of three years for asserting claims is within the range of time periods adopted by state statutes.

Directors must generally discharge or make provision for discharging the corporation's liabilities before distributing the remaining assets to the shareholders. See section 14.09(a). Many claims covered by this section are of a type for which provision may be made by the purchase of insurance or by the setting aside of a portion of the assets, thereby permitting prompt distributions in liquidation. Claimants, of course, may always have recourse to the remaining assets of the dissolved corporation. See section 14.07(d)(1). Further, where unbarred claims arise after distributions have been made to shareholders in liquidation, section 14.07(d)(2) authorizes recovery against the shareholders receiving the earlier distributions. The recovery, however, is limited to the smaller of the recipient shareholders' pro rata share of the claim or the total amount of assets received as liquidating distributions by the shareholder from the corporation. The provision ensures that claimants seeking to recover distributions from shareholders will try to recover from the entire class of shareholders rather than concentrating only on the larger shareholders and protects the limited liability of shareholders. Shareholders also may be liable to directors for recoupment under section 8.33(b) (2).

§ 14.08. COURT PROCEEDINGS

(a) A dissolved corporation that has published a notice under section 14.07 may file an application with the [name or describe] court of the county where the dissolved corporation's principal office (or, if none in this state, its registered office) is located for a determination of the amount and form of security to be provided for payment of claims that are contingent or have not been made known to the dissolved corporation or that are based on an event occurring after the effective date of dissolution but that, based on the facts known to the dissolved corporation, are reasonably estimated to arise after the effective date of dissolution. Provision need not be made for any claim that is or is reasonably anticipated to be barred under section 14.07(c).

(b) Within 10 days after the filing of the application, notice of the proceeding shall be given by the dissolved corporation to each claimant holding a contingent claim whose contingent claim is shown on the records of the dissolved corporation.

(c) The court may appoint a guardian *ad litem* to represent all claimants whose identities are unknown in any proceeding brought under this section. The reasonable fees and expenses of such guardian, including all reasonable expert witness fees, shall be paid by the dissolved corporation.

(d) Provision by the dissolved corporation for security in the amount and the form ordered by the court under section 14.08(a) shall satisfy the dissolved corporation's obligations with respect to claims that are contingent, have not been made known to the dissolved corporation or are based on an event occurring after the effective date of dissolution, and such claims may not be enforced against a shareholder who received assets in liquidation.

CROSS-REFERENCES

"Dissolved corporation" defined, see § 14.03.

"Effective date of notice, see § 1.41.

"Notice" defined, see § 1.41.

“Principal office":

defined, see § 1.40.

designated in annual report, see § 16.21.

"Proceeding" defined, see § 1.41.

Registered office:

designated in annual report, see § 16.21.

required, see § 2.02 & 5.01.

OFFICIAL COMMENT

Section 14.08 adds a provision to the Model Act allowing a dissolved corporation to initiate a proceeding to establish the provision that should be made for unknown or contingent claims before a distribution in liquidation is made to shareholders. Similar proceedings are authorized in several states to remove the risk of director and shareholder liability for inadequate provision for claims.

Section 14.08(a) authorizes the proceeding and specifies that provision for unknown and contingent claims can only be for those claims that are estimated to arise after dissolution that are not expected to be barred by section 14.07(d). The same analysis may be made by the board of directors under section 14.09 if court proceedings are not used. As a result, estimates for unknown or contingent claims, such as product liability injury claims that might arise after dissolution, need only be made for those claims that the court determines are reasonably anticipated to be asserted within three years after dissolution. Such estimates might reasonably be based on the claims experience of the corporation prior to its dissolution.

If the dissolved corporation elects to initiate a proceeding, it must give notice of the proceeding within 10 days after filing the court application to each holder of a contingent claim whose claim is shown on the records of the corporation. Notice to holders of guarantees made by the corporation typically would be required under this subsection.

Subsection (c) allows the court to appoint a guardian ad litem for unknown claimants, but does not make the appointment mandatory. Reasonable fees and expenses of the guardian ad litem are to be paid by the dissolved corporation. Section 14.08 is designed to permit the court to adopt procedures appropriate to the circumstances.

If the proceeding is completed, section 14.08(d) establishes that the dissolved corporation is deemed to have satisfied its obligation to discharge or make provision for discharging its liabilities (see section 14.05(a)(3)). With respect to claims that have not matured, directors are protected from liability by section 14.09(b), and shareholders are protected from claims under section 14.08(d).

If a court determines that the corporation is dissolving for the primary purpose of avoiding anticipated claims of future tort claimants, it is expected that the court will use its general discretionary powers and deny the protections of section 14.08 to the dissolved corporation.

§ 14.09. DIRECTOR DUTIES

(a) Directors shall cause the dissolved corporation to discharge or make reasonable provision for the payment of claims and make distributions of assets to shareholders after payment or provision for claims.

(b) Directors of a dissolved corporation which has disposed of claims under sections 14.06, 14.07, or 14.08 shall not be liable for breach of section 14.09(a) with respect to claims against the dissolved corporation that are barred or satisfied under sections 14.06, 14.07, or 14.08.

CROSS-REFERENCES

Claims against dissolved corporation, see § 14.06 & 14.07.

Directors' liability for unlawful distributions, see § 8.33.

Director standards of conduct, see § 8.30.

Dissolved corporation" defined, see § 14.03.

Distribution" defined, see § 1.40.

Known claims, see § 14.06.

Other claims, see § 14.07.

Proceeding to determine security for contingent claims, see § 14.08.

OFFICIAL COMMENT

New section 14.09(a) establishes the duty of directors to discharge or make provision for claims and to make distributions of the remaining assets to shareholders. The earlier version of chapter 14 implied the obligation from sections 14.05(3) and (4) concerning the powers of the corporation to pay claims and make distributions upon dissolution. Liability of directors formerly was based on violations of section 6.40 concerning distributions. New section 6.40(h) removed distributions in liquidation from the coverage of section 6.40.

Section 14.09(b) provides that directors of a dissolved corporation that complies with sections

14.06, 14.07, or 14.08 are not liable for breach of section 14.09(a) with respect to claims that are disposed of under those sections. For example, directors need not make provision for claims of known creditors who are barred under section 14.06 for failure to file a claim or commence a proceeding within the specified times, for contingent claimants whose estimated claims are barred by the three-year period after publication, pursuant to section 14.07(c), or for claimants such as guarantors if provision for the claims have been approved by a court under section 14.08(d).

Section 14.09(b) leaves unchanged the section 8.33 provision that director liability is to the corporation. There are, however, cases that under various theories recognize liability directly to creditors for wrongful payments in liquidation. While there might be circumstances under which direct creditor claims are appropriate, the basic approach of chapter 14 is that claims against directors for breach of section 14.09(a) and claims against shareholders for recoupment of amounts improperly distributed in liquidation should be mediated through the corporation.

Subchapter B. ADMINISTRATIVE DISSOLUTION

§ 14.20. GROUNDS FOR ADMINISTRATIVE DISSOLUTION

The secretary of state may commence a proceeding under section 14.21 to administratively dissolve a corporation if:

(1) the corporation does not pay within 60 days after they are due any franchise taxes or penalties imposed by this Act or other law;

(2) the corporation does not deliver its annual report to the secretary of state within 60 days after it is due;

(3) the corporation is without a registered agent or registered office in this state for 60 days or more;

(4) the corporation does not notify the secretary of state within 60 days that its registered agent or registered office has been changed, that its registered agent has resigned, or that its registered office has been discontinued; or

(5) the corporation's period of duration stated in its articles of incorporation expires.

CROSS-REFERENCES

Annual report, see § 16.21.

Appeal from administrative dissolution, see § 14.23.

"Deliver," see § 1.40.

Duration of corporation, see § 3.02.

Judicial dissolution, see § 14.30-14.34.

Registered office and agent, see ch. 5.

Reinstatement following administrative dissolution, see § 14.22.

Voluntary dissolution, see § 14.01 & 14.02.

OFFICIAL COMMENT

Involuntary dissolution in earlier versions of the Model Act required judicial order upon suit filed by the state attorney general. In the comment to section 95 of the 1969 Model Act, this decision was explained on the basis that the Model Act "provides for judicial review in protection of rights that might otherwise be lost." This position, however, was not generally accepted-in 1982 only three jurisdictions limited involuntary dissolution to judicial action-with all other jurisdictions permitting administrative dissolution for a variety of reasons, usually including a failure to pay franchise taxes and often including failure to file annual reports or otherwise comply with similar requirements of the corporation statutes. Some of these administrative dissolution statutes appear in the tax statutes rather than the corporation statutes of the states.

The experience in most states has been that administrative dissolution, or the threat thereof, is an effective enforcement mechanism for a variety of statutory obligations. Judicial dissolution is inappropriate for many of these violations because of its cost and the diversion of limited legal resources, particularly since most violations reflect the abandonment of the corporation by its owners.

The advantages of administrative dissolution in these circumstances are compelling: it not only reduces the number of records maintained by the secretary of state, but also avoids further wasteful attempts to compel compliance by the abandoned corporations and returns the corporate name promptly to the status of available names. Therefore, the revised Model Act includes, in sections 14.20 through 14.23, a model provision for the administrative dissolution of corporations in certain limited circumstances. These circumstances are set forth in section 14.20 and closely parallel provisions found in most state statutes on this subject.

§ 14.21. PROCEDURE FOR AND EFFECT OF ADMINISTRATIVE DISSOLUTION

(a) If the secretary of state determines that one or more grounds exist under section 14.20 for dissolving a corporation, the secretary of state shall serve the corporation with written notice of such determination under section 5.04.

(b) If the corporation does not correct each ground for dissolution or demonstrate to the reasonable satisfaction of the secretary of state that each ground determined by the secretary of state does not exist within 60 days after service of the notice is perfected under section 5.04, the secretary of state shall administratively dissolve the corporation by signing a certificate of dissolution that recites the ground or grounds for dissolution and its effective date. The secretary of state shall file the original of the certificate and serve a copy on the corporation under section 5.04.

(c) A corporation administratively dissolved continues its corporate existence but may not carry on any business except that necessary to wind up and liquidate its business and affairs under section 14.05 and notify claimants under sections 14.06 and 14.07.

(d) The administrative dissolution of a corporation does not terminate the authority of its registered agent.

CROSS-REFERENCES

Appeal from denial of reinstatement, see § 14.23.

Claims, see § 14.06 & 14.07.

Deposit with state treasurer, see § 14.40.

Perfection of service, see § 5.04.

Reinstatement following administrative dissolution, see § 14.22.

Winding up, see § 14.05.

OFFICIAL COMMENT

Many failures to comply with statutory requirements that may give rise to administrative dissolution under section 14.20 occur because of oversight or inadvertence by responsible corporate officers of corporations that are continuing in business. Such failures are usually corrected promptly when brought to the corporation's attention. Sections 14.21(a) and (b) therefore provide a mandatory notice by the secretary of state to each corporation subject to administrative dissolution and a 60-day grace period following the notice before the certificate of administrative dissolution may be filed.

In most instances, the issue whether the corporation is subject to administrative dissolution will not be controverted. If a corporation is administratively dissolved, it may petition the secretary of state for reinstatement under section 14.22 and, if this is denied, it may appeal to the courts under section 14.23.

§ 14.22. REINSTATEMENT FOLLOWING ADMINISTRATIVE DISSOLUTION

(a) A corporation administratively dissolved under section 14.21 may apply to the secretary of state for reinstatement within two years after the effective date of dissolution. The application must:

(1) recite the name of the corporation and the effective date of its administrative dissolution;

(2) state that the ground or grounds for dissolution either did not exist or have been eliminated;

(3) state that the corporation's name satisfies the requirements of section 4.01; and

(4) contain a certificate from the [taxing authority] reciting that all taxes owed by the corporation have been paid.

(b) If the secretary of state determines that the application contains the information required by subsection (a) and that the information is correct, the secretary of state shall cancel the certificate of dissolution and prepare a certificate of reinstatement that recites such determination and the effective date of reinstatement, file the original of the certificate, and serve a copy on the corporation under section 5.04.

(c) When the reinstatement is effective, it relates back to and takes effect as of the effective date of the administrative dissolution and the corporation resumes carrying on its business as if the administrative dissolution had never occurred.

CROSS-REFERENCES

Appeal from denial of reinstatement, see § 14.23.

Corporate name generally, see ch. 4.

Effective date of administrative dissolution, see § 14.21.

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

Grounds for administrative dissolution, see § 14.20.

OFFICIAL COMMENT

Section 14.22 provides a two-year period during which a corporation may seek reinstatement following administrative dissolution. This section may apply when a corporation through inadvertence or a failure to maintain a registered agent fails to receive or respond to the predissolution notice of default required by section 14.21. A corporation that is reinstated pursuant to this section resumes carrying on its business as before dissolution.

In order to be eligible for reinstatement, a corporation must comply with all statutory requirements at the time it seeks reinstatement. It must establish, for example, that all taxes have been paid and that its name is available when it files the application for reinstatement.

§ 14.23. APPEAL FROM DENIAL OF REINSTATEMENT

(a) If the secretary of state denies a corporation's application for reinstatement following administrative dissolution, the secretary of state shall serve the corporation under section 5.04 with a written notice that explains the reason or reasons for denial.

(b) The corporation may appeal the denial of reinstatement to the [name or describe] court within 30 days after service of the notice of denial is perfected. The corporation appeals by petitioning the court to set aside the dissolution and attaching to the petition copies of the secretary of state's certificate of dissolution, the corporation's application for reinstatement, and the secretary of state's notice of denial.

(c) The court may summarily order the secretary of state to reinstate the dissolved corporation or may take other action the court considers appropriate.

(d) The court's final decision may be appealed as in other civil proceedings.

CROSS-REFERENCES

"Court" described, see § 1.26.

Grounds for administrative dissolution, see § 14.20.

"Notice" defined, see § 1.41.

Perfection of service, see § 5.04.

Reinstatement following administrative dissolution, see § 14.22.

OFFICIAL COMMENT

Section 14.23 provides for an appeal from a decision by the secretary of state denying a petition for reinstatement. The court with jurisdiction over an appeal should be specified, and states adopting this section of the Model Act should specify who has the burden of proof on appeal and the standard for judicial review. See the Official Comment to section 1.26.

Subchapter C. JUDICIAL DISSOLUTION

§ 14.30. GROUNDS FOR JUDICIAL DISSOLUTION

The [name or describe court or courts] may dissolve a corporation:

(a) (1) in a proceeding by the attorney general if it is established that:

(i) the corporation obtained its articles of incorporation through fraud; or

(ii) the corporation has continued to exceed or abuse the authority conferred upon it by law;

(2) in a proceeding by a shareholder if it is established that:

(i) the directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of the deadlock;

(ii) the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent;

(iii) the shareholders are deadlocked in voting power and have failed, for a period that includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired; or

(iv) the corporate assets are being misapplied or wasted;

(3) in a proceeding by a creditor if it is established that:

(i) the creditor's claim has been reduced to judgment, the execution on the judgment returned unsatisfied, and the corporation is insolvent; or

(ii) the corporation has admitted in writing that the creditor's claim is due and owing and the corporation is insolvent; or

(4) in a proceeding by the corporation to have its voluntary dissolution continued under court supervision.

(5) in a proceeding by a shareholder if the corporation has abandoned its business and has failed within a reasonable time to liquidate and distribute its assets and dissolve.

(b) Section 14.30(a) (2) shall not apply in the case of a corporation that, on the date of the filing of the proceeding, has shares which are:

(i) listed on the New York Stock Exchange, the American Stock Exchange or on any exchange owned or operated by the NASDAQ Stock Market LLC, or listed or quoted on a system owned or operated by the National Association of Securities Dealers, Inc.; or

(ii) not so listed or quoted, but are held by at least 300 shareholders and the shares outstanding have a market value of at least $20 million (exclusive of the value of such shares held by the corporation's subsidiaries, senior executives, directors and beneficial shareholders owning more than 10% of such shares).

(c) In this section, "beneficial shareholder" has the meaning specified in section 13.01(2).

CROSS-REFERENCES

Administrative dissolution, see § § 14.20-14.23.

Appointment of Custodian or Receiver, see § 7.48.

Custodianship or Receivership in judicial dissolution proceeding, see § 14.32.

Director action, see § 8.20-8.24.

Election of directors, see § 8.03.

"Proceeding" defined, see § 1.40.

Purchase of shares in lieu of dissolution, see § 14.34.

Revocation of articles of incorporation by state, see § 2.03.

Shareholder voting, see § 7.25-7.27.

Terms of directors, see § 8.05 & 8.06.

Ultra vires acts, see § 3.04.

Voluntary dissolution, see § 14.01-14.05.

OFFICIAL COMMENT

Section 14.30 provides grounds for the judicial dissolution of corporations at the request of the state, a shareholder, a creditor, or a corporation which has commenced voluntary dissolution. This section states that a court "may" order dissolution if a ground for dissolution exists. Thus, there is discretion on the part of the court as to whether dissolution is appropriate even though grounds exist under the specific circumstances. The grounds listed in section 14.30(a)(2) are available only if the corporation does not meet the tests for being publicly traded set forth in section 14.30(b), whereas a shareholder may seek dissolution under section 14.30(a)(5) regardless of whether or not the corporation meets those tests.

1. Involuntary Dissolution by State

Section 14,30(a)(1) preserves long standing and traditional provisions authorizing the state to seek to dissolve involuntarily a corporation by judicial decree. While this power has been exercised only rarely in recent years, this right of the state involves a policing action that provides a means by which the state may ensure compliance with, and nonabuse of, the fundamentals of corporate existence. Section 14.30(a)(1) limits the power of the state in this regard to grounds that are reasonably related to this objective.

The legality of proposed corporations or of proposed actions has sometimes been tested by the secretary of state's refusal to accept documents for filing. The role of the secretary of state in reviewing documents for filing has been restricted by the Model Act (see section 1.25 and its Official Comment). It is intended that suits under this subchapter will replace those actions.

2. Involuntary Dissolution by Shareholders

Section 14.30(a)(2) provides for involuntary dissolution at the suit of a shareholder under circumstances involving deadlock or significant abuse of power by controlling shareholders or directors. The remedy of judicial dissolution under section 14.30(a)(2) is appropriate only for shareholders of corporations that are not widely-held. Even in those situations, however, the court can take into account the number of shareholders and the nature of the trading market for the shares in deciding whether to exercise its discretion to order dissolution. Shareholders of corporations that meet the tests of section 14.30(b) will normally have the ability to sell their shares if they are dissatisfied with current management. In addition, (1) they may seek traditional remedies for breach of fiduciary duty; (ii) they may seek judicial removal of directors in case of fraud, gross abuse of power, or the intentional infliction of harm on the corporation, under section 8.09, or (iii) in the narrow circumstances covered in section 7.48(a), if irreparable injury is occurring or threatened, they may seek the appointment of a custodian or receiver outside the context of a dissolution proceeding. In contrast, a resort to litigation may result in an irreparable breach of personal relationships among the shareholders of a nonpublic corporation, making it impossible for them to continue in business to their mutual advantage, and making liquidation and dissolution (subject to the buy-out provisions of section 14.34) the appropriate solution. The grounds for dissolution under section 14.30(a)(2) are broader than those required to be shown for the appointment of a custodian or receiver under section 7.48(a). The difference is attributable to the different focus of the two proceedings. While some of the grounds listed in 14.30(a)(2), such as deadlock, may implicate the welfare of the corporation as a whole, the primary focus is on the effect of actions by those in control on the value of the complaining shareholder's individual investment: for example, the "oppression" ground in section 14.30(a)(2)(ii) is often cited in complaints for dissolution and generally describes action directed against a particular shareholder. In contrast, the primary focus of an action to appoint a custodian or receiver under section 7.48(a) is the corporate entity, and the action is intended to protect the interests of all shareholders, creditors and others who may have an interest therein. In other instances, action that is "illegal" or "fraudulent" under 14.30(a)(2) may be severely prejudicial to the interests of the individual complaining shareholder, whereas conduct that is illegal with respect to the corporation may be remedied by other causes of action available to shareholders, and "fraudulent" conduct or a board deadlock under section 7.48(a) must be accompanied by or threaten irreparable harm to warrant the appointment of a custodian or receiver. An action under section 7.48(a) may be brought by a shareholder of any corporation.

A. DEADLOCK

Dissolution because of deadlock is available if there is a deadlock at the directors' level but only if (1) the shareholders are unable to break the deadlock and (2) either "irreparable injury" to the corporation is being threatened or suffered or the business and affairs "can no longer be conducted to the advantage of" the shareholders. This language closely follows the earlier versions of the Model Act except that the requirement of "irreparable injury" has been relaxed to some extent. Dissolution because of deadlock at the directors' level is not dependent on the lapse of time during which the deadlock continues.

Dissolution is also available because of deadlock at the shareholders' level if the shareholders are unable to elect directors over a two-year period. This remedy is particularly important in small or family-held corporations in which share ownership may be divided on a 50-50 basis or a supermajority provision (including possibly a requirement of unanimity) may effectively pre-vent the election of any directors. Dissolution under section 14.30(a)(2)(iii) is not dependent on irreparable injury or misconduct by the directors then in office; if injury or misconduct is present, a deadlocked shareholder may proceed under another clause of section 14.30(a)(2).

B. ABUSE OF POWER

A shareholder may sue for involuntary dissolution upon proof either that those in control of the corporation are acting illegally, oppressively, or fraudulently (section 14.30(a)(2)(ii)) or that the corporate assets are being misapplied or wasted (section 14.30(a)(2)(iv)). The application of these grounds for dissolution to specific circumstances obviously involves judicial discretion in the application of a general standard to concrete circumstances. The court should be cautious in the application of these grounds so as to limit them to genuine abuse rather than instances of acceptable tactics in a power struggle for control of a corporation.

3. Dissolution by Creditors

Creditors may obtain involuntary dissolution only when the corporation is insolvent and only in the limited circumstances set forth in section 14.30(a)(3).

Typically, a proceeding under the federal Bankruptcy Act is an alternative in these situations.

4. Dissolution by Corporation

A corporation that has commenced voluntary dissolution may petition a court to supervise its dissolution. Such an action may be appropriate to permit the orderly liquidation of the corporate assets and to protect the corporation from a multitude of creditors' suits or suits by dissatisfied shareholders.

5. Dissolution by Shareholder for Unreasonable Delay in Liquidation and Dissolution

Section 14.30(a)(5) provides a basis for a shareholder to obtain involuntary dissolution in the event the corporation has abandoned its business, but those in control of the corporation have delayed unreasonably in either liquidating and distributing its assets or completing the necessary procedures to dissolve the corporation. Such a situation might result from negligence or from the desire of those in control to continue enjoying salaries or other perquisites of office from the corporation, even though it is no longer engaged in productive operations. In either event, continued delay in winding up the business and dissolving will prejudice the rights of creditors and shareholders. Whether a delay is reasonable will be determined by the reason for the delay.

§ 14.31. PROCEDURE FOR JUDICIAL DISSOLUTION

(a) Venue for a proceeding by the attorney general to dissolve a corporation lies in [name the county or counties]. Venue for a proceeding brought by any other party named in section 14.30(a) lies in the county where a corporation's principal office (or, if none in this state, its registered office) is or was last located.

(b) It is not necessary to make shareholders parties to a proceeding to dissolve a corporation unless relief is sought against them individually.

(c) A court in a proceeding brought to dissolve a corporation may issue injunctions, appoint a receiver or custodian *pendente lite* with all powers and duties the court directs, take other action required to preserve the corporate assets wherever located, and carry on the business of the corporation until a full hearing can be held.

(d) Within 10 days of the commencement of a proceeding to dissolve a corporation under section 14.30(a)(2), the corporation must send to all shareholders, other than the petitioner, a notice stating that the shareholders are entitled to avoid the dissolution of the corporation by electing to purchase the petitioner's shares under section 14.34 and accompanied by a copy of section 14.34.

CROSS-REFERENCES

Custodian or receiver, see § 14.32.

Judicial dissolution:

grounds, see § 14.30(a)(2).

purchase of shares in lieu *of,* see § 14.34.

"Principal office":

defined, see § 1.40.

designated in annual report, see § 16.21.

"Proceeding" defined, see § 1.40.

Registered office:

designated in annual report, see § 16.21.

required, see § 2.02 & 5.01.

OFFICIAL COMMENT

Section 14.31 designates the attorney general as the officer to bring suits for involuntary dissolution by the state. The county or counties where these suits must be commenced should be specified; it typically is either the state capital or the county in which the corporation's principal office is located. See the Official Comment to section 1.26. Suits brought for judicial dissolution under other subdivisions of section 14.30(a) must be brought where the corporation's principal office is located or, if not located in this state, where its registered office is or was last located. Subsection (d) specifies the contents of the notice required of corporations subject to the elective purchase procedures provided for in section 14.34.

§ 14.32. RECEIVERSHIP OR CUSTODIANSHIP

(a) Unless an election to purchase has been filed under section 14.34, a court in a judicial proceeding brought to dissolve a corporation may appoint one or more receivers to wind up and liquidate, or one or more custodians to manage, the business and affairs of the corporation. The court shall hold a hearing, after notifying all parties to the proceeding and any interested persons designated by the court, before appointing a receiver or custodian. The court appointing a receiver or custodian has jurisdiction over the corporation and all of its property wherever located.

(b) The court may appoint an individual or a domestic or foreign corporation (authorized to transact business in this state) as a receiver or custodian. The court may require the receiver or custodian to post bond, with or without sureties, in an amount the court directs.

(c) The court shall describe the powers and duties of the receiver or custodian in its appointing order, which may be amended from time to time. Among other powers:

(1) the receiver (i) may dispose of all or any part of the assets of the corporation wherever located, at a public or private sale, if authorized by the court; and (ii) may sue and defend in his or her own name as receiver of the corporation in all courts of this state;

(2) the custodian may exercise all of the powers of the corporation, through or in place of its board of directors, to the extent necessary to manage the affairs of the corporation in the best interests of its shareholders and creditors.

(d) The court during a receivership may redesignate the receiver a custodian, and during a custodianship may redesignate the custodian a receiver, if doing so is in the best interests of the corporation, its shareholders, and creditors.

(e) The court from time to time during the receivership or custodianship may order compensation paid and expenses paid or reimbursed to the receiver or custodian from the assets of the corporation or proceeds from the sale of the assets.

CROSS-REFERENCES

Appointment of receiver or custodian, see § 7.48.

Custodianship *pendente lite*, see § 14.31.

"Expenses" defined, see § 1.40.

"Notice" defined, see § 1.41.

Receivership pendente lite, see § 14.31.

OFFICIAL COMMENT

Section 14.32 preserves provisions from earlier versions of the Model Act authorizing the appointment of a receiver, and adds authority to appoint a custodian as an alternative, for a corporation in a judicial dissolution proceeding. Although the court always has discretion to appoint a receiver or custodian *pendente lite* under section 14.31 (which would be temporary), an appointment under 14.32 may not be made during the 90 day period the corporation or other shareholders are given in section 14.34 to file an election to purchase the shares of a shareholder who has commenced a proceeding seeking dissolution under section 14.30(a)(2). After that 90 day period has expired, the court may grant leave to file an election. If no such election is filed, or if the court declines to permit the filing, the court may choose to appoint a receiver or custodian under section 14.32.

In many states, general statutes or rules of court regulate the appointment of receivers or custodians and define their duties. Section 14.32 is designed to supplement these general provisions and grant the court power to take the steps it considers necessary to resolve the internal corporate problem or to effect liquidation of the corporation in an efficient manner.

§ **14.33. DECREE OF DISSOLUTION**

(a) If after a hearing the court determines that one or more grounds for judicial dissolution described in section 14.30 exist, it may enter a decree dissolving the corporation and specifying the effective date of the dissolution, and the clerk of the court shall deliver a certified copy of the decree to the secretary of state, who shall file it.

(b) After entering the decree of dissolution, the court shall direct the winding up and liquidation of the corporation's business and affairs in accordance with section 14.05 and the notification of claimants in accordance with sections 14.06 and 14.07.

CROSS-REFERENCES

Claims against a dissolved corporation, see § 14.06 & 14.07.

Custodianship, see § 14.31 & 14.32.

"Deliver' see § 1.40.

Deposit with state treasurer, see § 14.40.

Dissolution does not terminate authority of registered agent, see § 14.05. "Proceeding" defined, see § 1.40.

Receivership, see § 14.31 & 14.32.

Secretary of state's filing duties, see § 1.25.

Winding-up, see § 14.05.

OFFICIAL COMMENT

A court decree ordering that a corporation be dissolved involuntarily has the same legal effect as articles of dissolution. Section 14.33 requires that the secretary of state receive and file a copy of the decree. Thereafter the corporation's business and affairs are to be wound up as provided in sections 14.05, 14.06, and 14.07.

§ **14.34. ELECTION TO PURCHASE IN LIEU OF DISSOLUTION**

(a) In a proceeding under section 14.30(a)(2) to dissolve a corporation, the corporation may elect or, if it fails to elect, one or more shareholders may elect to purchase all shares owned by the petitioning shareholder at the fair value of the shares. An election pursuant to this section shall be irrevocable unless the court determines that it is equitable to set aside or modify the election.

(b) An election to purchase pursuant to this section may be filed with the court at any time within 90 days after the filing of the petition under section 14.30(a)(2) or at such later time as the court in its discretion may allow. If the election to purchase is filed by one or more shareholders, the corporation shall, within 10 days thereafter, give written notice to all shareholders, other than the petitioner. The notice must state the name and number of shares owned by the petitioner and the name and number of shares owned by each electing shareholder and must advise the recipients of their right to join in the election to purchase shares in accordance with this section. Shareholders who wish to participate must file notice of their intention to join in the purchase no later than 30 days after the effective date of the notice to them. All shareholders who have filed an election or notice of their intention to participate in the election to purchase thereby become parties to the proceeding and shall participate in the purchase in proportion to their ownership of shares as of the date the first election was filed, unless they otherwise agree or the court otherwise directs. After an election has been filed by the corporation or one or more shareholders, the proceeding under section 14.30(a)(2) may not be discontinued or settled, nor may the petitioning shareholder sell or otherwise dispose of his or her shares, unless the court determines that it would be equitable to the corporation and the shareholders, other than the petitioner, to permit such discontinuance, settlement, sale, or other disposition.

(c) If, within 60 days of the filing of the first election, the parties reach agreement as to the fair value and terms of purchase of the petitioner's shares, the court shall enter an order directing the purchase of petitioner's shares upon the terms and conditions agreed to by the parties.

(d) If the parties are unable to reach an agreement as provided for in subsection (c), the court, upon application of any party, shall stay the section 14.30(a)(2) proceedings and determine the fair value of the petitioner's shares as of the day before the date on which the petition under section 14.30(a) (2) was filed or as of such other date as the court deems appropriate under the circumstances.

(e) Upon determining the fair value of the shares, the court shall enter an order directing the purchase upon such terms and conditions as the court deems appropriate, which may include payment of the purchase price in installments, where necessary in the interests of equity, provision for security to assure payment of the purchase price and any additional expenses as may have been awarded, and, if the shares are to be purchased by shareholders, the allocation of shares among them. In allocating petitioner's shares among holders of different classes of shares, the court should attempt to preserve the existing distribution of voting rights among holders of different classes insofar as practicable and may direct that holders of a specific class or classes shall not participate in the purchase. Interest may be allowed at the rate and from the date determined by the court to be equitable, but if the court finds that the refusal of the petitioning shareholder to accept an offer of payment was arbitrary or otherwise not in good faith, no interest shall be allowed. If the court finds that the petitioning shareholder had probable grounds for relief under paragraphs (ii) or (iv) of section 14.30(a)(2), it may award expenses to the petitioning shareholder.

(f) Upon entry of an order under subsections (c) or (e), the court shall dismiss the petition to dissolve the corporation under section 14.30(a)(2), and the petitioning shareholder shall no longer have any rights or status as a shareholder of the corporation, except the right to receive the amounts awarded by the order of the court which shall be enforceable in the same manner as any other judgment.

(g) The purchase ordered pursuant to subsection (e) shall be made within 10 days after the date the order becomes final unless before that time the corporation files with the court a notice of its intention to adopt articles of dissolution pursuant to sections 14.02 and 14.03, which articles must then be adopted and filed within 50 days thereafter. Upon filing of such articles of dissolution, the corporation shall be dissolved in accordance with the provisions of sections 14.05 through 14.07, and the order entered pursuant to subsection (e) shall no longer be of any force or effect, except that the court may award the petitioning shareholder expenses in accordance with the provisions of the last sentence of subsection (e) and the petitioner may continue to pursue any claims previously asserted on behalf of the corporation.

(h) Any payment by the corporation pursuant to an order under subsections (c) or (e), other than an award of expenses pursuant to subsection (e), is subject to the provisions of section 6.40.

CROSS-REFERENCES

"Expenses" defined, see § 1.40.

Judicial dissolution, see § 14.30.

Notice required, see § 14.3 1(d).

OFFICIAL COMMENT

The proceeding for judicial dissolution has become an increasingly important remedy for minority shareholders of closely held corporations who believe that the value of their investment is threatened by reason of circumstances or conduct described in section 14.30(a)(2). If the petitioning shareholder proves one or more grounds under section 14.30(a)(2), he or she is entitled to some form of relief but many courts have hesitated to award dissolution, the only form of relief explicitly provided, because of its adverse effects on shareholders, employees, and others who may have an interest in the continuation of the business.

Commentators have observed that it is rarely necessary to dissolve the corporation and liquidate its assets in order to provide relief: the rights of the petitioning shareholder are fully protected by liquidating only the petitioner's interest and paying the fair value of his or her shares while permitting the remaining shareholders to continue the business. In fact, it appears that most dissolution proceedings result in a buyout of one or another of the disputants' shares either pursuant to a statutory buyout provision or a negotiated settlement. See generally Hetherington & Dooley, "Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem," 63 VA. L. REV. 1 (1977); Haynsworth, "The Effectiveness of Involuntary Dissolution Suits as a Remedy for Close Corporation Dissension' 35 CLEV. ST. L. REV. 25 (1987). Accordingly, section 14.34 affords an orderly procedure by which a dissolution proceeding under section 14.30(a)(2) can be terminated upon payment of the fair value of the petitioner's shares.

1. Availability

There are two prerequisites to filing an election to purchase under section 14.34. First, a proceeding to dissolve the corporation under section 14.30(a)(2) must have been commenced. Second, the election may be made only by the corporation or by shareholders other than the shareholder who is seeking to dissolve the corporation under section 14.30(a)(2).

2. Effect of Filing

The election to purchase is wholly voluntary, but it can be made as a matter of right within 90 days after the filing of the petition under section 14.30(a)(2). After 90 days, leave of court is required. Once an election is filed:

(i) the election is irrevocable and may not be set aside or modified (as to one or more parties) unless the court determines it is equitable to do so; and

(ii) the dissolution proceeding under section 14.30(a)(2) may not be discontinued or settled and the petitioning shareholder may not dispose of his or her shares without court approval.

These provisions are intended to reduce the risk that either the dissolution proceeding or the buyout election will be used for strategic purposes. For example, the Official Comment to section 14.30 cautions courts to distinguish between dissolution petitions predicated on "genuine abuse" and those brought for other reasons. Section 14.34 makes strategic use of section 14.30(a)(2) a high-risk proposition for the petitioning shareholder because the petitioner's shares are, in effect, subject to a "call" for 90 days after commencement of the section 14.30(a)(2) proceeding. The petitioner becomes irrevocably committed to sell these shares pursuant to section 14.34 once an election is filed and may not thereafter discontinue the dissolution proceeding or dispose of his or her shares outside of section 14.34 without permission of the court, which is specifically directed to consider whether such action would be equitable from the standpoint of the corporation and the other shareholders.

By the same token, if the corporation or the other shareholders fail to elect to purchase the petitioner's shares within the first 90 days, they run the risk that the court will decline to accept a subsequent election and will, instead, allow the dissolution proceeding to go forward. Note also that the dissolution proceeding is not affected by the mere filing of an election; it will be stayed only upon application to the court to determine the fair value of the petitioner's shares after the expiration of the

60-day negotiating period provided for in section 14.34(c).

Once an election is filed, it may be set aside or modified only for reasons that the court finds equitable. If the court sets aside the election, the corporation or the electing shareholders are released from their obligation to purchase the petitioner's shares. Under section 14.34(a), the court also has discretion to "modify" the election by releasing one or more electing shareholders without releasing the others.

3. Election by Corporation or Shareholders

Any change in the allocation of shareholdings in a closely held corporation may upset control or other arrangements that have been previously negotiated by the parties. It is therefore desirable that the purchase of petitioner's shares under section 14.34 be made in ways that are least disruptive of existing arrangements. Accordingly, an election by the corporation is given preference during the 90-day period provided for in section 14.34(b). This preference does not affect the order of filing, and any shareholder may file an election (thus triggering the provisions of subsection (b)) as soon as the dissolution proceeding is commenced. If the corporation thereafter files an election within the 90-day period, its election takes precedence over any previously filed election by shareholders. An election by the corporation after 90 days may be filed only with the court's approval and would not be entitled to the same preemptive weight. Section 14.34 does not affect an agreement between the corporation and the other shareholders to participate jointly in the purchase of the petitioner's shares.

Concern over preserving existing control arrangements makes it inadvisable to extend purchase rights to holders of shares that have only preferential rights to distributions or assets but do not have any right to vote (other than as provided by law). On the other hand, control arrangements are not disturbed if shareholders having voting rights elect to purchase nonvoting shares of a petitioning shareholder, and such elections are permitted. If the election to purchase is made by one or more shareholders, section 14.34(b) requires the corporation to notify all other shareholders of their right to join in the purchase "in proportion to their ownership of shares as of the date the first election was filed." This raises the question of whether shareholders of a class different from the class of shares owned by the petitioner may participate in the purchase. Given the wide variety of capital structures adopted by closely held corporations, it is not possible to state a general rule that would be appropriate in all cases. Any allocation that is agreed to by the electing shareholders controls regardless of whether the other terms and conditions of the purchase are set by the parties' agreement pursuant to subsection (c) or are determined by the court pursuant to subsection (e). If electing shareholders cannot agree, the court, under subsection (e), must determine an allocation.

In making this determination, the court should be guided by the desirability of preserving existing arrangements, so far as that is practicable. Accordingly, holders of shares that carry lesser voting rights than the class owned by the petitioner ordinarily should not be permitted to participate pro rata in the purchase, whereas pro rata participation normally would be appropriate for those persons who own shares of a class having voting rights equivalent to those of the class owned by the petitioner. For example, suppose the corporation's articles provide for a five-member board of directors, with three directors to be elected by Class A and two by Class B. The fact that the two classes have been given separate representation on the board of directors strongly suggests the existence of important differences in interest between them. If the petitioning shareholder owns Class B shares, an election to purchase may be filed by any holder of Class A or Class B under subsection (a), and under subsection (b) notice must be given to all other members of each class and any member of either class may file an election to join in the purchase. If no holder of Class B has elected to purchase, the petitioner's Class B shares should be allocated among the electing holders of Class A, in proportion to their holdings of Class A. If one or more holders of Class B has filed an election, however, the court should allocate all of the petitioner's shares to the electing Class B holders unless the parties otherwise agree.

Ordinarily, there is no reason to prohibit interclass purchases where the classes differ only in their economic attributes and voting control is not in issue. Accordingly, the court should permit common shareholders to participate in the purchase of the petitioner's nonvoting preferred shares unless the economic attributes of the preferred are clearly material to some other arrangement that has been worked out among the parties. This would be the case, for example, where the preferred is held by members of a family group and has dissolution rights providing for the distribution of unique assets such as real estate. In that case, it would be inappropriate to permit common shareholders to participate in the purchase of petitioner's preferred stock even though voting control of the corporation would not be affected.

4. Court Order

A. VOLUNTARY AGREEMENT

All shareholders who file an election are joined as parties pursuant to subsection (b). If the parties come to terms within the 60-day negotiating period provided for in subsection (c), their agreement will be incorporated in an order of the court and will thereafter be enforceable as such.

B. TERMS SET BY COURT

If the parties are unable to reach agreement, any or all terms of the purchase may be set by the court under subsection (d). Section 14.34 does not specify the components of "fair value," and the court may find it useful to consider valuation methods that would be relevant to a judicial appraisal of shares under section 13.30. The two proceedings are not wholly analogous, however, and the court should consider all relevant facts and circumstances of the particular case in determining fair value. For example, liquidating value may be relevant in cases of deadlock but an inappropriate measure in other cases. If the court finds that the value of the corporation has been diminished by the wrongful conduct of controlling shareholders, it would be appropriate to include as an element of fair value the petitioner's proportional claim for any compensable corporate injury. In cases where there is dissension but no evidence of wrongful conduct, "fair value" should be determined with reference to what the petitioner would likely receive in a voluntary sale of shares to a third party, taking into account the petitioner's minority status. If the parties have previously entered into a shareholders' agreement that defines or provides a method for determining the fair value of shares to be sold, the court should look to such definition or method unless the court decides it would be unjust or inequitable to do so in light of the facts and circumstances of the particular case. The valuation date is set as the day before the filing of the petition under section 14.30(a)(2), although the court may choose an earlier or later date if appropriate under the circumstances of the particular case.

It is expected that an order pursuant to subsection (e) will ordinarily provide for payment in cash, subject, in the case of any payment by the corporation, to the provisions of section 6.40. However, mindful that cash settlement may sometimes impose hardship on the purchasers, subsection (e) recognizes the court's discretion to provide for payment of the purchase price in installments, but only "where necessary in the interests of equity." In determining whether installment payments are "necessary in the interests of equity' the court should weigh any possible hardship to the purchaser against the petitioner's interest in receiving full and prompt payment of the value of his or her shares. Accordingly, before ordering payment in installments, the court should be satisfied with the purchaser's ability to meet the scheduled payments and to provide such security as the court deems necessary.

Otherwise, the contents of the order under subsection (e) are entirely subject to the court's discretion. The court may allow discovery to determine "fair value" or to decide if the petitioner is entitled to expenses under the last sentence of subsection (e) or if interest should be withheld by virtue of the second sentence of that subsection.

C. EFFECT ON PETITIONING SHAREHOLDER

The entry of an order under either subsection (c) or (e) results in a dismissal, with prejudice, of the dissolution proceeding under section 14.30(a)(2) and terminates all rights of the petitioner as a shareholder. Thus, the order also terminates all claims that the petitioner may have had in his or her capacity as a shareholder, and the value of such claims must either be asserted as part of the "fair value" of the petitioner's shares or forever lost except as provided in subsection (g). Under subsection (f), claims asserted by the petitioner in any nonshareholder capacity, such as claims for back wages or indemnification, are not affected by the entry of an order nor does the order affect any rights the petitioner may have as a creditor with respect to shares pledged as security for the purchase price. Otherwise, the order is enforceable only in the same manner as any other judgment, and the petitioner may not seek to reopen the proceedings in the event of a default.

After the entry of an order under subsections (c) or (e), the petitioner is a creditor with respect to the electing shareholders who participate in the purchase, but any payments to be made by the corporation, other than expenses awarded under subsection (e), are subject to section 6.40.

D. APPEAL AND THE VOLUNTARY DISSOLUTION ALTERNATIVE

In addition to the usual rights of appeal available to any party under the laws of the local jurisdiction, subsection (g) affords the alternative of voluntary dissolution after entry of an order under subsection (e). The purchase ordered pursuant to subsection (e) may be consummated at any time during the 10-day period after the order becomes final and must be consummated on the 10th day unless the corporation has previously filed a notice of its intention to dissolve voluntarily. Articles of dissolution must be adopted and filed within the next 50 days. An appeal of the order to purchase stays the running of both the 10- and 50-day periods until the appeal is disposed of and the order becomes final.

If the corporation elects to adopt and file articles of dissolution, it may not thereafter revoke its dissolution pursuant to section 14.04 but must proceed in accordance with the provisions of sections 14.05-14.07. If the corporation elects to dissolve, the petitioning shareholder will receive his or her pro rata share of the liquidating proceeds distributed to shareholders without reference to the "value" of the shares as determined by the court under subsection (e). By virtue of subsection (f), the petitioning shareholder would not be entitled to vote on a proposal to adopt articles of dissolution under section 14.02. Once articles of dissolution are filed, however, subsection (g) provides that the order under subsection (e) is "no longer of any force or effect." Accordingly, subsection (f) no longer applies, the petitioner resumes shareholder status and will be entitled to a pro rata share of any liquidating distribution to shareholders. To prevent use of voluntary dissolution to evade responsibilities, subsection (g) further provides that the filing of articles of dissolution does not affect either the court's award of expenses to the petitioner under subsection (e) or the petitioner's standing to pursue derivative claims on behalf of the corporation, provided that the derivative claims had been previously asserted by the petitioner in the section 14.34 proceedings or otherwise.

CHAPTER 15

Foreign Corporations

Subchapter A.
CERTIFICATE OF AUTHORITY

Subchapter B.
WITHDRAWAL OR TRANSFER OF AUTHORITY

Subchapter C.
REVOCATION OF CERTIFICATE OF AUTHORITY

Subchapter A.
CERTIFICATE OF AUTHORITY

§ 15.01. AUTHORITY TO TRANSACT BUSINESS REQUIRED

(a) A foreign corporation may not transact business in this state until it obtains a certificate of authority from the secretary of state.

(b) The following activities, among others, do not constitute transacting business within the meaning of subsection (a):

(1) maintaining, defending, or settling any proceeding;

(2) holding meetings of the board of directors or shareholders or carrying on other activities concerning internal corporate affairs;

(3) maintaining bank accounts;

(4) maintaining offices or agencies for the transfer, exchange, and registration of the corporation's own securities or maintaining trustees or depositaries with respect to those securities;

(5) selling through independent contractors;

(6) soliciting or obtaining orders, whether by mail or through employees or agents or otherwise, if the orders require acceptance outside this state before they become contracts;

(7) creating or acquiring indebtedness, mortgages, and security interests in real or personal property;

(8) securing or collecting debts or enforcing mortgages and security interests in property securing the debts;

(9) owning, without more, real or personal property;

(10) conducting an isolated transaction that is completed within 30 days and that is not one in the course of repeated transactions of a like nature; or

(11) transacting business in interstate commerce.

(c) The list of activities in subsection (b) is not exhaustive.

CROSS-REFERENCES

Application of Act to existing qualified foreign corporation, see § 17.02.
Certificate of authority, see § 15.03.

“Foreign corporation” defined, see § 1.40.
Meetings of board of directors, see § 8.20.
Penalty for transacting business without authority, see § 15.02.
“Proceeding” defined, see § 1.40.
Shareholders’ meetings, see §§ 7.01–7.03.

OFFICIAL COMMENT

A state may prescribe the terms and conditions upon which a foreign corporation is permitted to transact business within the state, subject, of course, to the restrictions of the United States Constitution. Chapter 15 requires that a foreign corporation seeking to transact business within the state must (1) obtain a certificate of authority from the secretary of state and (2) maintain a registered office and appoint a registered agent within the state.

Section 15.01(a) states the basic requirement that a foreign corporation must obtain a certificate of authority before it transacts business within the state. Section 15.05 describes the scope of the privilege obtained by a certificate of authority while section 15.02 describes the consequences of transacting business in the state without first obtaining the certificate of authority.

The Model Act does not attempt to formulate an inclusive definition of what constitutes the transaction of business. Rather, the concept is defined in a negative fashion by section 15.01(b), which states that certain activities do not constitute the transaction of business. In general terms, any conduct more regular, systematic, or extensive than that described in section 15.01(b) constitutes the transaction of business and requires the corporation to obtain a certificate of authority. Typical conduct requiring a certificate of authority includes maintaining an office to conduct local intrastate business, selling personal property not in interstate commerce, entering into contracts relating to the local business or sales, and owning or using real estate for general corporate purposes. But the passive owning of real estate for investment purposes does not constitute transacting business. See section 15.01(b)(9).

The test of “transacting business” defined in a negative way in section 15.01(b) applies only to the question whether the corporation’s contacts with the state are such that it must obtain a certificate of authority. It is not applicable to other questions such as whether the corporation is amenable to service of process under state “long-arm” statutes or liable for state or local taxes. A corporation that has obtained (or is required to obtain) a certificate of authority to transact business under chapter 15 will generally be subject to suit and state taxation in the state, while a corporation that is subject to service of process or state taxation in a state will not necessarily be required to obtain a certificate of authority under chapter 15.

The list of activities set forth in section 15.01(b) is not exhaustive. See section 15.01(c). The list excludes several different types of activities from the definition of “transacting business,” which are discussed below.

1. Engaging in Litigation

Section 15.01(b)(1) excludes “maintaining, defending or settling any proceeding.” The word “proceeding” is defined in section 1.40 to include all civil suits and criminal, administrative, or investigative actions. Thus, a corporation is not "transacting business" solely because it resorts to the courts of the state to recover an indebtedness, enforce an obligation, recover possession of personal property, obtain the appointment of a receiver, intervene in a pending proceeding, bring a petition to compel arbitration, file an appeal bond, or pursue appellate remedies. Similarly, a foreign corporation is not required to obtain a certificate of authority merely because it files a complaint with the state securities commission or other governmental agency or participates in an administrative proceeding within the state.

2. Internal Affairs of the Corporation

A corporation does not "transact business" within a state under section 15.01 merely because some of its internal affairs occur within a state. Thus, a corporation may hold meetings of its board of directors or shareholders within a state without first obtaining a certificate of authority (section 15.01(b)(2)). It also may maintain offices or agencies within a state relating solely to the transfer, exchange or registration of its shares without obtaining a certificate of authority (section 15.01(b)(4)). Other activities relating to the internal affairs of the corporation that do not constitute the transaction of business under section 15.01(b) include having officers or representatives of a corporation who reside within or are physically present in the state; while there, the officers or representatives may make executive decisions relating to the internal affairs of the corporation without imposing on the corporation the requirement that it obtain a certificate of authority in the state, provided these activities are not so regular and systematic as to cause the residence to be viewed as a business office.

3. Maintaining Bank Accounts

A foreign corporation may maintain a bank account with a bank within the state, make deposits and write checks on the account without obtaining a certificate of authority (section 15.01(b)(3)).

4. Interstate Transactions

A corporation is not "transacting business" within the meaning of section 15.01(a) if it is transacting business in interstate commerce (section 15.01(b)(11)) or soliciting or obtaining orders that must be accepted outside the state before they become contracts (section 15.01(b)(6)). These limitations reflect the provisions of the United States Constitution that grant to the United States Congress exclusive power over interstate commerce, and preclude states from imposing restrictions or conditions upon this commerce. These sections should be construed in a manner consistent with judicial decisions under the United States Constitution. Under these decisions, a foreign corporation is not required to obtain a certificate of authority even though it sells goods within the state if they are shipped to the purchasers in interstate commerce. A corporation need not obtain a certificate of authority even if it also does work and performs acts within the state incidental to the interstate business, e.g., if it takes or enforces a security interest incidental to these transactions. Nor is it required to obtain a certificate of authority merely because it sends traveling salesmen or solicitors into a state so long as contracts are not made within the state. Similarly, an office may be maintained by a corporation in a state without obtaining a certificate of authority if the office's functions relate solely to interstate commerce.

Purchases of goods may of course be in interstate commerce as readily as sales. Thus, the purchase of personal property by a foreign corporation for shipment in interstate commerce out of the state does not require the corporation to obtain a certificate of authority.

5. Sales through Independent Contractors

A foreign corporation does not need to obtain a certificate of authority if it sells goods in the state through independent contractors (section 15.01(b)(5)). These transactions are viewed as transactions by the independent contractors, not by the corporation itself even though the corporation sets some limits or ground rules for its contractors. If these controls are sufficiently pervasive, however, the corporation may be deemed to be selling for itself in intrastate commerce, and not through the independent contractors and therefore engaged in the transaction of business in the state.

6. Creating, Acquiring, or Collecting Debts

The mere act of making a loan by a foreign corporation that is not in the business of making loans does not constitute transacting business in the state in which the loan is made. On the same theory a foreign corporation may obtain security for the repayment of a loan, and foreclose or enforce the lien or security interest to collect the loan, without being deemed to be transacting business. See section 15.01(b)(7) and (8). Similarly, a refunding or "roll over" of a loan or its adjustment or compromise does not involve the transaction of business.

7. Isolated Transactions

The concept of "transacting business" involves regular, repeated, and continuing business contacts of a local nature. A single agreement or isolated transaction within a state does not constitute the transaction of business if there is no intention to repeat the transaction or engage in similar transactions. Since the question is entirely one of fact, section 15.01(b)(10) retains the partially objective test from earlier versions of the Model Act that a transaction completed within 30 days does not constitute "transacting business" if it is not one in the course of "repeated transactions of a like nature." A continuing transaction that is not completed within 30 days will likely require obtaining a certificate of authority, whether or not it is one of a number of repeated transactions, but that issue is not addressed by the Model Act. The 30-day provision is, in other words, a "safe harbor" for not requiring a certificate of authority.

8. Other Transactions

Section 15.01(c) makes clear that the list of transactions in section 15.01(b) is not exhaustive. Among the large number of other transactions which do not give rise to the requirement that a certificate of authority be obtained are the ownership of all the shares of stock in a corporation that is engaged in local business within the state or as a limited partner in a limited partnership engaged in local business, or taking ministerial actions such as filing financing statements or registering trademarks.

§ 15.02. CONSEQUENCES OF TRANSACTING BUSINESS WITHOUT AUTHORITY

(a) A foreign corporation transacting business in this state without a certificate of authority may not maintain a proceeding in any court in this state until it obtains a certificate of authority.

(b) The successor to a foreign corporation that transacted business in this state without a certificate of authority and the assignee of a cause of action arising out of that business may not maintain a proceeding based on that cause of action in any court in this state until the foreign corporation or its successor obtains a certificate of authority.

(c) A court may stay a proceeding commenced by a foreign corporation, its successor, or assignee until it determines whether the foreign corporation or its successor requires a certificate of authority. If it so determines, the court may further stay the proceeding until the foreign corporation or its successor obtains the certificate.

(d) A foreign corporation is liable for a civil penalty of $______ for each day, but not to exceed a total of $______ for each year, it transacts business in this state without a certificate of authority. The attorney general may collect all penalties due under this subsection.

(e) Notwithstanding subsections (a) and (b), the failure of a foreign corporation to obtain a certificate of authority does not impair the validity of its corporate acts or prevent it from defending any proceeding in this state.

CROSS-REFERENCES

Certificate of authority, see § 15.03.
"Foreign corporation" defined, see § 1.40.
"Proceeding" defined, see § 1.40.
Transacting business, see § 15.01.

OFFICIAL COMMENT

The purpose of section 15.02 is to induce corporations that are required to obtain a certificate of authority but have not to qualify promptly, without imposing harsh or erratic sanctions. The Model Act rejects the provisions adopted in a few states that make unenforceable intrastate transactions by unqualified corporations or that impose punitive sanctions or forfeitures on nonqualifying corporations. Often the failure to qualify is a result of inadvertence or bona fide disagreement as to the scope of the provisions of section 15.01, which are necessarily imprecise; the imposition of harsh sanctions in these situations is inappropriate. Further, as a matter of state policy it is generally preferable to encourage qualification in case of doubt rather than to impose severe sanctions that may cause corporations to resist obtaining a certificate of authority in doubtful situations.

Section 15.02 closes the courts of the state to suits maintained by corporations which should have but which have not obtained a certificate of authority. However, this sanction is not a punitive one: section 15.02(e) states that the failure of the corporation to qualify does not affect the validity of corporate acts, including contracts. Thus, a contract made by a nonqualified corporation may be enforced by the corporation simply by obtaining a certificate. Further, section 15.02(c) authorizes a court to stay a proceeding to determine whether a corporation should have qualified to transact business and, if it concludes that qualification is necessary, it may grant a further stay to permit the corporation to do so. Thus, the corporation will not be compelled to refile a suit if the corporation qualifies to transact business within a reasonable period. The purpose of these provisions is to encourage corporations to obtain certificates of authority and to eliminate the temptation to raise section 15.02 defenses only after applicable statutes of limitation have run.

Section 15.02(e) does not prevent a foreign corporation that has failed to obtain a certificate of authority from "defending any proceeding." The distinction between "maintaining" a proceeding under section 15.02(a) and "defending any proceeding" under section 15.02(e) is determined on the basis of whether affirmative relief is sought. A nonqualified corporation may interpose any defense or permissive or mandatory counterclaim to defeat a claimed recovery, but may not obtain an affirmative judgment or decree based on the counterclaim unless it has obtained a certificate of authority.

In addition to closing the courts of the state to a nonqualified foreign corporation, many states impose a penalty equal to all fees and franchise taxes that the foreign corporation would have been liable for if it had qualified to transact business when it was first required to do so. This penalty is usually defined to equal the sum of fees and franchise taxes for each year or part thereof the corporation transacted business in the state without a certificate of authority. Similar provisions appeared in earlier versions of the Model Act, but were modified in the present revision in favor of a specific dollar amount (which each state adopting the revised Model Act should insert in section 15.02(d)) for each day and year the foreign corporation fails to qualify. The revised Model Act does not treat liability for taxes.

Section 15.02(b) prevents evasion of section 15.02(a) by an assignment of a claim on which the foreign corporation is barred from bringing suit under section 15.02(a). If the successor has acquired assets of the foreign corporation in a transaction requiring approval by the foreign corporation's shareholders, the successor may maintain suit after it has qualified. In the case of all other assignments, the foreign corporation itself must obtain a certificate of authority before the assignees may maintain suit on the claim. See sections 12.01 and 12.02.

§ 15.03. APPLICATION FOR CERTIFICATE OF AUTHORITY

(a) A foreign corporation may apply for a certificate of authority to transact business in this state by delivering an application to the secretary of state for filing. The application must set forth:

(1) the name of the foreign corporation or, if its name is unavailable for use in this state, a corporate name that satisfies the requirements of section 15.06;

(2) the name of the state or country under whose law it is incorporated;

(3) its date of incorporation and period of duration;

(4) the street address of its principal office;

(5) the address of its registered office in this state and the name of its registered agent at that office; and

(6) the names and usual business addresses of its current directors and officers.

(b) The foreign corporation shall deliver with the completed application a certificate of existence (or a document of similar import) duly authenticated by the secretary of state or other official having custody of corporate records in the state or country under whose law it is incorporated.

CROSS-REFERENCES

Amended certificate of authority, see § 15.04.
Annual report to secretary of state, see § 16.21.
Application of Act to existing qualified foreign corporation, see § 17.02.
Certificate of existence, see § 1.28.
Corporate name, see § 15.06, ch. 4.
"Deliver," see § 1.40.
Duration, see § 3.02.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.
Forms, see § 1.21.
"Principal office":
  defined, see § 1.40.
  designated in annual report, see § 16.21.
Registered office and agent, see §§ 2.02, 5.01, 15.07.

OFFICIAL COMMENT

1. Disclosure Requirements in General

Section 15.03 provides that a foreign corporation seeking a certificate of authority to transact business in the state must file an application that contains the information set forth in this section. These disclosure requirements are supplemented by the requirements of other sections in this chapter—15.04, 15.06, and 15.07—which require amended or supplemental filings in certain circumstances, and by section 16.21, which requires every qualified foreign corporation to file annual reports containing specified information. Generally, the revised Model Act eliminates repetitious filings, so that information need be submitted to the secretary of state in only one document.

The purposes of these disclosure requirements are: (1) to ensure that citizens of the state have adequate information about foreign corporations in their transactions with them; (2) to put them in a status of equality with domestic corporations with respect to information required to be furnished; (3) to facilitate their subjection to the jurisdiction of the state's courts, thereby removing any disadvantage citizens of the state may have when dealing with them; and (4) to provide readily accessible evidence of their existence. Other statutes relating to franchise taxes and regulatory matters may require a qualified foreign corporation to provide additional information.

2. The Application for a Certificate of Authority

The information required to be included in the application for a certificate of authority by section 15.03 is the minimum needed to administer the filing requirements of the Model Act. The application must also be accompanied by a certificate of existence and the filing fee required by section 1.22. A corporation that qualifies to transact business in a state must comply with the requirements of other statutes, including franchise tax and similar statutes. See section 15.05.

§ 15.04. AMENDED CERTIFICATE OF AUTHORITY

(a) A foreign corporation authorized to transact business in this state must obtain an amended certificate of authority from the secretary of state if it changes:

(1) its corporate name;

(2) the period of its duration; or

(3) the state or country of its incorporation.

(b) The requirements of section 15.03 for obtaining an original certificate of authority apply to obtaining an amended certificate under this section.

CROSS-REFERENCES

Annual report, see § 16.21.
Certificate of authority, see § 15.03.
Change of registered office or agent, see § 15.08.
Corporate name, see § 15.06, ch. 4.
Duration, see § 3.02.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.
Forms, see § 1.21.
Resignation of registered agent, see § 15.09.

OFFICIAL COMMENT

Section 15.04 requires a foreign corporation to obtain an amended certificate of authority if it changes its corporate name, its duration, or the state or country of its incorporation. An amendment is not necessary to reflect changes in its principal office address or in its current officers or directors since that information is supplied in the annual report. In addition, section 15.07 requires an immediate filing if the foreign corporation changes its registered office or registered agent within the state.

Other fundamental changes by a foreign corporation do not require amendments to the certificate of authority. The secretary of state will be advised of most of these changes through the annual report. See section 16.21. Thus, a person seeking to obtain current information about a foreign corporation should examine the annual reports of the corporation as well as the application for certificate of authority and amendments to it. This procedure of requiring most changes to be reported in the annual reports rather than as amendments to the certificate of authority should eliminate many unnecessary filings with the secretary of state without reducing the information available through the secretary of state's office.

§ 15.05. EFFECT OF CERTIFICATE OF AUTHORITY

(a) A certificate of authority authorizes the foreign corporation to which it is issued to transact business in this state subject, however, to the right of the state to revoke the certificate as provided in this Act.

(b) A foreign corporation with a valid certificate of authority has the same but no greater rights and has the same but no greater privileges as, and except as otherwise provided by this Act is subject to the same duties, restrictions, penalties, and liabilities now or later imposed on, a domestic corporation of like character.

(c) This Act does not authorize this state to regulate the organization or internal affairs of a foreign corporation authorized to transact business in this state.

CROSS-REFERENCES

Corporate powers, see § 3.02.
Corporate purposes, see § 3.01.
Revocation of certificate of authority, see §§ 15.30–15.32.
Withdrawal of foreign corporations, see § 15.20.

OFFICIAL COMMENT

A certificate of authority authorizes a foreign corporation to transact business in the state subject to the right of the state to revoke the certificate. The privileges of this status are defined in section 15.05(b): a qualified foreign corporation has the same (but no greater) privileges as a domestic corporation.

Section 15.05(b), by granting to qualified foreign corporations all of the rights and privileges enjoyed by a domestic corporation, avoids discrimination that might otherwise be subject to constitutional challenge. On the other hand, section 15.05(b) also contains a restriction or limitation: a qualified foreign corporation is subject to the same restrictions as a domestic corporation, including the same duties, penalties, and liabilities. This latter aspect of section 15.05(b) has declined in importance as states have eliminated unnecessary or outdated restrictions on domestic corporations and, as a consequence of section 15.05(b), on qualified foreign corporations as well. In particular, section 15.05(b) makes section 3.01 (corporate purposes) applicable to a qualified foreign corporation, and grants substantially the same powers to it as are possessed by a domestic corporation.

Section 15.05(c) preserves the judicially developed doctrine that internal corporate affairs are governed by the state of incorporation even when the corporation's business and assets are located primarily in other states.

§ 15.06. CORPORATE NAME OF FOREIGN CORPORATION

(a) If the corporate name of a foreign corporation does not satisfy the requirements of section 4.01, the foreign corporation to obtain or maintain a certificate of authority to transact business in this state:

(1) may add to its corporate name for use in this state the word "corporation," "incorporated," "company," or "limited," or the abbreviation "corp.," "inc.," "co.," or "ltd.,"; or

(2) may use a fictitious name to transact business in this state if its real name is unavailable and it delivers to the secretary of state for filing a copy of the resolution of its board of directors, certified by its secretary, adopting the fictitious name.

(b) Except as authorized by subsections (c) and (d), the corporate name (including a fictitious name) of a foreign corporation must be distinguishable upon the records of the secretary of state from:

(1) the corporate name of a corporation incorporated or authorized to transact business in this state;

(2) a corporate name reserved or registered under section 4.02 or 4.03;

(3) the fictitious name of another foreign corporation authorized to transact business in this state; and

(4) the corporate name of a not-for-profit corporation incorporated or authorized to transact business in this state.

(c) A foreign corporation may apply to the secretary of state for authorization to use in this state the name of another corporation (incorporated or authorized to transact business in this state) that is not distinguishable upon the secretary of state's records from the name applied for. The secretary of state shall authorize use of the name applied for if:

(1) the other corporation consents to the use in writing and delivers an undertaking in form satisfactory to the secretary of state to change its name to a name that is distinguishable upon the records of the secretary of state from the name of the applying corporation; or

(2) the applicant delivers to the secretary of state a certified copy of a final judgment of a court of competent jurisdiction establishing the applicant's right to use the name applied for in this state.

(d) A foreign corporation may use in this state the name (including the fictitious name) of another domestic or foreign corporation that is used in this state if the other corporation is incorporated or authorized to transact business in this state and the foreign corporation:

(1) has merged with the other corporation;

(2) has been formed by reorganization of the other corporation; or

(3) has acquired all or substantially all of the assets, including the corporate name, of the other corporation.

(e) If a foreign corporation authorized to transact business in this state changes its corporate name to one that does not satisfy the requirements of section 4.01, it may not transact business in this state under the changed name until it adopts a name satisfying the requirements of section 4.01 and obtains an amended certificate of authority under section 15.04.

CROSS-REFERENCES

Amended certificate of authority, see § 15.04.
Corporate names generally, see ch. 4.
"Deliver," see § 1.40.
Effective time and date of filing, see § 1.23.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.
Forms, see § 1.21.
Registered name, see § 4.03.
Reserved name, see § 4.02.

OFFICIAL COMMENT

The purpose of section 15.06, like that of section 4.01 relating to the name of a domestic corporation, is to ensure that names are distinguishable from one another upon the records of the secretary of state. Like section 4.01, it does not impose upon the secretary of state the responsibility of deciding issues of unfair competition or commercial similarity of names.

A foreign corporation applying for a certificate of authority must apply under its true corporate name if that name qualifies under section 15.06(a) or (c). If the true corporate name qualifies except that it does not contain one of the words of corporate status set forth in section 15.06(a), the corporation may simply add one of those words to its true corporate name and apply under that name as modified. See section 15.06(a)(1). If the true corporate name is unavailable because it is indistinguishable upon the records of the secretary of state from a name already in use or reserved, the corporation may use a fictitious name (if available) under section 15.06(a)(2) simply by delivering to the secretary of state for filing, together with its application for a certificate of authority, a certified copy of a resolution of its board of directors authorizing the use of the fictitious name in the state. Finally, the otherwise unavailable name of a foreign corporation may be augmented by the name of the state of its incorporation so as to make it distinguishable upon the records of the secretary of state. For example, a Delaware corporation, "Utopian Products, Inc.' which finds that a domestic corporation is using that name, may qualify under the name "Utopian Products, Inc. (Delaware)."

A corporation that qualifies to transact business in the state may do business under a fictitious name to the same extent as a domestic corporation. The name requirements of section 15.06, including the fictitious name of a corporation whose real name is unavailable, are designed to ensure that each corporation qualified to transact business in this state has a unique official name. For a fuller description of the policies underlying section 15.06, see the Official Comment to section 4.01.

If a foreign corporation changes its name it may file an amended certificate of authority under its new name or, if the new name is not available, it may either (1) continue to conduct business under its former name as an assumed name, or (2) adopt a new assumed name, by filing a certified resolution of its board of directors authorizing it to do so.

§ 15.07. REGISTERED OFFICE AND REGISTERED AGENT OF FOREIGN CORPORATION

Each foreign corporation authorized to transact business in this state must continuously maintain in this state:

(1) a registered office that may be the same as any of its places of business; and

(2) a registered agent, who may be:

(i) an individual who resides in this state and whose business office is identical with the registered office;

(ii) a domestic corporation or not-for-profit domestic corporation whose business office is identical with the registered office; or

(iii) a foreign corporation or foreign not-for-profit corporation authorized to transact business in this state whose business office is identical with the registered office.

CROSS-REFERENCES

Changing registered office or agent, see § 15.08.
Registered office and agent generally, see ch. 5.
Resignation of registered agent, see § 15.09.
Revocation of certificate of authority does not affect authority of registered agent, see § 15.31.
Revocation of certificate of authority for failure to appoint and maintain registered office and agent, see § 15.30.
Service on foreign corporation, see §§ 15.10, 15.20, 15.31.

OFFICIAL COMMENT

A foreign corporation that obtains a certificate of authority in a state thereby agrees that it is amenable to suit in the state. Section 15.07 requires every such corporation continuously to maintain a registered office and registered agent within the state upon whom service of process may be made. As is the case with a domestic corporation, the registered office may, but need not be, a business office of the foreign corporation.

Section 15.07 is patterned after section 5.01, relating to the registered office and registered agent of a domestic corporation. For a fuller description of the policies underlying section 15.07, see the Official Comment to section 5.01.

§ 15.08. CHANGE OF REGISTERED OFFICE OR REGISTERED AGENT OF FOREIGN CORPORATION

(a) A foreign corporation authorized to transact business in this state may change its registered office or registered agent by delivering to the secretary of state for filing a statement of change that sets forth:

(1) its name;

(2) the street address of its current registered office;

(3) if the current registered office is to be changed, the street address of its new registered office;

(4) the name of its current registered agent;

(5) if the current registered agent is to be changed, the name of its new registered agent and the new agent's written consent (either on the statement or attached to it) to the appointment; and

(6) that after the change or changes are made, the street addresses of its registered office and the business office of its registered agent will be identical.

(b) If a registered agent changes the street address of his or her business office, the agent may change the street address of the registered office of any foreign corporation for which he or she is the registered agent by notifying the corporation in writing of the change and signing (either manually or in facsimile) and delivering to the secretary of state for filing a statement of change that complies with the requirements of subsection (a) and recites that the corporation has been notified of the change.

CROSS-REFERENCES

"Deliver," see § 1.40.
Effective date of notice, see § 1.41.
Effective time and date of filing, see § 1.23.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.
Notice to corporation, see § 1.41.

Resignation of registered agent, see § 15.09.
Revocation of certificate of authority for failure to file notice of change of registered office or agent, see § 15.30.

OFFICIAL COMMENT

A foreign corporation that changes its registered agent or registered office, or both, must file a statement with the secretary of state containing the information set forth in section 15.08(a). A registered agent, typically a corporation service company, that changes the street address of its business office (and thereby the street address of the registered office of all corporations for which it serves as registered agent) may notify the secretary of state by complying with section 15.08(b) rather than with section 15.08(a).

This section is patterned after section 5.02, relating to changes of registered office or registered agent of a domestic corporation. For a fuller description of the policies underlying section 15.08, see the Official Comment to section 5.02.

§ 15.09. RESIGNATION OF REGISTERED AGENT OF FOREIGN CORPORATION

(a) The registered agent of a foreign corporation may resign the agency appointment by signing and delivering to the secretary of state for filing the signed original and two exact or conformed copies of a statement of resignation. The statement of resignation may include a statement that the registered office is also discontinued.

(b) After filing the statement, the secretary of state shall attach the filing receipt to one copy and mail the copy and receipt to the registered office if not discontinued. The secretary of state shall mail the other copy to the foreign corporation at its principal office address shown in its most recent annual report.

(c) The agency appointment is terminated, and the registered office discontinued if so provided, on the 31st day after the date on which the statement was filed.

CROSS-REFERENCES

Annual report, see § 16.21.
Change of registered agent, see § 15.08.
"Deliver," see § 1.40.
Effective time and date of filing, see § 1.23.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.
"Principal office":
defined, see § 1.40.
designated in annual report, see § 16.21.

OFFICIAL COMMENT

Section 15.09 permits the registered agent of a foreign corporation to resign by following the procedure set forth in the section, which is designed to maximize the probabilities that the corporation is advised of the resignation of the agent. This section is principally used by compensated registered agents who are corporation service companies and who desire to resign as registered agent as a result of nonpayment of fees. Section 15.09 is patterned after section 5.03, relating to the resignation of a registered agent of a domestic corporation. For a fuller description of the policies underlying section 15.09, see the Official Comment to section 5.03.

§ 15.10. SERVICE ON FOREIGN CORPORATION

(a) The registered agent of a foreign corporation authorized to transact business in this state is the corporation's agent for service of process, notice, or demand required or permitted by law to be served on the foreign corporation.

(b) A foreign corporation may be served by registered or certified mail, return receipt requested, addressed to the secretary of the foreign corporation at its principal office shown in its application for a certificate of authority or in its most recent annual report if the foreign corporation:

(1) has no registered agent or its registered agent cannot with reasonable diligence be served;

(2) has withdrawn from transacting business in this state under section 15.20; or

(3) has had its certificate of authority revoked under section 15.31.

(c) Service is perfected under subsection (b) at the earliest of:

(1) the date the foreign corporation receives the mail;

(2) the date shown on the return receipt, if signed on behalf of the foreign corporation; or

(3) five days after its deposit in the United States mail, as evidenced by the postmark, if mailed postpaid and correctly addressed.

(d) This section does not prescribe the only means, or necessarily the required means, of serving a foreign corporation.

CROSS-REFERENCES

Annual report, see § 16.21.
Application for certificate of authority, see § 15.03.
"Notice" defined, see § 1.40.
"Principal office":
defined, see § 1.40.
designated in annual report, see § 16.21.
Revocation of certificate of authority does not revoke authority of registered agent, see § 15.31.
"Secretary" defined, see § 1.40.

Service of process fees, see § 1.22.
Service on foreign corporation with revoked certificate of authority, see § 15.31.
Service on withdrawn foreign corporation, see § 15.20.

OFFICIAL COMMENT

Service on the registered agent is the typical method of service of process on a qualified foreign corporation. Section 15.10(a). But if the corporation does not have a registered agent, or if the agent cannot be found at the registered office, section 15.10(b) authorizes service on the secretary of the corporation at its principal office as shown in its certificate of authority or most recent annual report. Service may be effected in the same way on a corporation which has withdrawn from the state or whose certificate of authority has been revoked. Section 15.10(c) establishes the date on which service is effective under section 15.10(b), while section 15.10(d) makes clear that the method of service provided by this section does not preclude the use of other means of effecting service of process. Service of process may also be effected, for example, under a "long-arm" statute or under other special statutes authorizing service in some other manner.

Section 15.10 is patterned after section 5.04, relating to service of process on domestic corporations. For a fuller description of the policies underlying section 15.10, see the Official Comment to section 5.04.

Subchapter B.
WITHDRAWAL OR TRANSFER OF AUTHORITY

§ 15.20. WITHDRAWAL OF FOREIGN CORPORATION

(a) A foreign corporation authorized to transact business in this state may not withdraw from this state until it obtains a certificate of withdrawal from the secretary of state.

(b) A foreign corporation authorized to transact business in this state may apply for a certificate of withdrawal by delivering an application to the secretary of state for filing. The application must set forth:

(1) the name of the foreign corporation and the name of the state or country under whose law it is incorporated;

(2) that it is not transacting business in this state and that it surrenders its authority to transact business in this state;

(3) that it revokes the authority of its registered agent to accept service on its behalf and appoints the secretary of state as its agent for service of process in any proceeding based on a cause of action arising during the time it was authorized to transact business in this state;

(4) a mailing address to which the secretary of state may mail a copy of any process served on the secretary of state under subdivision (3); and

(5) a commitment to notify the secretary of state in the future of any change in its mailing address.

(c) After the withdrawal of the corporation is effective, service of process on the secretary of state under this section is service on the foreign corporation. Upon receipt of process, the secretary of state shall mail a copy of the process to the foreign corporation at the mailing address set forth under subsection (b).

CROSS-REFERENCES

"Deliver," see § 1.40.
Effective time and date of filing, see § 1.23.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.
Forms, see § 1.21.
Registered agent, see § 15.07.
Service of process fees, see § 1.22.
Service of process on foreign corporation, see § 15.10.
Transacting business, see § 15.01.

OFFICIAL COMMENT

A foreign corporation that ceases to transact business within a state may withdraw from the state only by obtaining a certificate of withdrawal. A foreign corporation that ceases to transact business in the state but fails to obtain a certificate of withdrawal will continue to be (1) subject to service of process on its registered agent or on its secretary pursuant to section 15.10 and (2) liable for franchise and other taxes under other statutes.

The certificate of withdrawal provided by this section is recognition by the state that the foreign corporation has ceased to transact business in the state.

The application for certificate of withdrawal must appoint the secretary of state as the withdrawing corporation's agent for service of process in any proceeding based on a cause of action which arose during the time it was authorized to transact business in the state. The application must also set forth a mailing address to which the secretary of state may forward any process received, and the corporation must agree to notify the secretary of state of any change in that address. There is no time limit on the obligation to advise the secretary of state of changes of mailing address. To ensure that the appointment of the secretary of state is unqualified and meets the precise requirements of this section, the secretary of state may require that an application for certificate of withdrawal be on a prescribed form. See section 1.21.

Service of process on the secretary of state pursuant to the statements in the application for certificate of withdrawal effects service on the corporation under section 15.20(c). The secretary of state must then mail the process to the corporation at the mailing address specified in the application or in a subsequent communication advising of a change in mailing address.

§ 15.21. AUTOMATIC WITHDRAWAL UPON CERTAIN CONVERSIONS

A foreign corporation authorized to transact business in this state that converts to a domestic nonprofit corporation or any form of domestic filing entity shall be deemed to have withdrawn on the effective date of the conversion.

CROSS-REFERENCES

"Domestic nonprofit corporation" defined, see § 1.40.
"Filing entity" defined, see § 1.40.
"Foreign corporation" defined, see § 1.40.

OFFICIAL COMMENT

The procedures by which a foreign corporation may convert to a domestic nonprofit corporation or a domestic filing entity are outside the scope of this Act. The purpose of this section is simply to coordinate the foreign corporation provisions of this act with those other procedures.

States that authorize a foreign business corporation to convert to a domestic nonprofit corporation or a domestic filing entity may wish to include the rule of this section in the statute or statutes providing for those conversions and, in that event, this section may be omitted.

§ 15.22. WITHDRAWAL UPON CONVERSION TO A NONFILING ENTITY

(a) A foreign corporation authorized to transact business in this state that converts to a domestic or foreign nonfiling entity shall apply for a certificate of withdrawal by delivering an application to the secretary of state for filing. The application must set forth:

(1) the name of the foreign corporation and the name of the state or country under whose law it was incorporated before the conversion;

(2) that it surrenders its authority to transact business in this state as a foreign corporation;

(3) the type of unincorporated entity to which it has been converted and the jurisdiction whose laws govern its internal affairs;

(4) if it has been converted to a foreign unincorporated entity:

(i) that it revokes the authority of its registered agent to accept service on its behalf and appoints the secretary of state as its agent for service of process in any proceeding based on a cause of action arising during the time it was authorized to transact business in this state;

(ii) a mailing address to which the secretary of state may mail a copy of any process served on the secretary of state under paragraph (i); and

(iii) a commitment to notify the secretary of state in the future of any change in its mailing address.

(b) After the withdrawal under this section of a corporation that has converted to a foreign unincorporated entity is effective, service of process on the secretary of state is service on the foreign unincorporated entity. Upon receipt of process, the secretary of state shall mail a copy of the process to the foreign unincorporated entity at the mailing address set forth under subsection (a)(4).

(c) After the withdrawal under this section of a corporation that has converted to a domestic unincorporated entity is effective, service of process shall be made on the unincorporated entity in accordance with the regular procedures for service of process on the form of unincorporated entity to which the corporation was converted.

CROSS-REFERENCES

“Domestic unincorporated entity” defined, see § 1.40.
Effective time and date of filing, see § 1.23.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.
“Foreign corporation” defined, see § 1.40.
“Foreign unincorporated entity” defined, see § 1.40.

Forms, see § 1.21.
Nonfiling entity" defined, see § 1.40.
Unincorporated entity" defined, see § 1.40.

OFFICIAL COMMENT

The procedures by which a foreign corporation may convert to a domestic or foreign nonfiling entity are outside the scope of this Act.

In the case of a conversion of a foreign corporation to a domestic nonprofit corporation or a domestic filing entity, a filing with the secretary of state will be necessary to effectuate the conversion, and thus it is possible for section 15.21 to provide that the previous filing by the converting entity as a foreign corporation will be cancelled automatically. In the case of a conversion that is the subject of this section, however, a filing with the secretary of state is not necessary to effectuate the conversion. Thus, absent the procedures in this section, there would be no document of public record indicating that the conversion has occurred and the converted entity would incorrectly continue to appear in the public records as a foreign corporation.

§ 15.23. TRANSFER OF AUTHORITY

(a) A foreign business corporation authorized to transact business in this state that converts to a foreign nonprofit corporation or to any form of foreign unincorporated entity that is required to obtain a certificate of authority or make a similar type of filing with the secretary of state if it transacts business in this state shall file with the secretary of state an application for transfer of authority executed by any officer or other duly authorized representative. The application shall set forth:

(1) the name of the corporation;

(2) the type of unincorporated entity to which it has been converted and the jurisdiction whose laws govern its internal affairs; and

(3) any other information that would be required in a filing under the laws of this state by an unincorporated entity of the type the corporation has become seeking authority to transact business in this state.

(b) The application for transfer of authority shall be delivered to the secretary of state for filing and shall take effect at the effective time provided in section 1.23.

(c) Upon the effectiveness of the application for transfer of authority, the authority of the corporation under this chapter to transact business in this state shall be transferred without interruption to the converted entity which shall thereafter hold such authority subject to the provisions of the laws of this state applicable to that type of unincorporated entity.

CROSS-REFERENCES

"Deliver" defined, see § 1.40.

Filing fees, see § 1.22.
Filing requirements, see § 1.20.
"Foreign corporation" defined, see § 1.40.
"Foreign nonprofit corporation" defined, see § 1.40.
"Foreign unincorporated entity" defined, see § 1.40.
Forms, see § 1.22.
"Unincorporated entity" defined, see § 1.40(24A).

OFFICIAL COMMENT

The procedures by which a foreign corporation may convert to a foreign nonprofit corporation or a foreign unincorporated entity required to register to do business in this state are outside the scope of this Act.

The purpose of this section is to clarify the status of the foreign unincorporated entity in the public records of this state. A filing under this section has the two-fold effect of canceling the authority of the foreign corporation to do business in this state while at the same time reregistering it as a foreign unincorporated entity under the appropriate law of this state. If the foreign unincorporated entity subsequently wishes to cancel its registration to do business in this state, it may do so under the foreign unincorporated entity provisions to which it has become subject as provided in section 15.23(c).

Subchapter C.
REVOCATION OF CERTIFICATE OF AUTHORITY

§ 15.30. GROUNDS FOR REVOCATION

The secretary of state may commence a proceeding under section 15.31 to revoke the certificate of authority of a foreign corporation authorized to transact business in this state if:

(1) the foreign corporation does not deliver its annual report to the secretary of state within 60 days after it is due;

(2) the foreign corporation does not pay within 60 days after they are due any franchise taxes or penalties imposed by this Act or other law;

(3) the foreign corporation is without a registered agent or registered office in this state for 60 days or more;

(4) the foreign corporation does not inform the secretary of state under section 15.08 or 15.09 that its registered agent or registered office has changed, that its registered agent has resigned, or that its registered office has been discontinued within 60 days of the change, resignation, or discontinuance;

(5) an incorporator, director, officer, or agent of the foreign corporation signed a document knowing it was false in any material respect with intent that the document be delivered to the secretary of state for filing; or

(6) the secretary of state receives a duly authenticated certificate from the secretary of state or other official having custody of corporate records in the state or country under whose law the foreign corporation is incorporated stating that it has been dissolved or disappeared as the result of a merger.

CROSS-REFERENCES

Annual report, see § 16.21.
Appeal from revocation, see § 15.32.
"Deliver," see § 1.40.
Delivery of false document to secretary of state, see § 1.29.
Procedure for revocation, see § 15.31.
Registered office and agent, see §§ 15.07 & 15.08.

OFFICIAL COMMENT

Section 15.30 authorizes the administrative revocation of the certificate of authority of a foreign corporation on the grounds specified. Administrative revocation is effective only upon compliance with the procedure specified in section 15.31. A foreign corporation that believes the administrative revocation is unwarranted may obtain judicial review of the secretary of state's determination pursuant to section 15.32.

If a qualified foreign corporation has dissolved or merged into another corporation, the secretary of state may proceed to revoke its certificate of authority to transact business solely on the basis of a certificate from the secretary of state or other official of the state of incorporation. Section 15.30(6). This subdivision provides a simple and inexpensive method to eliminate the names of corporations that are no longer in existence from the records of the secretary of state, thereby making the corporate names available for use by other entities.

Section 15.30 is patterned after section 14.20, relating to the administrative dissolution of domestic corporations. See the Official Comment to section 14.20 for a fuller description of the policies underlying section 15.30.

§ 15.31. PROCEDURE FOR AND EFFECT OF REVOCATION

(a) If the secretary of state determines that one or more grounds exist under section 15.30 for revocation of a certificate of authority, the secretary of state shall serve the foreign corporation with written notice of such determination under section 15.10.

(b) If the foreign corporation does not correct each ground for revocation or demonstrate to the reasonable satisfaction of the secretary of state that each ground determined by the secretary of state does not exist within 60 days after service of the notice is perfected under section 15.10, the secretary of state may revoke the foreign corporation's certificate of authority by signing a certificate of revocation that recites the ground or grounds for revocation and its effective date. The secretary of state shall file the original of the certificate and serve a copy on the foreign corporation under section 15.10.

(c) The authority of a foreign corporation to transact business in this state ceases on the date shown on the certificate revoking its certificate of authority.

(d) The secretary of state's revocation of a foreign corporation's certificate of authority appoints the secretary of state the foreign corporation's agent for service of process in any proceeding based on a cause of action which arose during the time the foreign corporation was authorized to transact business in this state. Service of process on the secretary of state under this subsection is service on the foreign corporation. Upon receipt of process, the secretary of state shall mail a copy of the process to the secretary of the foreign corporation at its principal office shown in its most recent annual report or in any subsequent communication received from the corporation stating the current mailing address of its principal office, or, if none are on file, in its application for a certificate of authority.

(e) Revocation of a foreign corporation's certificate of authority does not terminate the authority of the registered agent of the corporation.

CROSS-REFERENCES

Annual report, see § 16.21.
Appeal from revocation, see § 15.32.
Grounds for revocation, see § 15.30.
"Principal office":

defined, see § 1.40.
designated in annual report, see § 16.21.
Service on foreign corporation, see § 15.10.

OFFICIAL COMMENT

The procedure for revocation of a certificate of authority in section 15.31 establishes a simple method of completing the revocation while at the same time ensuring that the foreign corporation is advised of the contemplated action and has an opportunity to contest it in appropriate situations. In most situations, revocation by the secretary of state will not be contested.

After revocation, the secretary of state is appointed the foreign corporation's agent for service of process; upon receipt of service, the secretary of state must forward the process to the foreign corporation's principal address, as last reflected in the secretary of state's records. Revocation, however, does not of itself terminate the authority of the foreign corporation's registered agent, so that process served on that agent by a third person who was unaware of the revocation may be effective.

Section 15.31 is patterned after section 14.21, relating to the administrative dissolution of a domestic corporation. See the Official Comment to section 14.21 for a fuller statement of the policies underlying section 15.31.

§ 15.32. APPEAL FROM REVOCATION

(a) A foreign corporation may appeal the secretary of state's revocation of its certificate of authority to the [name or describe] court within 30 days after service of the certificate of revocation is perfected under section 15.10. The foreign corporation appeals by petitioning the court to set aside the revocation and attaching to the petition copies of its certificate of authority and the secretary of state's certificate of revocation.

(b) The court may summarily order the secretary of state to reinstate the certificate of authority or may take any other action the court considers appropriate.

(c) The court's final decision may be appealed as in other civil proceedings.

CROSS-REFERENCES

Effective date of service, see § 15.10.
Grounds for revocation, see § 15.30.
Procedure for revocation, see § 15.31.

OFFICIAL COMMENT

A corporation whose certificate of authority is revoked may obtain judicial review of the revocation decision. In the review proceeding the court may summarily order the secretary of state to reinstate the corporation or take other action it deems appropriate.

The court with jurisdiction over an appeal should be specified; it is typically either a court in the state capital or a court in the county in which the corporation's principal office is located. Moreover, states adopting this section of the Model Act should specify who has the burden of proof on appeal and the standard for judicial review. See the Official Comment to section 1.26.

CHAPTER 16

Records and Reports

Subchapter A.
RECORDS

§ 16.01. CORPORATE RECORDS

(a) A corporation shall keep as permanent records minutes of all meetings of its shareholders and board of directors, a record of all actions taken by the shareholders or board of directors without a meeting, and a record of all actions taken by a committee of the board of directors in place of the board of directors on behalf of the corporation.

(b) A corporation shall maintain appropriate accounting records.

(c) A corporation or its agent shall maintain a record of its shareholders, in a form that permits preparation of a list of the names and addresses of all shareholders, in alphabetical order by class of shares showing the number and class of shares held by each.

(d) A corporation shall maintain its records in written form or in another form capable of conversion into written form within a reasonable time.

(e) A corporation shall keep a copy of the following records at its principal office:

(1) its articles or restated articles of incorporation, all amendments to them currently in effect, and any notices to shareholders referred to in section 1.20(k)(5) regarding facts on which a filed document is dependent;

(2) its bylaws or restated bylaws and all amendments to them currently in effect;

(3) resolutions adopted by its board of directors creating one or more classes or series of shares, and fixing their relative rights, preferences, and limitations, if shares issued pursuant to those resolutions are outstanding;

(4) the minutes of all shareholders' meetings, and records of all action taken by shareholders without a meeting, for the past three years;

(5) all written communications to shareholders generally within the past three years, including the financial statements furnished for the past three years under section 16.20;

(6) a list of the names and business addresses of its current directors and officers; and

(7) its most recent annual report delivered to the secretary of state under section 16.21.

CROSS-REFERENCES

Articles of incorporation, see § 2.02.
Articles of amendment, see § 10.06.

Bylaws, see § 2.06, ch. 10B.
Committees of board of directors, see § 8.25.
"Deliver," see § 1.40.
Directors' action without meeting, see § 8.21.
Inspection of corporate records, see §§ 16.02 & 16.04.
Meetings of board of directors, see § 8.20.
Officers, see § 8.40.
"Principal office":
  defined, see § 1.40.
  designated in annual report, see § 16.21.
Reports of corporation, see §§ 16.20–16.21.
Restatement of articles of incorporation, see § 10.07.
Series of shares, see § 6.02.
Shareholders' action without meeting, see § 7.04.
Shareholders' meeting, see §§ 7.01–7.03.
Shareholders' voting list, see § 7.20.

OFFICIAL COMMENT

Section 16.01 describes in general terms the records every corporation must keep or maintain, the form in which they may be maintained, and, to a limited extent, where the records must be kept.

1. Minutes and Related Documents

Section 16.01(a) requires a corporation to "keep" as permanent records the minutes of meetings of its shareholders and board of directors, and a record of actions taken by consent by its shareholders or board of directors. In addition, each corporation must "keep" a record of all actions taken by a committee of the board of directors when acting on behalf of the board of directors for the corporation; this includes, for example, action taken by an executive committee between meetings of the board and final action of a special litigation committee authorized to act on behalf of the board. Section 16.01(a) does not require a record of actions taken by a committee when the committee is not acting in place of the board of directors, e.g., when the committee is discussing policy and formulating recommendations for action by the board of directors. Also, it does not require either minutes or a record of committee deliberations under any circumstances. Committee meetings are preserved as forums for open and frank discussion and discussion of sensitive corporate data without fear of recordation or disclosure.

Section 16.01 also does not address the amount of detail that should appear in the minutes of meetings of shareholders or the board of directors—the content of minutes is largely fixed by tradition and no inference about their content should be drawn from the section's treatment of the records of committee deliberation and action.

2. Shareholders' Lists and Accounting Records

Sections 16.01(b) and (c) require the corporation to "maintain" appropriate accounting and shareholder records. The word "maintain" is used to denote current records only and does not require the corporation to keep on hand as permanent records, data, or information of historical interest only; the periods for which these records, data, or information should be kept is not addressed by the Model Act.

Section 16.01(b) relates to accounting records. The word "appropriate" is used to indicate that the nature of the financial records to be kept is dependent to some extent on the nature of the corporation's business; the phrase "adequate records" is used in some state statutes to convey essentially the same meaning. "Appropriate" records are generally records that permit financial statements to be prepared which fairly present the financial position and transactions of the corporation. In some very small businesses operating on a cash basis, however, "appropriate" accounting records may consist only of a check register, vouchers, and receipts.

Section 16.01(c) requires the corporation to maintain such records of its shareholders as will permit it to compile a list of shareholders when required. These records may consist of stubs from which certificates have been detached in the case of corporations with a few shareholders or of elaborate electronic data retrievable only by modern technology in the case of large, publicly held corporations. The record may be retained by the corporation or an agent, who traditionally is the transfer agent but may be another agent.

3. Form of Records

Section 16.01(d) generally authorizes corporations to retain records on microfilm, microfiche, computer memory or disc, or any other method that is convenient or appropriate under the circumstances. The basic requirement is that the method chosen must be capable of reduction to written form within a reasonable time. In addition, in the case of the record of shareholders, the method must permit the development of an alphabetical list of shareholders of record as required by section 16.01(c).

4. Keeping Records at Principal Office

Section 16.01(e) requires certain basic records to be kept at the principal office of the corporation, including minutes of shareholders' meetings for the preceding three years and records of shareholder action taken without a meeting during the same period. This requirement is imposed because these records must be available for inspection by any shareholder at that office. See section 16.02(a). The "principal office" of the corporation is defined in section 1.40 to be the location of the executive offices of the corporation and its address must be set forth by the corporation in its annual report required by section 16.21. The Model Act does not generally specify where records other than those described in section 16.01(e) must be kept. They may be kept in one or more offices within or without the state; indeed, in the case of records kept in non-written form, it may be impossible to determine "where" they are located.

§ 16.02. INSPECTION OF RECORDS BY SHAREHOLDERS

(a) A shareholder of a corporation is entitled to inspect and copy, during regular business hours at the corporation's principal office, any of the records of the corporation described in section 16.01(e) if the shareholder gives the corporation written notice of the shareholder's demand at least five business days before the date on which the shareholder wishes to inspect and copy.

(b) A shareholder of a corporation is entitled to inspect and copy, during regular business hours at a reasonable location specified by the corporation, any of the following records of the corporation if the shareholder meets the requirements of subsection (c) and gives the corporation written notice of the shareholder's demand at least five business days before the date on which the shareholder wishes to inspect and copy:

(1) excerpts from minutes of any meeting of the board of directors, records of any action of a committee of the board of directors while acting in place of the board of directors on behalf of the corporation, minutes of any meeting of the shareholders, and records of action taken by the shareholders or board of directors without a meeting, to the extent not subject to inspection under section 16.02(a);

(2) accounting records of the corporation; and

(3) the record of shareholders.

(c) A shareholder may inspect and copy the records described in subsection (b) only if:

(1) the shareholder's demand is made in good faith and for a proper purpose;

(2) the shareholder describes with reasonable particularity the shareholder's purpose and the records the shareholder desires to inspect; and

(3) the records are directly connected with the shareholder's purpose.

(d) The right of inspection granted by this section may not be abolished or limited by a corporation's articles of incorporation or bylaws.

(e) This section does not affect:

(1) the right of a shareholder to inspect records under section 7.20 or, if the shareholder is in litigation with the corporation, to the same extent as any other litigant; or

(2) the power of a court, independently of this Act, to compel the production of corporate records for examination.

(f) For purposes of this section, "shareholder" includes a beneficial owner whose shares are held in a voting trust or by a nominee on the shareholder's behalf.

CROSS-REFERENCES

Articles of incorporation, see § 2.02.
Bylaws, see § 2.06, ch. 10B.
Committees of board of directors, see § 8.25.
Corporate records required, see § 16.01.
Court-ordered inspection, see § 16.04.
"Deliver," see § 1.40.

Directors' action without meeting, see § 8.21.
Effective date of notice, see § 1.41.
Meeting of board of directors, see § 8.20.
"Notice" defined, see § 1.41.
Notice to corporation, see § 1.41.
"Principal office":
  defined, see § 1.40.
  designated in annual report, see § 16.21.
"Shareholder" defined, see § 1.40.
Shareholders' action without meeting, see § 7.04.
Shareholders' list inspection, see § 7.20.
Shareholders' meeting, see §§ 7.01–7.03.
Voting trusts, see § 7.30.

OFFICIAL COMMENT

1. Section 16.02 (a)

Section 16.02(a) provides that every shareholder is entitled to examine upon written request at the principal office of the corporation all documents described in section 16.01(e). These documents all deal with the shareholder's interest as such in the corporation. While some of these documents may also be a matter of public record in the office of secretary of state, a shareholder should not be compelled to go to a public office that may be physically distant to examine the basic documents relating to the corporation of which he or she is a shareholder.

2. Section 16.02(b)

Section 16.02(b) grants a shareholder who meets the requirements of section 16.02(c) the right to inspect three classes of corporate records:

(1) Excerpts from minutes of meetings of the board of directors, records of action of committees of the board of directors when acting in place of the board on behalf of the corporation, and minutes of meetings of shareholders (to the extent they do not fall within section 16.02(a)). The corporation is required to make available only relevant excerpts of minutes and need not make available minutes of entire meetings merely because a portion of the minutes is directly connected with the shareholder's purpose.

(2) The accounting records of the corporation. The Act does not attempt to define what accounting records must be kept. See the Official Comment to section 16.01.

(3) The record of shareholders, subject to section 16.03(c). If a shareholder makes a demand in good faith and with a proper purpose under section 16.02(c), the shareholder is entitled to inspect the shareholders' list under section 16.02(b) without regard to the size or value of his holding. This right is independent of the right to inspect a shareholders' list immediately before a meeting under section 7.20. See section 16.02(e).

3. Section 16.02(c)

Section 16.02(c) follows earlier versions of the Model Act and permits inspection of the records described in section 16.02(b) by a shareholder only if the demand is made in good faith and for a "proper purpose." A "proper purpose" means a purpose that is reasonably relevant to the demanding shareholder's interest as a shareholder. Some statutes do not use the phrase "proper purpose"; the Model Act continues to use it because it is traditional and well understood language defining the scope of the shareholder's right of inspection and its use ensures that the very substantial case law that has developed under it will continue to be applicable under the revised Act.

As a practical matter, a shareholder who alleges a purpose in general terms, such as a desire to determine the value of his or her shares, to communicate with fellow shareholders, or to determine whether improper transactions have occurred, has been held to allege a "proper purpose." Section 16.02(c) thus attempts to require more meaningful statements of purpose, if feasible, by requiring that a shareholder designate "with reasonable particularity" the purpose and the records he or she desired to inspect; the records demanded must also be "directly connected" with that purpose. If disputed by the corporation, the "connection" of the records to the shareholder's purpose may be determined by a court's in camera examination of the records.

4. Sections 16.02(d) and (e)

Section 16.02(d) states that the inspection rights granted by this chapter are inherent rights of shareholders and may not be abolished or limited by the articles of incorporation or bylaws; the subsection is based on California Corporations Code Annotated section 1600(d). No inference of any kind should be drawn from this subsection as to whether other, unrelated sections of the Model Act may be modified by provisions in the articles of incorporation or bylaws.

Section 16.02(e) provides that the right of inspection granted by section 16.02 is an independent right of inspection that is not a substitute for or in derogation of rights of inspection that may exist (1) under section 7.20, to inspect the shareholders' list following the establishment of a record date for a meeting; (2) as part of a right of discovery that exists in connection with litigation; and (3) as a "common law" right of inspection, if any is found to exist by a court, to examine corporate records. Section 16.02(e) simply preserves whatever independent right of inspection exists under these sources and does not create or recognize any rights, either expressly or by implication.

5. Section 16.02(f)

Section 16.02(f) extends the inspection rights provided by section 16.02 to beneficial owners of shares held by a nominee or in a voting trust. It was added as a technical correction to the revised Model Act in 1986.

§ 16.03. SCOPE OF INSPECTION RIGHT

(a) A shareholder's agent or attorney has the same inspection and copying rights as the shareholder represented.

(b) The right to copy records under section 16.02 includes, if reasonable, the right to receive copies by xerographic or other means, including copies through an electronic transmission if available and so requested by the shareholder.

(c) The corporation may comply at its expense with a shareholder's demand to inspect the record of shareholders under section 16.02(b)(3) by providing the shareholder with a list of shareholders that was compiled no earlier than the date of the shareholder's demand.

(d) The corporation may impose a reasonable charge, covering the costs of labor and material, for copies of any documents provided to the shareholder. The charge may not exceed the estimated cost of production, reproduction or transmission of the records.

CROSS-REFERENCES

Corporate records, see § 16.01.
Court-ordered inspection, see § 16.04.
"Electronic transmission" defined, see § 1.40.
Inspection right generally, see § 16.02.
Shareholders' list inspection, see § 7.20.

OFFICIAL COMMENT

The right of inspection set forth in section 16.02 includes the general right to copy the documents inspected. Section 16.03 follows precedent established under earlier statutes and extends the right of inspection to an agent or attorney of a shareholder as well as the shareholder. The right to copy means more than a right to copy by longhand and extends to the right to receive copies made by copying machines or through an electronic transmission with the cost of reproduction and transmission being paid by the shareholder. The requirement of availability with respect to electronic transmissions is intended to insure that the corporation can provide the document electronically and that an undue burden is not placed on the corporation to provide copies through an electronic transmission or other similar means.

Section 16.03(c) is designed to give the corporation the option of providing a reasonably current list of its shareholders instead of granting the right of inspection; a "reasonably current" list is defined in section 16.03(c) as one compiled no earlier than the date of the written demand, which under section 16.02(b) must provide at least five days' notice.

Many corporations make available to shareholders without charge some or all of the basic documents described in section 16.01(e). Section 16.03(d) authorizes the corporation to charge a reasonable fee based on reproduction costs (including labor and materials) for providing a copy of any document. The phrase "estimated cost of production, reproduction or transmission of the records" in section 16.03(d) refers to the cost of assembling information and data to meet a demand as well as the cost of reproducing and transmitting documents that are already in existence.

Under applicable law, a list of shareholders generally will include underlying information in the corporation's possession relating to stock ownership, including, where applicable, breakdowns of stock holdings by nominees and nonobjecting beneficial ownership (NOBO) lists.

However, a corporation generally is not required to generate this information for the requesting shareholder and is only required to provide NOBO and other similar lists to the extent such information is in the corporation's possession.

Section 7.20 creates a right of shareholders to inspect a list of shareholders in advance of and at a meeting that is independent of the rights of shareholders to inspect corporate records under chapter 16.

§ 16.04. COURT-ORDERED INSPECTION

(a) If a corporation does not allow a shareholder who complies with section 16.02(a) to inspect and copy any records required by that subsection to be available for inspection, the [name or describe court] of the county where the corporation's principal office (or, if none in this state, its registered office) is located may summarily order inspection and copying of the records demanded at the corporation's expense upon application of the shareholder.

(b) If a corporation does not within a reasonable time allow a shareholder to inspect and copy any other record, the shareholder who complies with sections 16.02(b) and (c) may apply to the [name or describe court] in the county where the corporation's principal office (or, if none in this state, its registered office) is located for an order to permit inspection and copying of the records demanded. The court shall dispose of an application under this subsection on an expedited basis.

(c) If the court orders inspection and copying of the records demanded, it shall also order the corporation to pay the shareholder's expenses incurred to obtain the order unless the corporation proves that it refused inspection in good faith because it had a reasonable basis for doubt about the right of the shareholder to inspect the records demanded.

(d) If the court orders inspection and copying of the records demanded, it may impose reasonable restrictions on the use or distribution of the records by the demanding shareholder.

CROSS-REFERENCES

Corporate records, see § 16.01.
"Principal office":
  defined, see § 1.40.
  designated in annual report, see § 16.21.
"Expenses" defined, see § 1.40.
"Principal office:"
  defined, see § 1.41.
  designated in annual report, see § 6.21.
Registered office:
  designated in annual report, see § 16.21.
  required, see §§ 2.02 & 5.01.
Service on corporation, see § 5.04.
Shareholders' list inspection, see § 7.20.

Voluntary inspection, see § 16.02.

OFFICIAL COMMENT

Section 16.04 provides a judicial remedy if a corporation refuses to grant the right of inspection provided by section 16.02.

If the right of inspection under section 16.02(a) is invoked and the corporation refuses to grant inspection, the shareholder may seek a summary order compelling inspection. A summary order is appropriate since the right of inspection under this subsection is either automatic or subject only to a determination that the person is in fact a shareholder of the corporation. By contrast, if inspection is demanded under section 16.02(b), the shareholder's good faith and purpose may be in issue; in this situation section 16.04(b) directs the court to handle the proceeding "on an expedited basis." The purpose of this phrase is to discourage dilatory tactics to avoid or delay inspection without requiring the court to resolve these issues on a summary basis. This language does not mandate any specific procedure by which these issues are to be resolved.

If a court enters a summary order directing inspection under section 16.02(a), the expense of reproducing the records, if any, is placed on the corporation. Section 16.04 does not address who should bear the expense of reproducing other records ordered by the court; this is a matter for the courts to decide in light of the policy of the Model Act that expenses of reproduction are generally the responsibility of the requesting shareholder and should be assessed against such shareholder.

The principal sanction against unreasonable delay or refusal to grant inspection is provided by section 16.04(c), which imposes on the corporation the plaintiff's expenses unless the corporation can establish that it acted reasonably. The corporation may avoid these expenses by showing that the corporation refused inspection in good faith because it had a reasonable basis for doubt about the right of the shareholder to inspect the records demanded. This normally will involve reasonable doubt whether the shareholder had the necessary good faith and proper purpose or whether the records demanded are directly connected to the shareholder's purpose. The phrase "in good faith because it had a reasonable basis for doubt" establishes a partially objective standard, in that the corporation must be able to point to some objective basis for its doubt that the shareholder was acting in good faith or had a purpose that was proper. For example, a corporation may point to earlier conduct of the shareholder involving improper use of information obtained from the corporation in the past as indicating that reasonable doubt existed as to his present purpose. A corporation may not avoid the imposition of expenses under this section merely by showing it had no information one way or the other about the issues in controversy.

Earlier versions of the Model Act and the statutes of many states imposed a penalty upon the corporation or its officers for refusal to permit inspection of books and records by shareholders who (1) had been shareholders for at least six months or (2) owned 5% or more of the outstanding shares. This provision has been omitted. A penalty unrelated to the expenses of securing inspection was arbitrary and, as a result, was seldom actually enforced; further, a qualification based on the size or duration of the shareholder's holding unrelated to the shareholder's actual purpose was subject to the criticism that it constituted unreasonable discrimination against small shareholders.

§ 16.05. INSPECTION OF RECORDS BY DIRECTORS

(a) A director of a corporation is entitled to inspect and copy the books, records and documents of the corporation at any reasonable time to the extent reasonably related to the performance of the director's duties as a director, including duties as a member of a committee, but not for any other purpose or in any manner that would violate any duty to the corporation.

(b) The [name or describe the court] of the county where the corporation's principal office (or if none in this state, its registered office) is located may order inspection and copying of the books, records and documents at the corporation's expense, upon application of a director who has been refused such inspection rights, unless the corporation establishes that the director is not entitled to such inspection rights. The court shall dispose of an application under this subsection on an expedited basis.

(c) If an order is issued, the court may include provisions protecting the corporation from undue burden or expense, and prohibiting the director from using information obtained upon exercise of the inspection rights in a manner that would violate a duty to the corporation, and may also order the corporation to reimburse the director for the director's expenses incurred in connection with the application.

CROSS-REFERENCES

Corporate records, see § 16.01.
Court-ordered inspection, see § 16.04.
"Expenses" defined, see § 1.40.
Director standards of conduct, see § 8.30.
Functions of board of directors, see § 8.01.
"Principal office:"
  defined, see § 1.41.
  designated in annual report, see § 6.21.
Registered office:
  designated in annual report, see § 16.21.
  required, see §§ 2.02 & 5.01.

OFFICIAL COMMENT

The purpose of subsection 16.05(a) is to confirm the principle that a director always is entitled to inspect books, records and documents to the extent reasonably related to the performance of the director's oversight or decisional duties provided that the requested inspection is not for an improper purpose and the director's use of the information obtained would not violate any duty to the corporation. The statute attempts to reconcile and balance competing principles articulated in the common law which suggest that a director has a nearly "absolute" right to information subject only to limitation if it can be shown that the director has an improper motive or intent in asking for the information or would violate law by receiving the information. In addition, the statutory provision sets forth a remedy for the director in circumstances where the corporation improperly denies the right of inspection.

Under subsection (a), a director typically would be entitled to review books, records and documents relating to matters such as (i) compliance by a corporation with applicable law, (ii) adequacy of the corporation's system of internal controls to provide accurate and timely financial statements and disclosure documents, or (iii) the proper operation, maintenance and protection of the corporation's assets. In addition, a director would be entitled to review records and documents to the extent required to consider and make decisions with respect to matters placed before the Board.

Section 16.05(b) provides a director with the right to seek on an expedited basis a court order permitting inspection and copying of the books, records and documents of the corporation, at the corporation's expense. There is a presumption that significant latitude and discretion should be granted to the director, and the corporation has the burden of establishing that a director is not entitled to inspection of the documents requested. Circumstances where the director's inspection rights might be denied include requests which (i) are not reasonably related to performance of a director's duties (e.g., seeking a specified confidential document not necessary for the performance of a director's duties), (ii) impose an unreasonable burden and expense on the corporation (e.g., compliance with the request would be duplicative of information already provided or would be unreasonably expensive and time-consuming), (iii) violate the director's duty to the corporation (e.g., the director could reasonably be expected to use or exploit confidential information in personal or third-party transactions), or (iv) violate any applicable law (e.g., the director does not have the necessary governmental security clearance to see the requested classified information).

Section 16.05 does not directly deal with the ability of a director to inspect records of a subsidiary of which he or she is not also a director. A director's ability to inspect records of a subsidiary generally should be exercised through the parent's rights or power and section 16.05(a) does not independently provide that right or power to a director of the parent. In the case of wholly-owned subsidiaries, a director's ability to inspect should approximate his or her rights with respect to the parent. In the case of a partially-owned subsidiary, the ability of the director to inspect is likely to be influenced by the level of ownership of the parent (this ability can be expected to be greater for a subsidiary which is part of a consolidated group than for a minority-owned subsidiary). In any case, the inspection by a director of the parent will be subject to the parent's fiduciary obligation to the subsidiary's other shareholders.

Section 16.05(c) provides that the court may place limitations on the use of information obtained by the director and may include in its order other provisions protecting the corporation from undue burden or expense. Further, the court may order the corporation to reimburse the director for expenses incurred in connection with the application. The amount of any reimbursement is left in the court's discretion, since it must consider the reasonableness of the expenses incurred, as well as the fact that a director may be only partially successful in the application.

§ 16.06. EXCEPTION TO NOTICE REQUIREMENT

(a) Whenever notice is required to be given under any provision of this Act to any shareholder, such notice shall not be required to be given if:

(i) Notice of two consecutive annual meetings, and all notices of meetings during the period between such two consecutive annual meetings, have been sent to such shareholder at such shareholder's address as shown on the records of the corporation and have been returned undeliverable; or

(ii) All, but not less than two, payments of dividends on securities during a 12-month period, or two consecutive payments of dividends on securities during a period of more than 12 months, have been sent to such shareholder at such shareholder's address as shown on the records of the corporation and have been returned undeliverable.

(b) If any such shareholder shall deliver to the corporation a written notice setting forth such shareholder's then-current address, the requirement that notice be given to such shareholder shall be reinstated.

CROSS-REFERENCES

Annual meeting, see § 7.01.
Notice, see § 1.41.
Notice of meeting, see § 7.05.

OFFICIAL COMMENT

Section 16.06 balances the requirement that the corporation provide notice to shareholders regarding meetings and the practical need to allow corporations to cease providing notices where notices are being returned undelivered and it is clear that the shareholder no longer is located at the address previously provided to the corporation. Absent such a provision, the corporation technically may be required to continue to attempt to provide a notice to the shareholder in order to satisfy a statutory requirement regarding notices to shareholders or otherwise risk questions concerning the validity of the meeting for which the notice is required. A number of states have adopted statutory provisions eliminating the obligation of the corporation to provide notice under certain circumstances. In addition, the federal proxy rules have adopted a similar provision.

Section 16.06 provides that notice is not required to be given to a shareholder if a notice of two consecutive annual meetings, and all notices required during the period between the meetings, are returned undeliverable. In addition, no notice is required if all dividends required to be paid during a 12-month period (assuming at least two dividends were payable during that period) or two consecutive payments of dividends during a period of more than 12 months, are returned undeliverable. In both of these instances, written notice is not required, and any meeting which is held will have the same force and effect as if notice had been given. The notice for a particular shareholder is reinstated if a written notice to the corporation setting forth the shareholder's then current address is sent to the corporation.

Based upon these provisions, the corporation generally will be required to continue to provide the notice unless undeliverable items are returned over a period that could not be less than 12 months and could extend for up to 24 months. For instance, if the first undeliverable communication were sent to a shareholder six months before the next notice of an annual meeting is required, the corporation would have to wait until the annual meeting notice proves to be undeliverable to commence the nondelivery period, and then would have to wait until the next annual meeting notice after that also proves to be undeliverable before suspending the notification requirement. This amounts to a nondelivery period of 18 months which could extend to two years under the right circumstances. It is believed that this accomplishes the proper balance between protecting the rights of shareholders and eliminating unnecessary notices.

Section 16.06 only deals with notices and does not have application to payment of dividends or other distributions to shareholders. There is no statutorily mandated practice with respect to payment of dividends. However, a decision by a corporation to withhold dividends pending location of the shareholder will not affect the validity of corporate action. Under state law, dividend payments unclaimed by shareholders eventually will escheat to the state in accordance with applicable statutory provisions.

Subchapter B.
REPORTS

§ 16.20. FINANCIAL STATEMENTS FOR SHAREHOLDERS

(a) A corporation shall deliver to its shareholders annual financial statements, which may be consolidated or combined statements of the corporation and one or more of its subsidiaries, as appropriate, that include a balance sheet as of the end of the fiscal year, an income statement for that year, and a statement of changes in shareholders' equity for the year unless that information appears elsewhere in the financial statements. If financial statements are prepared for the corporation on the basis of generally accepted accounting principles, the annual financial statements must also be prepared on that basis.

(b) If the annual financial statements are reported upon by a public accountant, the report must accompany them. If not, the statements must be accompanied by a statement of the president or the person responsible for the corporation's accounting records:

(1) stating such person's reasonable belief whether the statements were prepared on the basis of generally accepted accounting principles and, if not, describing the basis of preparation; and

(2) describing any respects in which the statements were not prepared on a basis of accounting consistent with the statements prepared for the preceding year.

(c) A corporation shall mail the annual financial statements to each shareholder within 120 days after the close of each fiscal year. Thereafter, on written request from a shareholder who was not mailed the statements, the corporation shall mail the shareholder the latest financial statements.

CROSS-REFERENCES

"Deliver" defined, see § 1.40.
Inspection of records, see § 16.02.
"Shareholder" defined, see § 1.40.

OFFICIAL COMMENT

The requirement that a corporation regularly provide some financial information to shareholders is appropriate considering the relationship between corporate management and the shareholders as the ultimate owners of the enterprise. This requirement was first added as an amendment in 1979 to the 1969 Model Act.

Section 16.20 has its principal impact on small, closely held corporations, since enterprises whose securities are registered under federal statutes are required to supply audited financial statements to shareholders. The securities of the vast majority of corporations in the United States are not registered under federal law. It is these corporations that section 16.20 principally affects.

Section 16.20 requires every corporation to prepare and submit to shareholders annual financial statements consisting of a balance sheet as of the end of the fiscal year, an income statement for the year, and a statement of changes in shareholders' equity for the year. The last statement may be omitted if the data that normally appears in that statement appears in the other financial statements or in the notes thereto. Consolidated statements of the corporation and any subsidiary, or subsidiaries, or combined statements for corporations under common control, may be used. Section 16.20 does not require financial statements to be prepared on the basis of generally accepted accounting principles ("GAAP"). Many small corporations have never prepared financial statements on the basis of GAAP. "Cash basis" financial statements (often used in preparing the tax returns of small corporations) do not comply with GAAP. Even closely held corporations that keep accrual basis records, and file their federal income tax returns on that basis, frequently do not make the adjustments that may be required to present their financial statements on a GAAP basis. In light of these considerations, it would be too burdensome on some small and closely held corporations to require GAAP statements. Accordingly, internally or externally prepared financial statements prepared on the basis of other accounting practices and principles that are reasonable in the circumstances, including tax returns filed with the Federal Internal Revenue Service (if that is all that is prepared), will suffice for these types of corporations. If a corporation does prepare financial statements on a GAAP basis for any purpose for the particular year, however, it must send those statements to the shareholders as provided by the last sentence of section 16.20(a).

Section 16.20(b) requires an accompanying report or statement in one of two forms: (1) if the financial statements have been reported upon by a public accountant, that report must be furnished; or (2) in other cases, a statement of the president or the person responsible for the corporation's accounting records must be furnished (i) stating such person's reasonable belief as to whether the financial statements were prepared on the basis of generally accepted accounting principles, and, if not, describing the basis on which they were prepared, and (ii) describing any respects in which the financial statements were not prepared on a basis of accounting consistent with those prepared for the previous year.

Section 16.20 refers to a "public accountant." The same terminology is used in section 8.30 (standards of conduct for directors) of the Model Act. In various states different terms are employed to identify those persons who are permitted under the state licensing requirements to act as professional accountants. Phrases like "independent public accountant," "certified public accountant," "public accountant," and others may be used. In adopting the term "public accountant," the Model Act uses the words in a general sense to refer to any class or classes of persons who, under the applicable requirements of a particular jurisdiction, are professionally entitled to practice accountancy.

In requiring a statement by the president or person responsible for the corporation's financial affairs, it is recognized that in many cases this person will not be a professionally trained accountant and should not be held to the standard required of a professional. To emphasize this difference, section 16.20 requires a "statement" (rather than a "report" or "certificate") and calls for the person to express "reasonable belief" (rather than "opinion") about whether the statements are prepared on the basis of GAAP or, if not, to describe the basis of presentation and any inconsistencies in the basis of the presentation as compared with the previous year. The person providing the statement is not required to describe any inconsistencies between the basis of presentation and GAAP. If the statements are not prepared on a GAAP basis, the description would normally follow guidelines of the accounting profession as to the reporting format considered appropriate for a presentation which departs from GAAP. See, e.g., "Statement on Auditing Standards No. 14" of the American Institute of Certified Public Accountants. For example, the description might state, with respect to a cash basis statement of receipts and disbursements, that the statement was prepared on that basis and that it presents the cash receipts and disbursements of the entity for the period but does not purport to present the results of operations on the accrual basis of accounting.

Section 16.20(c) specifies that annual financial statements are to be mailed to each shareholder within 120 days after the close of each fiscal year, further emphasizing that the statements required to be delivered are annual statements and not interim statements. In addition, if a shareholder was not mailed the corporation's latest annual financial statements, he may obtain them on written request. See also section 16.01(e)(5).

Failure to comply with the requirements of section 16.20 does not adversely affect the existence or good standing of the corporation. Rather, failure to comply gives an aggrieved shareholder rights to compel compliance or to obtain damages, if they can be established, under general principles of law.

§ 16.21. ANNUAL REPORT FOR SECRETARY OF STATE

(a) Each domestic corporation, and each foreign corporation authorized to transact business in this state, shall deliver to the secretary of state for filing an annual report that sets forth:

(1) the name of the corporation and the state or country under whose law it is incorporated;

(2) the address of its registered office and the name of its registered agent at that office in this state;

(3) the address of its principal office;

(4) names and business addresses of its directors and principal officers;

(5) a brief description of the nature of its business;

(6) the total number of authorized shares, itemized by class and series, if any, within each class; and

(7) the total number of issued and outstanding shares, itemized by class and series, if any, within each class.

(b) Information in the annual report must be current as of the date the annual report is signed on behalf of the corporation.

(c) The first annual report must be delivered to the secretary of state between January 1 and April 1 of the year following the calendar year in which a domestic corporation was incorporated or a foreign corporation was authorized to transact business. Subsequent annual reports must be delivered to the secretary of state between January 1 and April 1 of the following calendar years.

(d) If an annual report does not contain the information required by this section, the secretary of state shall promptly notify the reporting domestic or foreign corporation in writing and return the report to it for correction. If the report is corrected to contain the information required by this section and delivered to the secretary of state within 30 days after the effective date of notice, it is deemed to be timely filed.

CROSS-REFERENCES

Administrative dissolution for failure to file annual report, see § 14.20.
Annual report form prescribed by secretary of state, see § 1.21.
Authorized shares, see § 2.02.
"Deliver," see § 1.40.
Effective date of notice, see § 1.41.
Effective time and date of filing, see § 1.23.
Filing fees, see § 1.22.
Filing requirements, see § 1.20.
Issuance of shares, see §§ 6.01–6.03.
"Notice" defined, see § 1.41.
Notice to the corporation, see § 1.41.
Officers, see § 8.40.
"Principal office" defined, see § 1.40.
Registered agent, see §§ 5.01 & 15.07.
Registered office, see §§ 5.01 & 15.07.
Revocation of certificate of authority for failure to file annual report, see § 15.30.
Series of shares, see § 6.21.

OFFICIAL COMMENT

The requirement relating to the annual report that each corporation must submit to the secretary of state has been modified in section 16.21 in an effort to make it a limited information document for use by the secretary of state, members of the general public, and shareholders. The purpose of the annual report is to show the location of the principal office of the corporation, the names and business addresses of its directors and principal officers, the general nature of the corporation's business, and its capital structure. It permits members of the general public to ascertain the identity of the corporation and communicate directly with it. It also establishes the alternative to the registered office for service of process and related matters. The "principal office" of the corporation is defined as the location of its executive office in section 1.40.

The reference to "principal officers" in section 16.21(a)(4) is intended to simplify reporting requirements of corporations with very large numbers of employees who have some managerial responsibility and who, for business reasons, are designated as officers. The "principal officers" of a corporation include at least the chair of the board of directors, the chief executive officer, and the officers performing the traditional functions performed by the corporate secretary and treasurer, no matter what their designation.

The annual report is required of both domestic corporations and foreign corporations qualified to transact business in the state. The failure to file the annual report, like the failure to satisfy other mandatory requirements of the Act, is a ground for administrative dissolution or revocation of the certificate of authority to transact business.

CHAPTER 17

Transition Provisions

INTRODUCTORY COMMENT

Most states, when enacting the revised Model Act, should establish a single effective date for the new statute and all general business corporations should become subject to the new Act on that date. See sections 17.01, 17.02, and 17.06.

Some of the provisions of the revised Model Act may differ in significant respects from earlier laws. When this occurs, it may be appropriate for the state to "grandfather" existing corporations, provide an opt-in election for them, or provide delayed effective dates for certain provisions, or certain types of provisions, to give existing domestic corporations adequate time to revise controlling corporate documents to take into account the provisions of the new Act. The provisions that are most likely to give rise to transitional problems are discussed below.

1. Changes in Voting Requirements

All state statutes require that certain important transactions be approved by a specified fraction of the outstanding votes of the shares. This fraction varies from state to state with most states, like the revised Model Act, requiring a majority of all the outstanding votes, but many states continue to require a 2/3 or larger vote. The revised Model Act, following the 1969 version of that Act, uniformly requires a majority of the outstanding votes of shares for transactions such as mergers, sale of substantially all the assets, important amendments to the articles of incorporation, and dissolution. When considering a reduction of these voting requirements it is important to recognize that specific control arrangements in closely held corporations may have been established on the assumption that the voting requirements would not be reduced. For example, in a state with a 2/3 voting requirement, a 40% shareholder in a closely held corporation might feel it unnecessary to request specific protection against unwanted changes in the articles of incorporation. In states with these super-majority voting requirements it may be necessary to "grandfather" existing corporations and provide an opt in election for them.

2. The Effect of Silence in the Articles of Incorporation

Under the revised Model Act, corporations that make no special provision in their articles of incorporation thereby elect not to recognize preemptive rights (section 6.30) or require cumulative voting (section 7.28). Statutes in many states now draw precisely the opposite implications from silence in the articles of incorporation. Many existing corporations may now be legally required to recognize preemptive rights and cumulative voting whereas if they become subject to the revised Model Act they would not be required to do so. It may be appropriate in this situation also to "grandfather" existing corporations or provide longer grace periods for the application of sections 6.30 and 7.28 to permit existing corporations to determine whether they wish to amend their articles to retain preemptive rights and cumulative voting.

3. Obsolete Provisions in Articles of Incorporation

Under the revised Model Act, corporations automatically have unlimited purpose clauses (section 3.01) and perpetual duration (section 3.02). Under many state statutes, these privileges are available only if specifically provided in the articles of incorporation. These special provisions will become unnecessary once the corporation becomes subject to the Model Act.

While they should cause no direct harm, it would generally be desirable to eliminate them in order to avoid possible negative inferences as to the scope of the purpose or duration of the corporation. See the Official Comment to section 3.01. These inferences are probably more likely to be drawn from purpose clauses than from duration clauses.

4. Increased Power of the Board of Directors

The revised Model Act generally grants the board of directors authority to increase or decrease its own size without specific authority (section 8.03) unless this power is restricted by the articles. Many state statutes do not grant this power to the board of directors unless express provision is made in the articles or bylaws. Corporations that have not granted this express power to the board of directors may in effect do so when they become subject to the revised Model Act and a delayed effective date therefore may be appropriate. A somewhat similar problem may also arise with respect to the power to amend bylaws (section 10.20), but this is a much less serious problem since under present state law boards of directors generally have power to amend the bylaws in the absence of specific authorization.

5. Share Transfer Restrictions

Section 6.27 limits the enforceability of share transfer restrictions to those (with certain exceptions) that are noted conspicuously on the certificate. It is believed that the application of this requirement to existing corporations and outstanding share certificates is not likely to be a serious problem because section 6.27 is based on general principles, including principles applicable to share certificates under the Uniform Commercial Code.

6. Financial Provisions

Even though the financial provisions of the Model Act underwent radical restructuring in 1980, a delayed effective date for their application to outstanding securities is not generally necessary. Par value and related concepts may still be given effect as an option under the revised Model Act. Thus existing corporations that have par value provisions may continue to give them effect as a matter of contract. If there is no advantage to maintaining par value provisions under tax or other state statutes, the state may appropriately provide that these provisions have no further force and effect unless the corporation affirmatively elects to retain them as an optional matter before the effective date of the revised Model Act. If there may be an outside tax or other advantage to retention of par value provisions (which the state legislature does not wish to reconsider when it is considering adoption of the revised Model Act), the legislature may appropriately provide for the retention of par value provisions in existing articles of incorporation as an optional matter indefinitely.

The rules governing distributions in section 6.40 have also been greatly simplified. However, they are not more relaxed or permissive than under existing, more traditional statutes, so that no special transition provision is normally required. Indeed, contractual restrictions on distributions are widely used today precisely because the more traditional statutes provide little protection; the enforceability of these contractual restrictions is not affected by the revised Model Act.

7. Indemnification

In states that have narrow indemnification provisions in their present statutes, it may be desirable to make chapter 8E applicable to transactions arising before the effective date of the revised Model Act. The policy judgments made in that subchapter, as well as the procedures established for resolution of issues arising thereunder, may appropriately be extended to all claims for indemnification even though they arise from transactions antedating the Act.

8. Conclusion

Because it is impossible to anticipate precisely what changes adoption of the revised Model Act will make in the rules applicable to business corporations of particular jurisdictions, it is not feasible to draft a model provision to cover all transitional problems. Generally, however, the only transitional provisions required should be extended grace periods for certain provisions becoming applicable to existing domestic corporations, and upon expiration of these grace periods, all domestic and foreign corporations should become subject to all provisions of the revised Model Act.

§ 17.01. APPLICATION TO EXISTING DOMESTIC CORPORATIONS

This Act applies to all domestic corporations in existence on its effective date that were incorporated under any general statute of this state providing for incorporation of corporations for profit if power to amend or repeal the statute under which the corporation was incorporated was reserved.

OFFICIAL COMMENT

The fundamental principle underlying section 17.01 is that the revised Model Act should ultimately be made fully applicable to all existing business corporations as well as to all new business corporations formed after the effective date of the new statute. It is undesirable to "grandfather" existing corporations under earlier statutes since that results in the permanent coexistence of two different and overlapping systems of corporation law, with resulting confusion. This is particularly true of the revised Model Act, which builds directly on the experience of many years with existing corporation statutes and contains few major substantive changes.

Section 17.01 applies this basic principle in its broadest sense by making the revised Act applicable as of its "effective date" (prescribed in section 17.06) to all domestic corporations formed under general statutes for corporations for profit. This includes all prior general business corporation acts, but not statutes providing for not-for-profit corporations or associations, or corporations formed for the purpose of engaging in a business for which the state has provided a separate incorporation procedure.

Section 17.01 applies the revised Model Act to all corporations to which that application is constitutionally permissible. In view of the universal adoption of "reservation of power" clauses in all states for more than a century, there are very few active business corporations to which this Act will not be applicable under this section.

§ 17.02. APPLICATION TO QUALIFIED FOREIGN CORPORATIONS

A foreign corporation authorized to transact business in this state on the effective date of this Act is subject to this Act but is not required to obtain a new certificate of authority to transact business under this Act.

OFFICIAL COMMENT

Section 17.02 makes the revised Model Act applicable on its effective date to all foreign corporations that are qualified to transact business in the state on that date. But these corporations need not refile and obtain new certificates of authority under the Act. While chapter 15 of the revised Model Act may change the rules applicable to foreign corporations in some states, these changes are not of a type that require a transition period. It is therefore recommended that only a single effective date be provided for the application of the Act to foreign corporations and that delayed effective dates for specific provisions in this regard are unnecessary.

§ 17.03. SAVING PROVISIONS

(a) Except as provided in subsection (b), the repeal of a statute by this Act does not affect:

(1) the operation of the statute or any action taken under it before its repeal;

(2) any ratification, right, remedy, privilege, obligation, or liability acquired, accrued, or incurred under the statute before its repeal;

(3) any violation of the statute, or any penalty, forfeiture, or punishment incurred because of the violation, before its repeal;

(4) any proceeding, reorganization, or dissolution commenced under the statute before its repeal, and the proceeding, reorganization, or dissolution may be completed in accordance with the statute as if it had not been repealed.

(b) If a penalty or punishment imposed for violation of a statute repealed by this Act is reduced by this Act, the penalty or punishment if not already imposed shall be imposed in accordance with this Act.

OFFICIAL COMMENT

The saving provisions of section 17.03 are derived from section 25 of the Uniform Statutory Construction Act, which was promulgated by the National Conference of Commissioners on Uniform State Laws in 1965.

§ 17.04. SEVERABILITY

If any provision of this Act or its application to any person or circumstance is held invalid by a court of competent jurisdiction, the invalidity does not affect other provisions or applications of the Act that can be given effect without the invalid provision or application, and to this end the provisions of the Act are severable.

§ 17.05. REPEAL

The following laws and parts of laws are repealed: [to be inserted by the adopting state].

OFFICIAL COMMENT

The Model Act is intended to be a complete substitute for earlier statutes of general applicability to business corporations and it is contemplated that all these statutes should normally be repealed when the revised Model Act is enacted. A few states in the past have retained portions of earlier statutes while enacting integrated codifications of business corporation law. This practice is generally undesirable since it tends to cause unnecessary confusion in determining the applicable law as well as creating possible internal statutory conflicts.

Many states have enacted statutes providing special incorporation and regulatory provisions for corporations engaged in specific businesses, like banking and insurance. These specialized statutes should not be included in the list of statutes repealed by section 17.05. Many of these specialized statutes expressly “borrow” provisions from the general corporation act to fill in gaps or to provide applicable rules when the specialized statute is silent. As a general matter, it would be desirable to ensure that these statutes are amended to refer specifically to the present Act rather than to an earlier statute; an appropriate provision would apply this Act to all these corporations except to the extent the specialized statute expressly provides that a different principle should be applicable.

§ 17.06. EFFECTIVE DATE

This Act takes effect ______ [to be inserted by the adopting state].

OFFICIAL COMMENT

The transition provisions of the revised Model Act contemplate that a single effective date will be provided for the entire Act. As indicated in the Introductory Comment to this chapter, however, some states may wish to make special provisions, including delayed effective dates, for particular sections.