

### 8.33 Liability for Unlawful Distributions

(a) A director who votes for or assents to a distribution made in violation of section 6.40 or the articles of incorporation is personally liable to the corporation for the amount of the distribution that exceeds what could have been distributed without violating section 6.40 or the articles of incorporation if it is established that he did not perform his duties in compliance with section 8.30. In any proceeding commenced under this section, a director has all of the defenses ordinarily available to a director.

(b) A director held liable under subsection (a) for an unlawful distribution is entitled to contribution:

(1) from every other director who could be held liable under subsection (a) for the unlawful distribution; and

(2) from each shareholder for the amount the shareholder accepted knowing the distribution was made in violation of section 6.40 or the articles of incorporation.

(c) A proceeding under this section is barred unless it is commenced within two years after the date on which the effect of the distribution was measured under section 6.40(e) or (g).

## Subchapter D

### Officers

#### 8.40 Required Officers

(a) A corporation has the officers described in its bylaws or appointed by the board of directors in accordance with the bylaws.

(b) A duly appointed officer may appoint one or more officers or assistant officers if authorized by the bylaws or the board of directors.

(c) The bylaws or the board of directors shall delegate to one of the officers responsibility for preparing minutes of the directors' and shareholders' meetings and for authenticating records of the corporation.

(d) The same individual may simultaneously hold more than one office in a corporation.

#### 8.41 Duties of Officers

Each officer has the authority and shall perform the duties set forth in the bylaws or, to the extent consistent with the bylaws, the duties prescribed by the board of directors or by direction of an officer authorized by the board of directors to prescribe the duties of other officers.

#### 8.42 Standards of Conduct for Officers

(a) An officer with discretionary authority shall discharge his duties under that authority:

(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.

(b) In discharging his duties an officer is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation whom the officer reasonably believes to be reliable and competent in the matters presented; or

(2) legal counsel, public accountants, or other persons as to matters the officer reasonably believes are within the person's professional or expert competence.

(c) An officer is not acting in good faith if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

(d) An officer is not liable for any action taken as an officer, or any failure to take any action, if he performed the duties of his office in compliance with this section.

/\* A standard quite similar to that for 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 date. If a resignation is made effective at a later date and the corporation accepts the future effective date, its board of directors may fill the pending vacancy before the effective date if the board of directors provides that the successor does not take office until the effective date.

(b) A board of directors may remove any officer at any time with or without cause.

#### 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.

/\* This separates the appointment of office from the compensation related to the office. \*/

#### Subchapter E

### INDEMNIFICATION

#### INTRODUCTORY COMMENT

The indemnification provisions 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 between important social policies.

Indemnification provides financial protection by the corporation for its directors, officers and employees against expenses and liabilities incurred by them in connection with proceedings based on an alleged breach of some duty in their service to or on behalf of the corporation. Today, when both the amount and the cost of litigation have skyrocketed, it would be difficult or impossible 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.

Indemnification if permitted too broadly, may violate basic tenets of public policy. It is inappropriate to permit management to use corporate funds to avoid the consequences of wrongful conduct or conduct involving bad faith. A director, officer, or employee who acted wrongfully or in bad faith should

not expect to receive assistance from the corporation for legal or other expenses and should be required to satisfy not only any judgment entered against him but also expenses incurred in connection with the proceeding from his personal assets. 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 express provisions of state or federal civil or criminal statutes. A shift of these liabilities from the individual director or officer to the corporation by way of indemnification may in some instances be viewed as frustrating the public policy of those statutes which expressly impose the sanctions on the director or officer.

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 accepted corporate goals 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 BusLaw 1993, 1994 (1978). The increasing number of suits against directors, the increasing cost of defense, and the increasing emphasis on broadening membership of boards of directors of public companies all militate in favor of establishing workable arrangements to protect directors and officers against liability for action taken in good faith to the extent consistent with broad public policy.

## 8.50 Subchapter Definitions

In this subchapter:

- (1) "Corporation" includes any domestic or foreign predecessor entity of a corporation in a merger or other transaction in which the predecessor's existence ceased upon consummation of the transaction.
- (2) "Director" means an individual who is or was a director of a corporation or an individual who, while a director of a corporation, is or was serving at the corporation's request as a director, officer, partner, trustee, employee, or agent of another foreign or domestic corporation, partnership, joint venture, trust, employee benefit plan, or other enterprise. A director is considered to be serving an employee benefit plan at the corporation's request if his duties to the corporation also impose duties on, or otherwise involve services by, him to the plan or to participants in or beneficiaries of the plan. "Director" includes, unless the context requires otherwise, the estate or personal

representative of a director.

(3) "Expenses" include counsel fees.

(4) "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.

(5) "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 individual other than a director, as contemplated in section 8.56, the office in a corporation held by the officer or the employment or agency relationship undertaken by the employee or agent on behalf of the corporation. "Official capacity" does not include service for any other foreign or domestic corporation or any partnership, joint venture, trust, employee benefit plan, or other enterprise.

(6) "Party" includes an individual who was, is, or is threatened to be made a named defendant or respondent in a proceeding.

(7) "Proceeding" means any threatened, pending, or completed action, suit, or proceeding, whether civil, criminal, administrative, or investigative and whether formal or informal.

#### Official Comment

The definitions set forth in section 8.50 apply only to subchapter E and have no application elsewhere in the Model Act.

## 2. Director

The second sentence of section 8.50(2) addresses the question of liabilities arising under the Employee Retirement Income Security Act (ERISA). It makes clear that a director who is serving as a fiduciary of an employee benefit plan is nevertheless viewed as acting as a director for purposes of this subchapter. Special treatment is felt to be necessary because of the broad definition of "fiduciary" in section 3(21) of ERISA, 29 U.S.C. 1002(21) (1974), and the requirement of section 404 ( 1104(a)) that a "fiduciary" must discharge his duties "solely in the interest" of the participants and beneficiaries of the employee benefit plan. Decisions by a director serving as a fiduciary under the plan on questions regarding eligibility for benefits, investment decisions, and interpretation of plan provisions regarding qualifying service, years of service, and retroactivity are all subject to the protections of this subchapter. See also sections 8.50(4) and 8.51(b) of this subchapter.

#### 4. Liability

"Liability" is defined for convenience, to avoid repeated references to recoverable items throughout the subchapter. Even though the definition of "liability" includes both expenses and amounts paid to satisfy or to settle substantive claims, indemnification against substantive claims is not allowed in several provisions in subchapter E. For example, indemnification in suits brought by or in the name of the corporation is limited to expenses. See section 8.51(e).

#### 5. 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 applies: if action is taken in an "official capacity," the person to be indemnified must have reasonably believed he was acting in the best interests of the corporation, while if the action in question was not taken in his "official capacity," he need only have reasonably believed that the conduct was not opposed to the best interests of the corporation.

#### 8.51 Authority to Indemnify

(a) Except as provided in subsection (d), a corporation may indemnify an individual made a party to a proceeding because he is or was a director against liability incurred in the proceeding if:

(1) he conducted himself in good faith; and

(2) he reasonably believed:

(i) in the case of conduct in his official capacity with the corporation, that his conduct was in its best interests; and

(ii) in all other cases, that his conduct was at least not opposed to its best interests; and

(3) in the case of any criminal proceeding, he had no reasonable cause to believe his conduct was unlawful.

A director's conduct with respect to an employee benefit plan for a purpose he reasonably believed to be in the interests of the participants in and beneficiaries of the plan is conduct that satisfies the requirement of subsection (a)(2)(ii).

(c) The termination of a proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent is not, of itself,

determinative that the director did not meet the standard of conduct described in this section.

/\* An important note that opens the possibility of a corporation nevertheless indemnifying a person if their actions may be wrong in a criminal (or plea bargain sense) but were not improper by consideration of the requirements of the corporation. \*/

(d) A corporation may not indemnify a director under this section:

(1) in connection with a proceeding by or in the right of the corporation in which the director was adjudged liable to the corporation; or

(2) in connection with any other proceeding charging improper personal benefit to him, whether or not involving action in his official capacity, in which he was adjudged liable on the basis that personal benefit was improperly received by him.

(e) Indemnification permitted under this section in connection with a proceeding by or in the right of the corporation is limited to reasonable expenses incurred in connection with the proceeding.

## Official Comment

### 1. Section 8.51(a)

The standards for indemnification of directors contained in this subsection define the outer limits for which voluntary indemnification is permitted under the Model Act. Conduct which does not meet these standards is not eligible for voluntary indemnification under the Model Act, although court-ordered indemnification may be available under section 8.54(2). Conduct that falls within these outer limits does not automatically entitle directors to indemnification, although many corporations have adopted bylaw provisions that obligate the corporation to indemnify directors to the maximum extent permitted by statute. Absent such a bylaw provision, section 8.52 defines a much narrower area in which the 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 name of the corporation. The Model Act establishes a single uniform test to make 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(e) limits indemnification in connection with suits

brought by or in the name of the corporation to expenses incurred and excludes amounts paid to settle or satisfy substantive claims.

The standards of conduct described in sections 8.51(a)(1) and 8.51(a)(2)(i) that a director's conduct in his official capacity was in "good faith" and in the corporation's "best interests" is closely related to the basic standards of conduct imposed by section 8.30, but the two standards are not identical. No attempt is made to define "good faith," a term used in both section 8.30 and section 8.51. The concept of good faith involves a subjective test, which would include "a mistake of judgment," in the words of the Official Comment to section 8.30, even though made unwisely by objective standards. But the affirmative requirement of section 8.3 that the "care of an ordinarily prudent person in a like position" be exercised-is not included in the standard of conduct for indemnification. On the other hand, section 8.51 requires that there be a "reasonable" belief on the part of the director in most instances, and in the case of criminal proceedings that there be no "reasonable" cause to believe the conduct was unlawful. Accordingly, it is possible that a director who has not acted "with the care an ordinarily prudent person in a like position would exercise under similar circumstances," as required by section 8.30, could nevertheless be indemnified if the standard of section 8.51 were met. As a corollary, it is clear that a director who has met the section 8.30 standards of conduct would be eligible in virtually every case to be indemnified under section 8.51.

Section 8.51(a)(2)(ii) requires, if a director is not acting in his official capacity, that his 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 he is or was a director. The words "at least" were added to qualify "not opposed to" in order to make it clear that this test is an outer limit for conduct other than in an official capacity.

#### 4. Section 8.51(d)

This subsection makes clear that indemnification is not permissible under section 8.51 in the face of a finding of improper conduct either because liability is imposed in favor of the corporation in a suit brought by or in its name or because there is a finding that the director improperly received a personal benefit as a result of his conduct. Indemnification under this subsection is prohibited if a director is adjudged liable in a derivative suit because it is believed that there should be no indemnification in this situation unless a court first finds it proper. Section 8.54 permits a director found liable to the corporation to petition a court for a judicial determination of entitlement to indemnification. Voluntary indemnification is also prohibited if there has been an adjudication that a director improperly received a personal benefit, even if, for example, he acted in a manner not opposed to



the best interests of the corporation. Improper use of inside information for personal benefit should not be an action for which the corporation may provide indemnification, even if the corporation was not thereby harmed. Although it is unlikely that a person found liable for receiving an improper personal benefit would be found to have met the statutory standard of conduct set forth in section 8.51(a)(2)(ii), this limitation is made explicit in section 8.51(d)(2). Recourse to a court under section 8.54 may also be appropriate in some improper benefit cases—for example, where it would be unfair for a small personal benefit to foreclose indemnification in an expensive and complicated matter.

## 5. Section 8.51(e)

This subsection limits indemnification in suits brought by or in the right of the corporation to expenses incurred in connection with the proceeding. Its purpose is to avoid circularity that would be involved if a corporation seeks to indemnify a director for payments made in settlement by the director to the corporation. This subsection applies only to settlements since all indemnification is prohibited by section 8.51(d)(1)—subject to the right to seek judicially approved indemnification under section 8.54—in cases where a director is "adjudged" liable to the corporation.

## 8.52 Mandatory Indemnification

Unless limited by its articles of incorporation, a corporation shall indemnify a director who was wholly successful, on the merits or otherwise, in the defense of any proceeding to which he was a party because he is or was a director of the corporation against reasonable expenses incurred by him in connection with the proceeding.

## 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 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(1), which also gives the director a statutory right to recover expenses incurred by him in enforcing his 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 he succeeded by plea bargaining or otherwise 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 involves a finding of nonliability. However, 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 pay for or reimburse the reasonable expenses incurred by a director who is a party to a proceeding in advance of final disposition of the proceeding if:

(1) the director furnishes the corporation a written affirmation of his good faith belief that he has met the standard of conduct described in section 8.51;

(2) the director furnishes the corporation a written undertaking, executed personally or on his behalf, to repay the advance if it is ultimately determined that he did not meet the standard of conduct; and

(3) a determination is made that the facts then known to those making the determination would not preclude indemnification under this subchapter.

(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 financial ability to make repayment.

/\* The provision of an advance for expense can in many cases be determinative of whether the corporation indemnifies the director as a realistic manner, since corporate litigation is expensive and in many cases can result in the expenditures of millions of dollars. Since no proof that the director can repay the advance is required, it can be money down the "drain" with the directors receiving the best of professional help at the corporations realistic expense. \*/

(c) Determinations and authorizations of payments under this section shall be made in the manner specified in section 8.55.

## Official Comment

It is often critically important to a director who is made a party to a complex proceeding that the corporation he served have power to make advances for expenses at the beginning of and during the proceeding. Adequate legal representation and adequate preparation of a defense may require substantial payments of expenses before a final determination, and unless the corporation may make advances for expenses, a defendant may be unable to finance his own defense. This problem is complicated by reason of the fact that during the early stages of a proceeding (when advances are often needed) the facts underlying the claim cannot be fully evaluated and the board of directors therefore cannot accurately ascertain the ultimate propriety of indemnification.

Section 8.53 establishes a workable standard: indemnification is permitted if the facts then known to those making the determination do not establish that indemnification would be precluded under section 8.51. The directors or special legal counsel) making the determination under section 8.53(c would normally communicate with counsel and the person or persons monitoring the matter for the corporation in order to gain familiarity with the status of the proceeding and the relevant facts that have emerged, but it is not required (or expected) that any form of independent investigation be undertaken for purposes of the determination. Thus, an advance may be made under section 8.53 unless it becomes clear, from the facts at hand, that indemnification under section 8.51 cannot be provided. As additional facts become known, a different determination may be required.

### 8.54 Court-Ordered Indemnification

Unless a corporation's articles of incorporation provide otherwise, a director of the corporation who is a party to a proceeding may apply for indemnification to the court conducting the proceeding or to another court of competent jurisdiction. On receipt of an application, the court after giving any notice the court considers necessary may order indemnification if it determines:

- (1) the director is entitled to mandatory indemnification under section 8.52, in which case the court shall also order the corporation to pay the director's reasonable expenses incurred to obtain court-ordered indemnification: or
- (2) the director is fairly and reasonably entitled to indemnification in view of all the relevant circumstances, whether or not he met the standard of conduct set forth in section 8.51 or was adjudged liable as described in section 8.51(d), but if he was adjudged so liable his indemnification is limited

to reasonable expenses incurred.

## 8.55 Determination and Authorization of Indemnification

(a) A corporation may not indemnify a director under section 8.51 unless authorized in the specific case after a determination has been made that indemnification of the director is permissible in the circumstances because he has met the standard of conduct set forth in section 8.51.

(b) The determination shall be made:

(1) by the board of directors by majority vote of a quorum consisting of directors not at the time parties to the proceeding;

(2) if a quorum cannot be obtained under subdivision (1), by majority vote of a committee duly designated by the board of directors (in which designation directors who are parties may participate), consisting solely of two or more directors not at the time parties to the proceeding;

(3) by special legal counsel:

(i) selected by the board of directors or its committee in the manner prescribed in subdivision (1) or (2); or

(ii) if a quorum of the board of directors cannot be obtained under subdivision (1) and a committee cannot be designated under subdivision (2), selected by majority vote of the full board of directors (in which selection directors who are parties may participate); or

(4) by the shareholders, but shares owned by or voted under the control of directors who are at the time parties to the proceeding may not be voted on the determination.

(c) Authorization of indemnification and evaluation as to reasonableness of expenses shall be made in the same manner as the determination that indemnification is permissible, except that if the determination is made by special legal counsel, authorization of indemnification and evaluation as to reasonableness of expenses shall be made by those entitled under subsection (b)(3) to select counsel.

### Official Comment

Section 8.55 provides the method for determining whether a corporation should voluntarily indemnify directors 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 requisite standard of conduct under section 8.51 and is therefore eligible for indemnification. This decision may be made by the persons or groups described in section 8.55(0). In addition, after a favorable "determination" is made, the corporation must "authorize" indemnification; this includes a review of the reasonableness of the expenses, the financial ability of the corporation to make the payment, and the judgment whether limited financial resources should be devoted to this or some other use by the corporation.

Section 8.55(b) establishes a procedure for selecting the person or persons who will make the determination of eligibility for indemnification. Even though directors who are parties to the proceeding may not participate in the decision determining eligibility for indemnification, they may, if necessary to permit valid action by the board of directors, participate in the decision establishing a committee of independent directors or selecting special legal counsel. Directors who are parties may also participate in the decision to "authorize" indemnification on the basis of a favorable "determination" if necessary to permit action by board of directors. This limited participation of interested directors in the decision is justified by a principle of necessity.

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, he is referred to as "independent legal counsel. The word "special" is felt to be more descriptive of the role to be performed and is not intended to indicate that the counsel selected should not be independent in accordance with governing legal precepts. "Special legal counsel" should normally be counsel having no prior professional relationship with those seeking indemnification, should be retained for the specific occasion, and should not be either inside counsel or regular outside counsel. It is important that the selection 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.

## 8.56 Indemnification of Officers, Employees, and Agents

Unless a corporation's articles of incorporation provide otherwise:

- (1) an officer of the corporation who is not a director is entitled to mandatory indemnification under section 8.52, and is entitled to apply for court-ordered indemnification under section 8.54, in each case to the same extent as a director;
- (2) The corporation may indemnify and advance expenses under this subchapter to an officer, employee, or agent of the corporation who is not a director to the same extent as to a director; and

(3) a corporation may also indemnify and advance expenses to an officer, employee, or agent who is not a director to the extent, consistent with public policy, that may be provided by its articles of incorporation, bylaws, general or specific action of its board of directors, or contract.

/\* A provision giving specific authorization for contractual indemnification. \*/

## Official Comment

### 1. Officers, Employees, or Agents Who Are Not Directors

Section 8.56(3) authorizes indemnification for officers, employees, and agents who are not directors, but neither requires nor prescribes standards for their indemnification and expressly states that their indemnification may be broader than the right of indemnification granted to directors by this subchapter. The rights of employees or agents may derive from principles of agency, the doctrine of respondeat superior, or collective bargaining or other contractual agreement, rather than from the statute. . . . But indemnification under section 8.5(3(3) must ultimately be "consistent with law." In effect, this leaves public policy determinations as to what are permissible limits, in a particular case, to the courts. For example, in *Koster v. Warren*, 297 F.2d 418, 423 (9th Cir.1961), the court allowed indemnification of an officer and an employee, both of whom pleaded nolo contendere to an antitrust indictment at the corporation's request, the court reasoning that they had foregone their personal right to defend for the corporation's benefit. On the other hand, the court indicated in dictum that an agreement in advance by the corporation to indemnify anyone convicted of antitrust violations would be against public policy.

### 2. Directors Who Are Also Officers, Employees, or Agents

Section 8.56 provides that officers, employees, or agents who are also directors are subject to the same standards of indemnification as other directors. Consideration was given to whether these officer-directors, if acting in their capacity as an officer but not as a director, should have the benefit of the additional flexibility afforded by section 8.56(3) for officers who are not directors. It was concluded, however, that all directors should be treated alike; complications may be created if directors who are not officers have potentially less protection under the statute than directors who are officers. It would also be difficult in many instances to distinguish in what capacity an officer-director is acting. Finally, this subchapter offers sufficient flexibility in indemnifying directors so that, as a practical matter, foreseeable problems for officer-directors can be handled within the statutory framework.

## 8.57 Insurance

A corporation may purchase and maintain insurance on behalf of an individual who is or was a director, officer, employee, or agent of the corporation, or who, while a director, officer, employee, or agent of the corporation, is or was serving at the request of the corporation as a director, officer, partner, trustee, employee, or agent of another foreign or domestic corporation, partnership, joint venture, trust, employee benefit plan, or other enterprise, against liability asserted against or incurred by him in that capacity or arising from his status as a director, officer, employee, or agent, whether or not the corporation would have power to indemnify him against the same liability under section 8.51 or 8.52.

## 8.58 Application of Subchapter

(a) A provision treating a corporation's indemnification of or advance for expenses to directors that is contained in its articles of incorporation, bylaws, a resolution of its shareholders or board of directors, or in a contract or otherwise, is valid only if and to the extent the provision is consistent with this subchapter. If articles of incorporation limit indemnification or advance for expenses, indemnification and advance for expenses are valid only to the extent consistent with the articles.

(b) This subchapter does not limit a corporation's power to pay or reimburse expenses incurred by a director in connection with his appearance as a witness in a proceeding at a time when he has not been made a named defendant or respondent to the proceeding.

### Official Comment

Section 8.58(a) provides that a provision treating the indemnification of directors by the corporation in articles of incorporation, bylaws, shareholders' or directors' resolution, or contract "is valid only if and to the extent it is consistent with" this subchapter. Earlier versions of the Model Act and the statutes of many states provided that the statutory provisions were not "exclusive" and made no attempt to limit the nonstatutory creation of rights of indemnification. This kind of language is subject to misconstruction, however, since nonstatutory conceptions of public policy limit the power of a corporation to indemnify or to contract to indemnify directors, officers, employees, or agents.

It is important to recognize that "to the extent it is consistent with" is not synonymous with "exclusive." Situations may well develop from time to time in which indemnification is permissible under section 8.58 but would be precluded if all portions of subchapter E were viewed as exclusive. But indemnification provisions protecting against the consequences of bad faith

or willful misconduct are not consistent with this subchapter and would not be valid. Furthermore, they would violate well-understood principles of public policy and doubtless would be invalidated on that ground even under statutes purporting to make "nonexclusive" the statutory provisions for indemnification. To the extent the consistency language may preclude indemnification in circumstances where it is reasonable and violates no statutory policy, an escape valve is provided in section 8.55(2), which authorizes a court to grant indemnification if a director "is fairly and reasonably entitled to indemnification in view of all the relevant circumstances," even though he may not have fully met the standards of conduct set forth in section 8.51.

Section 8.58 does not preclude provisions in articles of incorporation, bylaws, resolutions, or contracts designed to provide procedural machinery different from that provided by section 8.55 or to make mandatory the permissive provisions of subchapter E. For example, a corporation may properly obligate the board of directors to consider and act expeditiously on an application for indemnification or advances, or obligate the board of directors to cooperate in the procedural steps required to obtain a judicial determination under section 8.54.

Some corporations currently commit themselves, in one form or another, to indemnify directors to the fullest extent permitted by applicable law. These commitments are consistent with subchapter E, subject to appropriate interpretation in light of the facts and circumstances of the particular case. Furthermore, a commitment to maintain liability insurance for a director, pursuant to section 8.57, is consistent with this subchapter.

## Subchapter F

### Directors' Conflicting Interest Transactions

#### Introductory Comment

#### 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, 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 a consensual bilateral arrangement 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 but rather a "deal." See the discussion regarding "transaction" under clause (2) of Section 8.60(2).

Third, subchapter F deals with directors only.

Subchapter F contemplates deletion of former Model Act section 8.32 dealing specially with loans to directors; a loan to a director is simply a subspecies of directors' conflicting interest transactions and is procedurally governed by subchapter F. See the Note on Fair Transactions in the Official Comment to section 8.61(0).

### 3. Structure of Subchapter F

The skeleton of 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 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.

#### Note

In the Official Comments to subchapter F, the director who has a conflicting interest is for convenience referred to as "the director" or "D", the corporation of which he is a director is referred to as "the corporation" or "X Co.," and another corporation dealing with X Co. is referred to as "Y Co."

#### 8.60 Subchapter Definitions

In this subchapter:

(1) "Conflicting interest with respect to a corporation means the interest a director of the corporation has respecting a transaction effected or proposed to be effected by the corporation (or by a subsidiary of the corporation or any other entity in which the corporation has a controlling interest) if

(i) whether or not the transaction is brought before the board of directors of the corporation for action, the director knows at the time of commitment that he or a related person is a party to the transaction or has a beneficial financial interest in or so closely linked to the transaction and of such financial significance to the director or a related person that the interest would reasonably be expected to exert an influence on the director's judgment if he were called upon to vote on the transaction; or

(ii) the transaction is brought (or is of such character and significance to the corporation that it would in the normal course be brought) before the board of directors of the corporation for action, and the director knows at the time of commitment that any of the following persons is either a party to the transaction or has a beneficial financial interest in or so closely linked to the transaction and of such financial significance to the person that the interest would reasonably be expected to exert an influence on the director's judgment if he were called upon to vote on the transaction: (A) an entity (other than the corporation) of which the director is a director, general partner, agent, or employee; (B) a person that controls one or more of the entities specified in subclause (A) or an entity that is controlled by, or is under common control with, one or more of the entities specified in subclause (A); or (C) an individual who is a general partner, principal, or employer of the director.

(2) "Director's conflicting interest transaction" with respect to a corporation means a transaction effected or proposed to be effected by the corporation (or by a subsidiary of the corporation or any other entity in which the corporation has a controlling interest) respecting which a director of the corporation has a conflicting interest.

(3) "Related person" of a director means (i) the spouse (or a parent or sibling thereof) of the director, or a child, grandchild, sibling, parent (or spouse of any thereof) of the director, or an individual having the same home as the director, or a trust or estate of which an individual specified in this clause (i) is a substantial beneficiary; or (ii) a trust, estate, incompetent, conservatee, or minor of which the director is a fiduciary.

(4) "Required disclosure" means disclosure by the director who has a conflicting interest of (i) the existence and nature of his conflicting interest, and (ii) all facts known to him respecting the subject matter of the transaction that an ordinarily prudent person would reasonably believe to be material to a judgment about whether or not to proceed with the transaction.

(5) "Time of commitment" respecting a transaction means the time when the transaction is consummated or, if made pursuant to contract, the time when the corporation (or its subsidiary or the entity in which it has a controlling interest) becomes contractually obligated so that its unilateral withdrawal from the transaction would entail significant loss, liability, or other damage.

#### Official Comment

The definitions set forth in section 8.60 apply to subchapter F only and have no application elsewhere in the Model Act.

## 1. Conflicting Interest

The definition of conflicting interest requires that the director know of the transaction. More than that, it requires that he know of his interest conflict at the time of the corporation's commitment to the transaction. Absent that knowledge by the director, the risk to the corporation addressed by subchapter F is not present. In a corporation of significant size, routine transactions in the ordinary course of business, involving decision-making at lower management levels, will usually not be known to the director and will thus be excluded by the "knowledge" criterion in the definition.

The term "conflicting interest" as defined in subchapter F is never abstract or freestanding; its use must always be linked to a particular director, to a particular transaction and to a particular corporation.

The definition of "conflicting interest" is exclusive. An interest of a director is a conflicting interest if and only if it meets the requirements of subdivision (1).

D can have a conflicting interest in only three ways.

First a conflicting interest of D will obviously arise if the transaction is between D and X Co.

A conflicting interest will also arise under subdivision (1)(i) if D is not a party but has a beneficial financial interest in the transaction that is separate from his interest as a director or shareholder and is of such significance to the director that it would reasonably be expected to exert an influence on his judgment if he were called upon to vote on the matter. The personal economic stake of the director must be in or closely linked to the transaction—that is, his gain must hinge directly on the transaction itself. A contingent or remote gain (such as a future reduction in tax rates in the local community) is not enough to give rise to a conflicting interest under subdivision (1)(i). See the discussion of "transaction" under the Official Comment to subdivision (2).

If Y Co. is a party to or interested in the transaction with X Co. and Y Co. is somehow linked to D, the matter is in general governed by subdivision (1)(ii). But D's economic interest in Y Co. could be so substantial and the impact of the transaction so important to Y Co. that D could also have a conflicting interest under subdivision (1)(i).

Note that basic standard set by subdivision (1)(i) and throughout subchapter F—"would reasonably be expected to exert an influence"—is an objective, not a subjective, criterion.

Second, a conflicting interest of D can arise under subdivision (1)(i) from the involvement in the transaction of a "related person" of D. "Related person" is defined in subdivision (3).

Third, in limited circumstances, subsequently discussed, a conflicting interest of D can arise through the economic involvement of certain other persons specified in subdivision (1)(ii). These are any entity (other than X Co.) of which the director is a director, general partner, agent, or employee; a person that controls, or an entity that is controlled by, or is under common control with one or more of the entities specified in the preceding clause; and any individual who is a general partner, principal, or employer of D.

The terms "principal" and "employer" as used in subdivision (1)(ii) are not separately defined but should be interpreted sensibly in the context of the purpose of the subdivision. The key question is whether D is, by force of an overt or covert tie to an employer or a principal who has a significant stake in the outcome of the transaction, beholden to act in the interest of that outside employer or principal rather than in the interest of X Co.

The "would reasonably be expected" criterion of subdivision (1)(i) applies also to subdivision (1)(ii).

Any director will, of course, have countless relationships and linkages to persons and institutions other than those specified in subdivision (1)(ii) and those defined in subdivision (3) to be related persons. But . . . the subcategories of persons encompassed by subdivision (1)(ii) are expressly intended to be exclusive and to cover the field for purposes of subchapter F and particularly section 8.61(a). Thus, if, in a case involving a transaction between X Co. and Y Co., a court is presented with the argument that D, a director of X Co., is also a major creditor of Y Co. and that that stake in Y Co. gives D a conflicting interest, the court should reply that D's creditor interest in Y Co. does not fit any subcategory of subdivision (1)(ii) or subdivision (3) and therefore the conflict of interest claim must be rejected by force of section 8.61(a). The result would be otherwise if Y Co.'s debt to D is of such economic significance to D that it would fall under subdivision or put him in control of Y Co. and thus come within subdivision

Subdivision (1)(ii) has a differentiated threshold keyed to the significance of the transaction. See the Official Comment to subdivision (2).

It is to be noted that under subdivision (1) of Section 8.60, any interest that the director has that meets the criteria set forth is considered a "conflicting interest". If a director has an interest that meets those criteria, subchapter F draws no further 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 the interests of the corporation. If the director's "interest" is present, "conflict" is assumed.

## 2. Director's Conflicting Interest Transaction

The definition of "director's conflicting interest transaction" in subdivision (2) is the key concept of subchapter F, establishing the area that lies within-and without-the scope of the subchapter's provisions. The definition operates preclusively; it not only designates the area within which the rules of subchapter F are to be applied but also denies the power of the court to act with respect to conflict of interest claims against directors in circumstances that lie outside the statutory definition of "director's conflicting interest transaction." See section 8.61(a).

### (1) Transaction

To constitute a director's conflicting interest transaction, there must first be a transaction by the corporation, its subsidiary, or controlled entity in which the director has a financial interest. As discussed earlier, the safe harbor provisions provided by subchapter F have no application to circumstances in which there is no "transaction" by the corporation, however apparent the director's conflicting interest. Other strictures of the law prohibit a director from seizing corporate opportunities for himself and from competing against the corporation of which he is a director; subchapter F has no application to such situations. Moreover, a director might personally benefit if the corporation takes no action, as where the corporation decides not to make a bid. Subchapter F has no application to such instances. The limited thrust of the subchapter is to establish procedures which, if followed, immunize a corporate transaction and the interested director against the common law doctrine of voidability grounded on the director's conflicting interest.

However, a policy decision and a transactional decision can blur and overlap. Assume X Co. operates a steel mini-mill that is running at a loss. A real estate developer offers to buy the land on which the mill is located and the X Co. board, having no other use for the land, accepts the offer. This corporate action can readily be characterized either as a transaction-the sale of the land-or as a business policy decision-to go out of an unprofitable business. If D is a partner of the real estate developer, D has a stake in the sale transaction and subdivisions (1)(i) and (1)(iii) and all of subchapter F apply. But what if D, having no such interest, is in the local trucking business and a predictable consequence of closing the local mini-mill is that D will benefit from a future increase in demand for hauling services to bring in steel from more distant supply sources. An intent of the words "in or so closely linked to the transaction" in subdivisions (1)(i) and (1)(ii) is to focus subchapter F on

the transaction itself. D's financial stake as a trucker in this situation lies not in the transaction, which is governed by subchapter F, but in the corporate business decision, which is not; accordingly, section 8.61(a) is inapplicable and imposes no bar to the court's discretion. Board action, though in compliance with section 8.62, will not, ipso facto, yield safe harbor protection for D or the transaction under section 8.61(b).

As another feature of the key term "transaction", the text of subdivision (1) emphasizes that the term implies and is limited to action by the corporation itself. The language of subchapter F has no application one way or the other to economic actions by the director in which the corporation is not a party or in which the corporation takes no action. Thus, a purchase by the director of the corporation's shares on the open market or from a third party is not a "transaction" within the scope of subchapter F and the subchapter does not govern an attack made on the propriety of such a share purchase.

If the board of directors of X Co. decides to distribute "poison pill" rights in order to fend off a possible takeover, that occurrence does not constitute a "transaction" as contemplated by subchapter F. . . . If, on the other hand, a board of directors commits the corporation to a crown jewel" option granted to a third party, there would be a "transaction".

But as noted earlier, for the transaction to be covered by sub chapter F, the director (or other person designated by Section 8.60(i)) must have a beneficial interest respecting the transaction. Subchapter F would obviously govern such a crown jewel contract if a director was himself (or had a defined relationship to) the third party. But the fact that the crown jewel contract was in part motivated by the directors' desire to keep themselves on the board would not, taken alone, constitute a sufficiently direct interest in the transaction to bring it with subchapter F.