

**MODEL BUSINESS CORPORATION ACT**

**(2016 Revision)**

**(December 9, 2017)**

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## CHAPTER 1

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# General Provisions

### **Subchapter A.**

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## **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 corporations, see § 17.01.

Application of Act to existing foreign corporations, see § 17.02.

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.

#### **§ 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 corporations, see § 17.01.

Application of Act to existing foreign corporations, see § 17.02.

Saving provisions, see § 17.03.

#### **OFFICIAL COMMENT**

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.

All articles of incorporation and foreign registration statements 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 or registered under earlier general incorporation statutes that contain such a reservation of power—are also subject to the reservation of power of section 1.02 and bound by subsequent amendments to the Act.

## **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 and may contain other information.
- (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.
- (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(a), 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.
- (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 by this Act or other law to be paid at the time of delivery for filing 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 must be set forth in the plan or filed document.
  - (2) The facts may include:
    - (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 corporation is a party, or any other agreement or document.
- (3) As used in this subsection § 1.20(k):
- (i) “filed document” means a document filed by 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, 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; and
  - (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 neither ascertainable by reference to a source described in subsection (k)(2)(i) or a document that is a matter of public record, nor have the affected shareholders received notice of the fact from the corporation, then the corporation shall file with the secretary of state articles of amendment to the filed document 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 to which they relate and may be filed by the corporation without further action by the board of directors or the shareholders.

## **CROSS-REFERENCES**

- Corporate name, see ch. 4 and § 15.06.
- Correcting filed document, see § 1.24.
- Effective time and date of filing, see § 1.23.
- “Electronic transmission” defined, see § 1.40.
- Filing fees, see § 1.22.
- Forms, see § 1.21.
- Penalty for signing false document, see § 1.29.
- Registration statement for foreign corporation, see § 15.03.
- Secretary of state’s filing duty, see § 1.25.
- “Sign” defined, see § 1.40.

## **OFFICIAL COMMENT**

Section 1.20 standardizes the filing requirements for all documents expressly required or permitted by the Act to be filed by 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 address documents required or permitted to be filed under other statutes. 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.

The filing requirements of chapter 1 are intended to minimize both the number of documents to be processed by the secretary of state and the number of disputes between persons seeking to file documents and the secretary of state as to the legal efficacy of documents.

### *1. Form*

The Act permits a document to be filed in typewritten or printed form through physical delivery to the secretary of state or (if permitted by the secretary of state) by electronic transmission, which is broadly defined in section 1.40. Section 1.21 permits the secretary of state to prescribe forms, but the secretary of state may only make mandatory those forms listed in section 1.21(a). As a result, the secretary of state may not reject other documents on the basis of form if they contain the information called for by the specific statutory requirement and meet the minimal formal requirements of this section. See section 1.25.

### *2. Signing*

Section 1.40 defines “sign” and “signing,” and section 1.20(f) states who must sign a document. The Act does not require that documents be acknowledged or verified as a condition for filing. Requirements such as these serve little purpose in connection with documents filed under the Act because section 1.29 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 these additional forms of authentication do not affect the eligibility of the document for filing.

### *3. Copies*

For purposes of section 1.20(i), an “exact” copy is a reproduction of the signed original document, and a “conformed” copy is a copy on which the existence of signatures is entered or noted on the copy. However, a person submitting “duplicate originals” meets any requirement for a conformed copy because the secretary of state may treat the duplicate original as a “conformed copy.”

### *4. Reference to Extrinsic Facts*

Section 1.20(k) applies where the Act permits any of the terms of a filed document or a plan to be made dependent on facts outside the document or plan. 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 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 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.

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 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, although 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 of domestication, conversion, merger or share exchange, and section 6.21 requires the board to determine the adequacy of consideration for shares to be issued by the corporation.

### **§ 1.21 Forms**

- (a) The secretary of state may prescribe and furnish on request forms for: (i) an application for a certificate of existence or certificate of registration, (ii) a foreign corporation's registration statement, (iii) a foreign corporation's statement of withdrawal, (iv) a foreign corporation's transfer of registration statement, and (v) 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.

Certificate of existence or registration, see § 1.28.

Filing requirements, see § 1.20.

Foreign registration statement, see § 15.03.

Statement of withdrawal, see § 15.09.

Transfer of foreign registration statement, see § 15.10.

### **OFFICIAL COMMENT**

The Act does not vest the secretary of state with general authority to establish mandatory forms for use under the Act. However, certain types of reports and requests for documents may be processed efficiently only if uniform forms are used. Applications for certificates of existence or registration, 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.

### **§ 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
----------	-----

Articles of incorporation	\$_____.
Application for use of indistinguishable name	\$_____.
Application for reserved name	\$_____.
Notice of transfer of reserved name	\$_____.
Application for registered name	\$_____.
Application for renewal of registered name	\$_____.
Corporation's statement of change of registered agent or registered office or both	\$_____.
Agent's statement of change of registered office for each affected corporation not to exceed a total of \$_____	\$_____.
Agent's statement of resignation	No fee.
Articles of domestication	\$_____.
Articles of conversion	\$_____.
Amendment of articles of incorporation	\$_____.
Restatement of articles of incorporation with amendment of articles	\$_____.
Restatement of articles of incorporation without amendment of articles	\$_____.
Articles of merger or share exchange	\$_____.
Articles of dissolution	\$_____.
Articles of revocation of dissolution	\$_____.
Certificate of administrative dissolution	No fee.
Application for reinstatement following administrative dissolution	\$_____.
Certificate of reinstatement	No fee.
Certificate of judicial dissolution	No fee.
Foreign registration statement	\$_____.
Amendment of foreign registration statement	\$_____.
Statement of withdrawal	\$_____.
Transfer of foreign registration statement	\$_____.
Notice of termination of registration	No fee.
Annual report	\$_____.
Articles of correction	\$_____.
Articles of validation	\$_____.
Application for certificate of existence or registration	\$_____.
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:  
\$ \_\_\_\_\_ a page for copying; and



\$ \_\_\_\_\_ for the certificate.

## **CROSS-REFERENCES**

Agent's change of registered office, see § 5.02.

Agent's resignation, see § 5.03.

Amendment of articles of incorporation, see §§ 10.06 and 10.08.

Annual report, see § 16.21.

Articles of conversion, see § 9.33.

Articles of domestication, see § 9.22.

Articles of merger or share exchange, see § 11.06.

Articles of validation, see § 1.51.

Corporation's change of registered agent or office, see § 5.02.

Correction of filed document, see § 1.24.

Dissolution:

    administrative, see § 14.21.

    judicial, see § 14.30.

    reinstatement, see § 14.22.

    revocation, see § 14.04.

    voluntary, see §§ 14.01 through 14.09.

Evidentiary effect of certified copy, see § 1.27.

Existence, see § 1.28.

Foreign registration statement, see § 15.03.

Incorporation, see § 2.03.

Name of corporation, see § 4.01.

Notice of termination of registration, see § 15.11.

Registered name, see § 4.03.

Renewal of registered name, see § 4.03.

Reserved name, see § 4.02.

Restated articles of incorporation, see § 10.07.

Service on secretary of state, see §§ 5.04, 9.24, 9.35, 11.07, § 15.07 and § 15.09.

Statement of withdrawal, see §§ 15.07 and 15.09.

Transfer of foreign registration statement, see § 15.10.

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 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 Act. The catch-all in the last item of the list will apply to any document for which a state does not establish a specific filing fee.

The provision relating to a registered agent's statement of change of registered office 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. 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.

### **§ 1.23 Effective Date of Filed Document**

- (a) Except to the extent otherwise provided in section 1.24(c) and subchapter E of this chapter, a document accepted for filing is effective:
  - (1) on the date and at the time of filing, as provided in section 1.25(b);
  - (2) on the date of filing and at the time specified in the document as its effective time if later than the time under subsection (a)(1);
  - (3) at a specified delayed effective date and time which may not be more than 90 days after filing; or
  - (4) if a delayed effective date is specified, but no time is specified, at 12:01 a.m. on the date specified, which may not be more than 90 days after the date of filing.
- (b) If a filed document does not specify the time zone or place at which a date or time or both is to be determined, the date or time or both at which it becomes effective shall be those prevailing at the place of filing in this state.

### **CROSS-REFERENCES**

“Effective date” defined, see § 1.40.

Filing requirements, see § 1.20.

### **OFFICIAL COMMENT**

Section 1.23 provides definitive rules governing when a filed document becomes effective. The definition of effective date in section 1.40 ties in with this section so that throughout the Act the term “effective date” of a filed document means the effective date and time determined pursuant to section 1.23. The Act does not generally distinguish between the effective date of a filed document and the effectiveness of what the document is accomplishing. However, in a few instances where filings in more than one jurisdiction are required, the Act distinguishes between the effective date of the document and the effectiveness of a transaction being effected by the document. See sections 9.22(d) and 9.33(d) regarding certain domestications and conversions and section 11.06(e) regarding certain mergers.

Section 1.41 deals with the effectiveness of notices and other communications and does not use or define the term “effective date.”

### **§ 1.24 Correcting Filed Document**

- (a) A document filed by the secretary of state pursuant to this Act may be corrected if (i) the

- document contains an inaccuracy, (ii) the document was defectively signed, attested, sealed, verified, or acknowledged, or (iii) 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 of correction,
      - (ii) specify the inaccuracy or defect to be corrected, and
      - (iii) correct the inaccuracy or defect; and
    - (2) by delivering the articles of correction 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**

- Effective time and date of filing, see § 1.23.  
“Electronic transmission” defined, see § 1.40.  
Filing requirements, see § 1.20.

### **OFFICIAL COMMENT**

Section 1.24 permits making corrections in filed documents without redelivering the entire document or submitting formal articles of amendment. This correction procedure has two advantages: (i) delivering articles of correction may be less expensive than delivering the document or filing articles of amendment, and (ii) articles of correction do not alter the effective date of the underlying document being corrected.

If no filing is made because of a defect in transmission or delivery, 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 under section 1.23 may be corrected under this section, but the corrected effective date 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, the secretary of state shall return to the person who delivered the document for filing 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 person who delivered the document for filing 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 of state’s filing or refusing to file a document does not create a presumption that:
  - (i) the document does or does not conform to the requirements of the Act; or
  - (ii) the

information contained in the document is correct or incorrect.

### **CROSS-REFERENCES**

Appeal from refusal to file document, see § 1.26.

Effective time and date of filing, see § § 1.23.

Filing requirements, see § § 1.20.

Powers of secretary of state, see § § 1.30.

### **OFFICIAL COMMENT**

Section 1.25 limits the discretion of the secretary of state to a ministerial role in reviewing the contents of documents. If the document submitted contains the information required by section 1.20 and the applicable provision of the Act (and if a mandatory form has been prescribed under section 1.21(a), the document is in that form), the secretary of state under section 1.25 must file it even though it contains additional provisions the secretary of state may believe are irrelevant or not authorized by the Act or by general legal principles. 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 accepted for filing by 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 a provision from the fact that the secretary of state accepted the document for filing.

### **§ 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 person that delivered the document for filing may petition [name or describe court] to compel its filing. The document and the explanation of the secretary of state of the refusal to file must be attached to the petition. The court may decide the matter in a summary proceeding.
- (b) The court may 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**

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

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

### **OFFICIAL COMMENT**

The identity of the specific court with jurisdiction to hear proceedings under section 1.26 must be supplied by each state when enacting this section. This may be a court of general civil jurisdiction or a court of relevant specialized jurisdiction. Other sections of the 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.

The phrase “summary proceeding” in section 1.26(a) refers to a class of cases where the court takes action on an expedited basis and decides the case on a limited record given the narrowness of the issues involved. See section 1.25.

The Act 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.

### **§ 1.27 Evidentiary Effect of Certified 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.

### **OFFICIAL COMMENT**

Upon payment of the fees specified in section 1.22(c), the secretary of state may be requested to certify that a specific document has been filed. The limited effect of the certificate is consistent with the ministerial filing obligation imposed on the secretary of state under the Act.

### **§ 1.28 Certificate of Existence or Registration**

- (a) Any person may apply to the secretary of state to furnish a certificate of existence for a domestic corporation or a certificate of registration for a foreign corporation.
- (b) A certificate of existence sets forth:
  - (1) the domestic corporation’s corporate name;
  - (2) that 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;
  - (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 of the domestic 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;
  - (6) that the corporation is not administratively dissolved and a proceeding is not pending under section 14.21; and
  - (7) other facts of record in the office of the secretary of state that may be requested by the applicant.
- (c) A certificate of registration sets forth:
  - (1) the foreign corporation’s name used in this state;
  - (2) that the foreign corporation is registered to do 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 registration of the foreign corporation;
  - (4) that its most recent annual report required by section 16.21 has been filed with the secretary of state; and
  - (5) other facts of record in the office of the secretary of state that may be requested by the applicant.
- (d) Subject to any qualification stated in the certificate, a certificate of existence or registration issued by the secretary of state may be relied upon as conclusive evidence of the facts stated in the certificate.

### **CROSS-REFERENCES**

Filing fees, see § 1.22.

Filing requirements, see § 1.20.

Foreign registration statement, see § 15.03.

Forms, see § 1.21.

### **OFFICIAL COMMENT**

Section 1.28 establishes a procedure by which any person may obtain a conclusive certificate from the secretary of state that a particular domestic corporation is in existence or that a particular foreign corporation is registered to do business in the state. The secretary of state is to make the judgment whether the corporation is in existence or is registered to do 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.

Sections 1.28(b)(3) and 1.28(c)(3) refer only to fees, taxes and 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. Sections 1.28(b)(3) and 1.28(c)(3) relate only to fees, taxes and penalties to the extent their nonpayment affects the existence or registration to do business of the corporation.

### **§ 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**

“Sign” defined, see § 1.40.

### **OFFICIAL COMMENT**

As provided in section 1.40, “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.

Administrative termination of registration, see § 15.11.

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 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 involving claims 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 is usually not the governmental official that determines the scope of public policy through administration of the secretary of state's filing responsibilities under the Act. Rather, the attorney general may seek to enjoin the illegal conduct or to dissolve involuntarily the offending corporation.

## **Subchapter D. DEFINITIONS**

### **§ 1.40 Act Definitions**

In this Act, unless otherwise specified:

“Articles of incorporation” means the articles of incorporation described in section 2.02, all amendments to the articles of incorporation, and any other documents permitted or required to be delivered for filing by a domestic business corporation with the secretary of state under any provision of this Act that modify, amend, supplement, restate or replace the articles of incorporation. After an amendment of the articles of incorporation or any other document filed under this Act that restates the articles of incorporation in their entirety, the articles of incorporation shall not include any prior documents. When used with respect to a foreign corporation or a domestic or foreign nonprofit corporation, the “articles of incorporation” of such an entity means the document of such entity that is equivalent to the articles of incorporation of a domestic business corporation.

“Authorized shares” means the shares of all classes a domestic or foreign corporation is authorized to issue.

“Beneficial shareholder” means a person who owns the beneficial interest in shares, which may be a record shareholder or a person on whose behalf shares are registered in the name of an intermediary or nominee.

“Conspicuous” means so written, displayed, or presented that a reasonable person against whom the writing is to operate should have noticed it.

“Corporation,” “domestic corporation,” “business corporation” or “domestic business corporation” means a corporation for profit, which is not a foreign corporation, incorporated under this Act.

“Deliver” or “delivery” means any method of delivery used in conventional commercial practice, including delivery by hand, mail, commercial delivery, and, if authorized in accordance with section 1.41, by electronic transmission.

“Distribution” means a direct or indirect transfer of cash or other property (except a corporation’s 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 payment of a dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness; a distribution in liquidation; or otherwise.

“Document” means (i) any tangible medium on which information is inscribed, and includes handwritten, typed, printed or similar instruments, and copies of such instruments, or (ii) an electronic record.

“Domestic,” with respect to an entity, means an entity governed as to its internal affairs by the law of this state.

“Effective date,” when referring to a document accepted for filing by the secretary of state, means the time and date determined in accordance with section 1.23.

“Electronic” means relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities.

“Electronic record” means information that is stored in an electronic or other nontangible medium and is retrievable in paper form through an automated process used in conventional commercial practice, unless otherwise authorized in accordance with section 1.41(j).

“Electronic transmission” or “electronically transmitted” means any form or process of communication not directly involving the physical transfer of paper or another tangible medium, which (i) is suitable for the retention, retrieval, and reproduction of information by the recipient, and (ii) is retrievable in paper form by the recipient through an automated process used in conventional commercial practice, unless otherwise authorized in accordance with section 1.41(j).

“Eligible entity” means a domestic or foreign unincorporated entity or a domestic or foreign nonprofit corporation.

“Eligible interests” means interests or memberships.



“Employee” includes an officer but not a director. A director may accept duties that make the director also an employee.

“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.

“Expenses” means reasonable expenses of any kind that are incurred in connection with a matter.

“Filing entity” means an unincorporated entity, other than a limited liability partnership, that is of a type that is created by filing a public organic record or is required to file a public organic record that evidences its creation.

“Foreign,” with respect to an entity, means an entity governed as to its internal affairs by the organic law of a jurisdiction other than this state.

“Foreign corporation” or “foreign business 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 law of this state.

“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 law of this state.

“Foreign registration statement” means the foreign registration statement described in section 15.03.

“Governmental subdivision” includes authority, county, district, and municipality.

“Governor” means any person under whose authority the powers of an entity are exercised and under whose direction the activities and affairs of the entity are managed pursuant to the organic law governing the entity and its organic rules.

“Includes” and “including” denote a partial definition or a nonexclusive list.

“Individual” means a natural person.

“Interest” means either or both of the following rights under the organic law governing 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.

“Interest holder” means a person who holds of record an interest.

“Interest holder liability” means:

- (iii) personal liability for a debt, obligation, or other liability of a domestic or foreign corporation or eligible entity that is imposed on a person:

- (A) solely by reason of the person’s status as a shareholder, member or interest holder;  
or
- (B) by the articles of incorporation of the domestic corporation or the organic rules of the eligible entity or foreign corporation that make one or more specified shareholders, members, or interest holders, or categories of shareholders, members, or interest holders, liable in their capacity as shareholders, members, or interest holders for all or specified liabilities of the corporation or eligible entity;  
or
- (iv) an obligation of a shareholder, member, or interest holder under the articles of incorporation of a domestic corporation or the organic rules of an eligible entity or foreign corporation to contribute to the entity.

For purposes of the foregoing, except as otherwise provided in the articles of incorporation of a domestic corporation or the organic law or organic rules of an eligible entity or a foreign corporation, interest holder liability arises under clause (i) when the corporation or eligible entity incurs the liability.

“Jurisdiction of formation” means the state or country the law of which includes the organic law governing a domestic or foreign corporation or eligible entity.

“Means” denotes an exhaustive definition.

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

“Merger” means a transaction pursuant to section 11.02.

“Nonfiling entity” means an unincorporated entity that is of a type that is not created by filing a public organic record.

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

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

“Organic rules” means the public organic record and private organic rules of a domestic or foreign corporation or eligible entity.

“Person” includes an individual and an entity.

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

“Private organic rules” means (i) the bylaws of a domestic or foreign business or nonprofit corporation or (ii) the rules, regardless of whether in writing, that govern the internal affairs of an unincorporated entity, are binding on all its interest holders, and are not part of its public organic record, if any. Where private organic rules have been amended or restated, the term means the private organic rules as last amended or restated.

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

“Public organic record” means (i) the articles of incorporation of a domestic or foreign business or nonprofit corporation or (ii) the document, if any, the filing of which is required to create an unincorporated entity, or which creates the unincorporated entity and is required to be filed. Where a public organic record has been amended or restated, the term means the public organic record as last amended or restated.

“Record date” means the date fixed for determining the identity of the corporation’s shareholders and their shareholdings for purposes of this Act. Unless another time is specified when the record date is fixed, the determination shall be made as of the close of business at the principal office of the corporation on the date so fixed.

“Record shareholder” means (i) the person in whose name shares are registered in the records of the corporation or (ii) the person identified as the beneficial owner of shares in a beneficial ownership certificate pursuant to section 7.23 on file with the corporation to the extent of the rights granted by such certificate.

“Registered foreign corporation” means a foreign corporation registered to do business in the state pursuant to chapter 15.

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

“Share exchange” means a transaction pursuant to section 11.03.

“Shareholder” means a record shareholder.

“Shares” means the units into which the proprietary interests in a domestic or foreign corporation are divided.

“Sign” or “signature” means, with present intent to authenticate or adopt a document:

- (v) to execute or adopt a tangible symbol to a document, and includes any manual, facsimile, or conformed signature; or
- (vi) to attach to or logically associate with an electronic transmission an electronic sound, symbol, or process, and includes an electronic signature in an electronic transmission.

“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.

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

“Type of entity” means a generic form of entity:

- (vii) recognized at common law; or
- (viii) formed under an organic law, regardless of whether some entities formed under that law are subject to provisions of that law that create different categories of the form of entity.

“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, a series of a limited liability company or of another type of entity, an estate, a trust, a state, United States, or foreign government. The term includes a general partnership, limited liability company, limited partnership, business trust, joint stock association and unincorporated nonprofit association.

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

“Unrestricted voting trust beneficial owner” means, with respect to any shareholder rights, a voting trust beneficial owner whose entitlement to exercise the shareholder right in question is not inconsistent with the voting trust agreement.

“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.

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

“Voting trust beneficial owner” means an owner of a beneficial interest in shares of the corporation held in a voting trust established pursuant to section 7.30(a).

“Writing” or “written” means any information in the form of a document.

## **CROSS-REFERENCES**

Annual report, see § 16.21.

Nominee shares, see § 7.23.

Notice, see § 1.41.

Special definitions:

“acquired entity,” see § 11.01.

“acquiring entity,” see § 11.01.

“affiliate,” see § 13.01.

“beneficial shareholder,” see § § 13.01.

“claim,” see § 14.06.

“control,” see § 8.60.

“conversion,” see § 9.01.

“converted entity,” see § 9.01.

“converting entity,” see § 9.01.

“corporation,” see §§ 5.01, § 8.50 and § 13.01.

“derivative proceeding,” see § 7.40.

“director’s conflicting interest transaction,” see § 8.60.

“domesticated corporation,” see § 9.01.

“domesticating corporation,” see § 9.01.

- “domestication,” see § 9.01.
- “enactment date,” see § 9.01.
- “fair to the corporation,” see § 8.60.
- “fair value,” see § 13.01.
- “foreign corporation,” see § 7.47 and ch. 15.
- “interest,” see § 13.01.
- “interested transaction,” see § 13.01.
- “liability,” see § 8.50.
- “material financial interest,” see § 8.60.
- “merger,” see § 11.01.
- “new interest holder liability,” see §§ 10.03 and 11.01.
- “officer,” see § 8.50.
- “official capacity,” see § 8.50.
- “outstanding shares,” see § 6.03.
- “party,” see § 8.50.
- “party to a merger,” see § 11.01.
- “preferred shares,” see § 13.01.
- “proceeding,” see § 8.50.
- “protected agreement,” see § 9.01.
- “qualified director,” see § 1.43.
- “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.
- “shareholder,” see §§ 7.03, 7.40, 7.48, 13.01, 14.30 and 16.02.
- “shares,” see §§ 6.27 and 6.30.
- “survivor,” see § 11.01.

## **OFFICIAL COMMENT**

Section 1.40 contains definitions of terms used generally throughout the Act. Other subchapters and sections of the Act contain specialized definitions that are applicable only to those subchapters or sections.

### *Beneficial Shareholder*

Because various provisions of the Act allow beneficial owners of shares to take actions as a shareholder even in the absence of a beneficial ownership certificate under section 7.23, the term “beneficial shareholder” has been defined in section 1.40.

The definition does not specify what interests are necessary for a person to be a beneficial shareholder, but consistent with section 8-207(a) of the Uniform Commercial Code, the Act contemplates that the corporation is entitled to treat the beneficial shareholder as having the full bundle of economic and voting rights associated with the shares. For this reason, the beneficial owner of shares in a voting trust has been defined separately in section 1.40 as a “voting trust beneficial owner.”

Unlike section 7.23, which provides for a procedure to specify a beneficial owner in a beneficial ownership certificate, the definition of “beneficial shareholder” does not prescribe a procedure for establishing beneficial ownership. Where a court proceeding is involved, as it is, for example, in sections 7.41 (derivative proceeding), 13.30 (appraisal rights), and 14.30 (judicial dissolution), the court can determine what is necessary to establish beneficial ownership. In other situations, custom and practice and the reasonable requirements of the corporation should apply. Thus, a certification of a broker-dealer or other financial institution or a current account statement from such an institution often is sufficient to establish beneficial ownership. In the case of a public corporation, a filing with the Securities and Exchange Commission identifying beneficial ownership might be sufficient.

When shares of a public corporation are held, as explained in the Official Comment to section 7.23, indirectly in street name with a broker-dealer or other financial institution, which may in turn have the shares on deposit with Depository Trust Company (“DTC”) as a clearing agency, a reference to shares in this Act is technically a reference to a “securities entitlement” under section 8-102(a)(17) of the Uniform Commercial Code, which is an undivided interest in a mass of shares held by the financial intermediary or on deposit with DTC. Nevertheless, the Act continues for convenience to refer to the interests as “shares,” and thus references to shares should be read to include securities entitlements with respect to those shares.

### *Conspicuous*

“Conspicuous” is defined in section 1.40 and is comparable to section 1-201(10) of the Uniform Commercial Code. The test is whether attention can reasonably be expected to be elicited.

### *Corporation, Domestic Corporation, Domestic Business Corporation, Business Corporation and Foreign Corporation*

“Corporation,” “domestic corporation,” “business corporation,” and “domestic business corporation,” as defined in section 1.40, all mean the same thing and may be used interchangeably. The word “corporation,” when used alone, refers only to a domestic corporation. In some instances, the phrase “domestic corporation” has been used to contrast it with a foreign corporation, a term also defined in section 1.40. The phrase “domestic business corporation” has been used on occasion to contrast it with a domestic nonprofit corporation. “Corporation” has been given special meanings in sections 5.01, 8.50 and 13.01.

### *Distribution*

Section 1.40 defines “distribution” to include all transfers of cash 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 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 to shareholders 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 corporation, except in the situation addressed in section 6.40(g).

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

The test for validity of distributions other than distributions in liquidation is set forth in section 6.40, and for distributions in liquidation in 14.

### *Electronic Transmission*

The terms “electronic,” “electronic record,” “electronic transmission” and “electronically transmitted” incorporate into the Act terminology from the Uniform Electronic Transmissions Act (“UETA”) and the federal Electronic Signatures in Global and National Commerce Act (“E-Sign”). See Official Comment to section 1.41, Note on the Relationship Between Act Provisions on Electronic Technology and UETA and E-Sign. Electronic records and transmissions are intended to be broadly construed.

### *Entity*

The term “entity,” defined in section 1.40, appears in the definition of “person” in section 1.40 and covers 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 also defined in section 1.40. See also the definitions in section 1.40 of “governmental subdivision,” “state,” and “United States.” A form of co-ownership of property or sharing of returns from property that is not a partnership under the Uniform Partnership Act will not be an “unincorporated entity.”

### *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, for example, sections 7.46, 7.48, 8.53(a), 8.54, 13.31, 14.32(e), 16.04(c) and 16.05(c). Other than the requirement that expenses must be reasonable in the circumstances, the type or character of the expenses is not limited. Examples include such 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.

### *Interest Holder Liability*

The term “interest holder liability” is used in the context of provisions in chapters 9 and 11 that describe the effects on 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 is also used in section 2.02 and chapter 10 with respect to the articles of incorporation and certain amendments to them. The term includes only liabilities that are imposed solely because of the person's status as a shareholder, member or interest holder, or by the organic rules of an entity on shareholders, members or interest holders. Liabilities that a shareholder, member or interest holder incurs by contract (other than a contract that is part of an entity's organic rules, such as a partnership agreement) 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 "interest holder liability." If, on the other hand, a shareholder were to contractually guarantee payment of an obligation of a corporation, that liability would not be an "interest holder liability."

### *Membership*

"Membership" is defined in section 1.40 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 the Act they are referred to as "interest holders" and what they own in the limited liability company is referred to in the Act as an "interest."

### *Organic Rules, Public Organic Record and Private Organic Rules*

The term "organic rules" in section 1.40 includes both public organic records and private organic rules. The term "public organic record" includes such documents as the articles of incorporation of a business or nonprofit corporation, 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 record because it does not create the underlying general or limited partnership by filing the election, although the election may be made part of the public organic record of the partnership by its organic law. The term "private organic rules" includes corporate bylaws, a partnership agreement of a general or limited partnership, an operating agreement of a limited liability company and comparable agreements, however denominated, of unincorporated types of other entities. Private organic rules of unincorporated entities are not required by the Act to be in writing, and therefore would include oral partnership agreements and oral operating agreements.

### *Person*

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

### *Principal Office*

Many corporations maintain numerous offices, but there is usually one office, sometimes colloquially referred to as the home office or headquarters, where the principal corporate officers are located. The corporation must designate its principal office address in the annual report required by section 16.21, and a foreign corporation must also do so in its foreign registration statement. To clarify which corporate office is the principal office, the Act defines the office designated by the corporation in the annual report (or foreign registration statement) as the principal office of the corporation.



### *Secretary*

The term “secretary” is defined in section 1.40 because the 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 various sections of the Act refer to that officer as the “secretary.”

### *Shareholder and Record Shareholder*

The term “shareholder” is usually used in the Act to mean a “record shareholder” as defined in section 1.40, but section 1.40 contemplates that definitions may be expanded or limited by the Act for purposes of specific provisions. The definition of “record shareholder” in section 1.40 includes a beneficial owner of shares named in a beneficial ownership 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 Act also permit holders of voting trust certificates or beneficial owners of shares (not subject to a beneficial ownership certificate under section 7.23) to exercise some of the rights of a “shareholder.” See, for example, section 7.40, which relates to derivative proceedings. Separate definitions of “voting trust beneficial owner,” “unrestricted voting trust beneficial owner” and “beneficial shareholder” also appear in section 1.40.

### *Sign or Signature*

The definition of “sign” or “signature” incorporates into the Act concepts and terminology from UETA and the federal E-Sign. Thus, the terms “sign” and “signature” include not only traditional forms of signing, such as manual, facsimile, or conformed signatures, but also electronic signatures in electronic transmissions. The intent of the Act is that any manifestation of an intention to sign or authenticate a document be accepted, although electronic transmissions having electronic signatures must comply with the requirements in the definition of “electronic transmission,” including being retrievable in paper form by the recipient through an automated process unless otherwise authorized in accordance with section 1.41(j).

### *Unincorporated Entity*

The term “unincorporated entity” is a subset of the broader term “entity” and includes an unincorporated nonprofit association. 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.

As used in the definition of unincorporated entity, “business trust” includes any trust carrying on a business, such as a Massachusetts business trust, real estate investment trust, or other common law or statutory business trust. The term “unincorporated entity” (and thus the term “eligible entity”) expressly excludes series of limited liability companies or of other types of entities, and estates and trusts (*i.e.*, trusts that are not business trusts), regardless of whether 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 chapter 9 or a merger or share exchange under chapter 11.

### *Voting Group*

Section 1.40 defines “voting group” for purposes of the Act as a matter of convenient reference. When the definition refers to shares entitled to vote “generally” on a matter, it signifies all shares entitled to vote together on the matter by the articles of incorporation or the Act, regardless of whether they also have the right to be counted or tabulated separately. “Voting groups” are thus the basic units of collective voting by shareholders, 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 the Act. In a few instances under the Act, the board of directors may establish the right to vote by voting groups. On most matters to be voted on by shareholders, 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. In other circumstances, the vote of multiple groups may be required. See sections 7.25 and 7.26.

#### *Voting Power*

Application of the definition of “voting power” 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 unless the contingency has occurred, and then 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 the definition, even if the shares do not carry the power to vote for all directors.

#### *Voting Trust Beneficial Owner and Unrestricted Voting Trust Beneficial Owner*

Section 1.40 has a separate definition of “voting trust beneficial owner” because the number of such owners and value of their shares can enter into determinations under sections 13.02(b)(1) and 14.30(b)(2). It also has a separate definition of “unrestricted voting trust beneficial owner” because rights are given under some provisions of the Act for a beneficial owner of shares deposited in a voting trust established under section 7.30 to take actions as a shareholder. These owners have the economic interest in the shares but the voting rights have been given to the voting trustee. In addition to the typical grant of voting rights, section 7.30 permits the voting trust agreement to confer on the voting trustee the right otherwise to act with respect to the shares, and thus could vest in the trustee the exclusive right to exercise statutory shareholder rights. The term “unrestricted voting trust beneficial owner” is used to distinguish from this possible limitation. If the voting trust agreement grants the trustee the exclusive right to act with respect to the shareholder right in question, then the voting trustee, and not the voting trust beneficial owner, may exercise those rights.

#### *Writing or Written*

“Writing” or “written” means information in the form of a “document,” which in turn means any tangible medium on which information is inscribed, such as a paper instrument, as well as an electronic record. Thus, under the Act a written consent of shareholders under section 7.04, for example, may be in the form of paper or an electronic record.

## § 1.41 Notices and Other Communications

- (a) A notice under this Act must be in writing unless oral notice is reasonable in the circumstances. Unless otherwise agreed between the sender and the recipient, words in a notice or other communication under this Act must be in English.
- (b) A notice or other communication may be given by any method of delivery, except that electronic transmissions must be in accordance with this section. If the methods of delivery are impracticable, a notice or other communication may be given by means of a broad non-exclusionary distribution to the public (which may include a newspaper of general circulation in the area where published; radio, television, or other form of public broadcast communication; or other methods of distribution that the corporation has previously identified to its shareholders).
- (c) notice or other communication to a domestic corporation or to a foreign corporation registered to do business in this state may be delivered to the corporation's registered agent at its registered office or to the secretary at the corporation's 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 foreign registration statement.
- (d) A notice or other communications may be delivered by electronic transmission if consented to by the recipient or if authorized by subsection § 1.41(j).
- (e) Any consent under subsection § 1.41(d) may be revoked by the person who consented by written or electronic notice to the person to whom the consent was delivered. Any such consent is deemed revoked if (i) the corporation is unable to deliver two consecutive electronic transmissions given by the corporation in accordance with such consent, and (ii) such inability becomes known to the secretary or an assistant secretary or to the transfer agent, or other person responsible for the giving of notice or other communications; provided, however, the inadvertent failure to treat such inability as a revocation shall not invalidate any meeting or other action.
- (f) Unless otherwise agreed between the sender and the recipient, an electronic transmission is received when:
  - (1) it enters an information processing system that the recipient has designated or uses for the purposes of receiving electronic transmissions or information of the type sent, and from which the recipient is able to retrieve the electronic transmission; and
  - (2) it is in a form capable of being processed by that system.
- (g) Receipt of an electronic acknowledgement from an information processing system described in subsection § 1.41(f)(1) establishes that an electronic transmission was received but, by itself, does not establish that the content sent corresponds to the content received.
- (h) An electronic transmission is received under this section even if no person is aware of its receipt.
- (i) A notice or other communication, if in a comprehensible form or manner, is effective at the earliest of the following:
  - (1) if in a physical form, the earliest of when it is actually received, or when it is left at:
  - (2) (i) a shareholder's address shown on the corporation's record of shareholders maintained by the corporation under section 16.01(d);
    - (i) a director's residence or usual place of business; or
    - (ii) the corporation's principal office;

- (3) if mailed postage prepaid and correctly addressed to a shareholder, upon deposit in the United States mail;
  - (4) if mailed by United States mail postage prepaid and correctly addressed to a recipient other than a shareholder, the earliest of when it is actually received, or:
    - (i) if sent by registered or certified mail, return receipt requested, the date shown on the return receipt signed by or on behalf of the addressee; or
    - (ii) five days after it is deposited in the United States mail;
  - (5) if an electronic transmission, when it is received as provided in subsection § 1.41(f);  
and
  - (6) if oral, when communicated.
- (j) A notice or other communication may be in the form of an electronic transmission that cannot be directly reproduced in paper form by the recipient through an automated process used in conventional commercial practice only if (i) the electronic transmission is otherwise retrievable in perceivable form, and (ii) the sender and the recipient have consented in writing to the use of such form of electronic transmission.
- (k) If this Act prescribes requirements for notices or other communications in particular circumstances, those requirements govern. If articles of incorporation or bylaws prescribe requirements for notices or other communications, not inconsistent with this section or other provisions of this Act, those requirements govern. The articles of incorporation or bylaws may authorize or require delivery of notices of meetings of directors by electronic transmission.
- (l) In the event that any provisions of this Act are deemed to modify, limit, or supersede the federal Electronic Signatures in Global and National Commerce Act, 15 U.S.C. §§ 7001 *et seq.*, the provisions of this Act shall control to the maximum extent permitted by section 102(a)(2) of that federal act.

## CROSS-REFERENCES

Annual report, see § 16.21.

“Deliver” defined, see § 1.40.

“Electronic transmission” defined, see § 1.40.

Householding, see § 1.44.

“Principal office”:

defined, see § 1.40.

designated in annual report, see § 16.21.

designated in foreign registration statement, see § 15.03.

Record of shareholders, see § 16.01.

“Secretary” defined, see § 1.40.

Special notice requirements:

derivative proceedings, see § 7.40.

resignation of registered agent, see § 5.03.

service on corporation, see § 5.04.

“Writing” defined, see § 1.40.

## OFFICIAL COMMENT

Section 1.41 establishes rules for determining how notices and other communications may be given and when they are effective for a variety of purposes under the Act. Not only do the rules of section 1.41 apply to the delivery of notices of meetings of shareholders and directors and other similar notices, they apply as well to director and shareholder consents, demands to hold meetings, proxies, demands to commence derivative actions, demands to inspect books and records, assertions of appraisal rights, and other communications to and from the corporation.

### *Note on the Relationship Between Act Provisions on Electronic Technology and UETA and E-Sign*

The provisions of the Act relating to electronic records, electronic transmissions and related matters, found principally in the definitions in section 1.40, are set against the backdrop of the Uniform Electronic Transmissions Act (“UETA”) and the federal Electronic Signatures in Global and National Commerce Act (“E-Sign”). A brief description of certain aspects of UETA and E-Sign is useful to understand the Act’s electronic technology provisions.

UETA adopted definitions for the terms electronic, electronic records, electronic signatures, records, transactions, and the like, as well as provisions governing the use of those terms. UETA applies to “transactions,” which are defined to mean actions between two or more persons “relating to the conduct of business [or] commercial . . . affairs.” UETA §§ 2(16) and 3(a). The reach of the term “transactions” in the context of a comprehensive business corporation act is unclear. For example, although obtaining a proxy from a shareholder that is voting on a cash-out merger would likely constitute a “transaction,” the unilateral act by a corporation of sending notice of an annual meeting at which no significant action is proposed might not.

If UETA applies, it establishes certain statutory norms for the validity of electronic signatures, electronic records, etc. However, UETA also provides that it applies only to transactions between parties each of which has agreed to conduct transactions by electronic means, and that such agreement is determined from the context and surrounding circumstances, including the parties’ conduct. *Id.* § 5(b).

E-Sign, codified at 15 U.S.C. §§ 7001 *et seq.*, in turn adopted the substance of UETA’s principal definitions, including electronic, electronic signature, record, and transaction, as well as many of the operative provisions of UETA. The applicability of E-Sign, like UETA, turns on whether a “transaction” is involved. *Id.* § 7001(a). Like UETA, E-Sign’s applicability also depends upon the parties consenting to transact business by electronic means. *Id.* § 7001(b)(2).

Importantly, E-Sign contains a federal preemption provision that itself excepts certain state adoptions of UETA. Thus, in general terms, section 7002(a) of E-Sign allows a state statute to modify, limit, or supersede the provisions of E-Sign section 7001 only if (i) it is a state enactment of the version of UETA approved in 1999, and (ii) the state’s enactment of UETA does not contain any state exceptions, or “carve outs,” other than those contained in the 1999 version of UETA § 3(b)(4). If, for example, a state enactment of UETA carved out that state’s general business corporation law from the applicability of UETA, a carve out that is not contained in the 1999 version of UETA § 3(b)(4), and that business corporation law was deemed to be inconsistent with E-Sign, the offending provisions of the business corporation law would be preempted. *Id.* § 7002(a)(1).

Note one aspect of the definition of “record” in both UETA and E-Sign: they both provide that information that is stored in an electronic medium must simply be “retrievable in perceivable form.” This is in contrast to states that require not only that an electronic

transmission may be retained, retrieved, and reviewed but also requires that it “may be directly reproduced in paper form by [the] recipient through an automated process.” The former would include, *e.g.*, a voicemail, a text message, and an electronic page, although the latter would not.

Against that backdrop, the Act’s electronic technology provisions align, in all material respects, with the terminology and concepts of UETA and E-Sign. However, the Act does not adopt wholesale the vocabulary and concepts of UETA and E-Sign for the following reasons:

- Such wholesale changes would have involved amendments to the black letter in over 50 sections of the Act. Given that more than half the states in the United States have state corporation laws based in large measure on the Act, an approach to electronic technology that would require so many statutory changes in each state would have been extremely burdensome.
- The vocabulary of UETA and E-Sign, particularly the definition of “record” and “sign,” although technically precise, are not written in the same style as the Act, do not use its terminology, and are less understandable to the ordinary reader. And if engrafted directly into the full body of the Act, the result would have been a major change from well-understood, obvious, and traditional terminology (*e.g.*, a “unanimous written consent”) to a comparatively awkward and less intuitively obvious terminology (*e.g.*, a “consent in the form of a record”).
- The Act rejects the concept that a voicemail or a text message alone should, as a default matter, have the same status as a paper document. In so doing, the Act implicitly acknowledges the corruptibility and/or inaccessibility of electronic data.

The Act instead adopts an approach that involves incorporating into the definitions in section 1.40, the principal electronic technology vocabulary and concepts of UETA and E-Sign, in ways that do not require substantial changes throughout the Act.

Thus, the Act’s electronic technology provisions:

- define “document” “writing” and “written,” to include electronic records;
- define “deliver” and “delivery” to include electronic transmissions if properly authorized;
- use definitions of “electronic” and “electronic record” that borrow heavily from UETA and E-Sign;
- define “electronic transmission” and “electronically transmitted” to incorporate UETA and E-Sign vocabulary and concepts;
- require that electronic records and electronic transmissions be retrievable in paper form through an automated process used in conventional commercial practice, unless specifically authorized in accordance with section 1.41(j), thereby establishing the default rule that, until they are used in conventional commercial practice, voicemails and text messages are not generally recognized as valid, absent a specific consent (parties may, however, consent to their use); and
- define “sign” or “signature” to incorporate technical E-Sign and UETA terminology, while retaining common terminology such as “any manual, facsimile, or conformed signature.”

This approach is pragmatic, addresses the vast majority of recurring questions involving electronic transmissions and records, and yet enables parties who wish to do so to consent specifically to use electronic records or transmissions that are merely “retrievable in perceivable form.”

As for the preemption issue under E-Sign, the Act’s electronic technology provisions are consistent in all material respects with E-Sign and UETA. Although the Act’s basic provision has the additional requirement that electronic records or transmissions be retrievable in paper form through an automated process, section 1.41(j) permits parties to agree to the broader “retrievable in perceivable form” formulation found in E-Sign and UETA, and accordingly the Act’s provisions are consistent with those laws. Section 1.41(l) implements E-Sign section 7002(a)(2), which exempts from the federal preemption provisions of E-Sign certain state laws that modify, limit, or supersede E-Sign, and that also make specific reference to E-Sign.

Note that corporations desiring to conduct transactions by electronic means must also comply with the requirements of UETA or E-Sign, as applicable, to ensure the legal effect, validity, and enforceability of its transactions and records. For example, E-Sign contains specific provisions regarding accuracy, authenticity, accessibility, and retention of electronic records. Compliance with these statutes will require that corporations address certain technical issues, including system security and procedures.

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### *1. General*

The rules set forth in section 1.41 permit many other sections of the 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. If all methods of delivery used in conventional commercial practice and electronic transmission in accordance with section 1.41 are impracticable, section 1.41(b) provides for alternate methods of communication.

### *2. Rules Governing Use of Electronic Transmissions*

Electronic records and transmissions are effective under the Act if in accordance with section 1.41. The definition of writing in section 1.40 includes a document, which is defined in section 1.40 to include an electronic record. Section 1.40 then defines the terms “deliver” or “delivery” to include delivery by hand, mail, commercial delivery, or by electronic transmission if authorized in accordance with section 1.41. Authorization of notices or other communications delivered by electronic transmission is governed by sections 1.41(d) and 1.41(j), which require the consent of the recipient.

Assuming consent, section 1.41 then establishes a number of rules with respect to electronic transmissions and records. Subsection § 1.41(e) provides that any consent to the use of electronic transmissions may be revoked at any time. Subsection § 1.41(e) also establishes a default rule in cases of failed electronic deliveries: a consent under section 1.41(d) is deemed revoked if the corporation is unable to deliver two consecutive electronic transmissions and the inability becomes known to specified corporate officers or agents. Subsection § 1.41(f), based on UETA § 15(b), establishes basic rules, which can be varied by the sender and recipient, for when an electronic transmission is “received.” An electronic transmission is received, even if the recipient’s electronic filters, firewalls, or other similar systems effectively block the transmission, because a recipient who consents to the use of electronic transmissions is responsible for any such filters or firewalls that block access to them. Subsection § 1.41(g), based on UETA § 15(f), provides legal certainty regarding an electronic acknowledgment, but only addresses the fact of receipt, not the quality of the content or whether it was “opened” or read. Subsection § 1.41(h), based on UETA § 15(h), establishes that an electronic transmission is

received even if the recipient or individual is unaware of its receipt, just as a written notice physically delivered to a person's correct address is duly delivered even if the addressee is not aware of its delivery or declines to open the envelope.

Section 1.41(j) requires specific consent to the use of the electronic transmissions that are only "retrievable in perceivable form" and that cannot be directly reproduced in paper form through an automated process used in conventional commercial practice. See the Official Comment to section 1.40. Such consent between the sender and recipient must be in writing, except with respect to notices of meetings to directors, which may be in the articles of incorporation or bylaws.

### *3. When Notices or Other Communications Are Effective*

Section 1.41(i) establishes rules governing when notices or communications are deemed to be legally effective, serially addressing delivery in physical form, regular mail sent to shareholders and to other recipients, registered or certified mail, electronic transmissions, and oral communications.

## **§ 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; and
  - (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.

Market exception to appraisal rights, see § 13.02.

Record of shareholders, see §§ 7.20 and § 16.01.

"Shareholder" defined, see § 1.40.

Shareholder proceeding for judicial dissolution, see § 14.30.

Voting trusts, see § 7.30.

## **OFFICIAL COMMENT**

The 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 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).

## **§ 1.43 Qualified Director**



- (a) A “qualified director” is a director who, at the time action is to be taken under:
- (1) Section 2.02(b)(6), is not a director (i) to whom the limitation or elimination of the duty of an officer to offer potential business opportunities to the corporation would apply, or (ii) who has a material relationship with any other person to whom the limitation or elimination would apply;
  - (2) 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;
  - (3) 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 § 1.43(a)(3);
  - (4) 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
  - (5) Section 8.70, is not a director who (i) pursues or takes advantage of the business opportunity, directly, or indirectly through or on behalf of another person, or (ii) has a material relationship with a director or officer who pursues or takes advantage of the business opportunity, directly, or indirectly through or on behalf of another person.
- (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 of 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); (iv) who may disclaim the corporation’s interest in a business opportunity (section 8.70(a)); and (v) who may make applicable the limitation or elimination of a duty of an officer to offer the corporation business opportunities before the officer or a related person of the officer pursues or takes the opportunity (section 2.02(b)(6)).

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. 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. These disqualifications include the following:

- In the case of action under a provision adopted under the authority of section 2.02(b)(6) to limit or eliminate any duty of an officer to offer the corporation business opportunities, the definition excludes any director who is also an officer and to whom the provision would apply.
- In the case of action on dismissal of a derivative proceeding under section 7.44, the definition excludes any director who has 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.
- In the case of action to approve indemnification or advance of funds for expenses, the definition excludes any director who is a party to the proceeding (see section 8.50 for the definition of “party” and for the definition of “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 for the definition of “director’s conflicting interest transaction.”

- In the case of action under section 8.70(a) to disclaim corporate interest in a business opportunity, the definition excludes any director who directly or indirectly pursues or takes advantage of the business opportunity, or who has a material relationship with another director or officer who does so.

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. 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 section 1.43(a)(2), 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 section 1.43(a)(2) 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.

### *2. Disqualification Due to Relationships with Interested Persons*

In each context in which the “qualified director” definition applies, it also excludes any director who has a “material relationship” with another director (or, with respect to a provision applying to an officer under section 2.02(b)(6) or section 8.70, a “material relationship” with that officer) who is not disinterested for one or more of the reasons outlined in the preceding paragraph. Any relationship with such a person, whether the relationship is familial, financial, professional, employment or otherwise, is a “material relationship,” as that term is defined in section 1.43(b)(1), if 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 section 1.43(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.

The term “qualified director” is distinct from the generic term “independent director,” which is not used in the Act. As a result, a director who might typically be viewed as an “independent director” may in some circumstances not be a “qualified director,” and vice versa. See also the Official Comment to section 8.01.

### *3. Elimination of Automatic Disqualification in Certain Circumstances*

Section 1.43(c) addresses three categories of circumstances that, if present alone or together, do not automatically prevent a director from being a qualified director:

- Subsection (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 with regard to derivative litigation often consist of directors nominated or 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. 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.

The effect of section 1.43(c), while significant, is limited. It merely precludes an automatic inference of director disqualification from the circumstances specified in that subsection.

#### **§ 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.
- (b) Any such consent described in subsections § 1.44(a)(2) or § 1.44(a)(3) 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.
- (c) 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 deliver single copies of notices, reports or statements to shareholders who share a common address as permitted by subsection § 1.44(a), shall be deemed to have consented to receiving such single copy at the common address; provided that the notice of intention explains that consent may be revoked and the method for revoking.

## **CROSS-REFERENCES**

“Deliver” defined, see § 1.40.

Notices and other communications, 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. This practice is known as “householding.” This section permits a corporation comparable flexibility to household the written notice of shareholders’ meetings as well as any other written notices, reports or statements required to be delivered to shareholders under the Act or the corporation’s articles of incorporation or 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.

To meet the conditions of section 1.44(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. Whether consent is explicit or implicit, it is revocable at any time as provided in section 1.44(b).

To be effective, the written notice of intention to household notices, reports or other statements permitted by section 1.44(b) must explain that affirmative or implied consent may be revoked and the method for revoking.

## **Subchapter E.**

### **RATIFICATION OF DEFECTIVE CORPORATE ACTIONS**

#### **§ 1.45 Definitions**

Subchapter E In this subchapter:

“Corporate action” means any action taken by or on behalf of the corporation, including any action taken by the incorporator, the board of directors, a committee of the board of directors, an officer or agent of the corporation or the shareholders.

“Date of the defective corporate action” means the date (or the approximate date, if the exact date is unknown) the defective corporate action was purported to have been taken.

“Defective corporate action” means (i) any corporate action purportedly taken that is, and at the time such corporate action was purportedly taken would have been, within the power of the corporation, but is void or voidable due to a failure of authorization, and (ii) an overissue.

“Failure of authorization” means the failure to authorize, approve or otherwise effect a corporate action in compliance with the provisions of this Act, the articles of incorporation or bylaws, a corporate resolution or any plan or agreement to which the corporation is a party, if and to the extent such failure would render such corporate action void or voidable.

“Overissue” means the purported issuance of:

- (i) shares of a class or series in excess of the number of shares of a class or series the corporation has the power to issue under section 6.01 at the time of such issuance; or
- (ii) shares of any class or series that is not then authorized for issuance by the articles of incorporation.

“Putative shares” means the shares of any class or series (including shares issued upon exercise of rights, options, warrants or other securities convertible into shares of the corporation, or interests with respect to such shares) that were created or issued as a result of a defective corporate action, that (i) but for any failure of authorization would constitute valid shares, or (ii) cannot be determined by the board of directors to be valid shares.

“Valid shares” means the shares of any class or series that have been duly authorized and validly issued in accordance with this Act, including as a result of ratification or validation under this subchapter.

“Validation effective time” with respect to any defective corporate action ratified under this subchapter means the later of:

- (iii) the time at which the ratification of the defective corporate action is approved by the shareholders, or if approval of shareholders is not required, the time at which the notice required by section 1.49 becomes effective in accordance with section 1.41; and
- (iv) the time at which any articles of validation filed in accordance with section 1.51 become effective.

The validation effective time shall not be affected by the filing or pendency of a judicial proceeding under section 1.52 or otherwise, unless otherwise ordered by the court.

## **CROSS-REFERENCES**

Authorized shares, see § 6.01.

Corporate powers, see § 3.02.

Issuance of shares, see § 6.21.

Lack of power to act, see § 3.04.

Share rights, options, warrants and awards, see § 6.24.

## **OFFICIAL COMMENT**

The definitions of “corporate action,” “defective corporate action” and “failure of authorization” are intentionally broad so as to permit ratification of any corporate action purportedly taken that would have been within the power granted to a corporation under the Act.

The term “defective corporate action” includes an “overissue” of shares and other defects in share issuances that could cause shares to be treated as void. For purposes of determining which shares are overissued, only those shares issued in excess of the number of shares permitted to be issued under section 6.01 of the Act would be deemed overissued shares. If it cannot be determined from the records of the corporation which shares were issued before others, all shares included in an issuance that is or results in an overissue would be overissued shares.

### **§ 1.46 Defective Corporate Actions**

- (a) A defective corporate action shall not be void or voidable if ratified in accordance with section 1.47 or validated in accordance with section 1.52.
- (b) Ratification under section 1.47 or validation under section 1.52 shall not be deemed to be the exclusive means of ratifying or validating any defective corporate action, and the absence or failure of ratification in accordance with this subchapter shall not, of itself, affect the validity or effectiveness of any corporate action properly ratified under common law or otherwise, nor shall it create a presumption that any such corporate action is or was a defective corporate action or void or voidable.
- (c) In the case of an overissue, putative shares shall be valid shares effective as of the date originally issued or purportedly issued upon:
  - (1) the effectiveness under this subchapter and under chapter 10 of an amendment to the articles of incorporation authorizing, designating or creating such shares; or
  - (2) the effectiveness of any other corporate action under this subchapter ratifying the authorization, designation or creation of such shares.

### **CROSS-REFERENCES**

Amendment of articles of incorporation by board of directors and shareholders, see § 11.03.

Authorized shares, see § 6.01.

Correcting filed documents, see § 1.24.

### **OFFICIAL COMMENT**

Subchapter E provides a statutory ratification procedure for corporate actions that may not have been properly authorized and shares that may have been improperly issued. The statutory ratification procedure is designed to supplement common law ratification. Corporate actions ratified under this subchapter remain subject to equitable review.

Examples of defective corporate actions subject to ratification include the failure of the incorporator to validly appoint an initial board of directors, corporate action taken in the absence of board resolutions authorizing the action, the failure to obtain the requisite shareholder approval of a corporate action, issuance of shares in the absence of evidence that consideration payable to the corporation for shares was received, the failure to comply with appraisal requirements and the issuance of shares without complying with preemptive rights. The ratification procedure is intended to be available only where there is objective evidence that a corporate action was defectively implemented. For example, subchapter E would permit ratification of shares previously issued but subsequently determined to have been issued improperly. It would not permit the corporation to issue shares retroactively as of an earlier date, however, where there is no objective evidence that those shares had previously been issued. Objective evidence may include resolutions, issuance of share certificates, subscription or share purchase agreements, entries in a share ledger or other correspondence indicating that shares were issued or intended to have been issued.

Section 1.46(a) does not distinguish between void and voidable actions. Instead it provides that any defective corporate action that is ratified in accordance with section 1.47 or validated under section 1.52 shall not be void or voidable. Section 1.47 is not the exclusive means by which a defective corporate action may be ratified. Thus, the general common law doctrine of ratification, as applied to a board of directors' adoption of actions taken by officers who may not

have had the actual authority to take such actions, continues to be an effective mode of ratification. Section 1.46(b) makes clear that the corporation's ratification of a defective corporate action that is voidable but not void using common law methods of ratification rather than under section 1.47 will not, standing alone, affect the validity of the action or create a presumption that the action is not valid. In addition, ratification under subchapter E is distinct from correction of an already filed document under section 1.24.

Section 1.46(c) provides that an overissue can be remedied by the adoption of articles of amendment or other corporate action that has the effect of authorizing, designating or creating shares of a series or class, such that the putative shares that resulted in the overissue are deemed to be validly issued from the date of original issuance. This provision enables a corporation to cure an overissue occurring when shares have been duly authorized but are issued before articles of amendment are filed. It also permits a corporation to remedy an overissue even if it cannot specifically identify the putative shares.

### **§ 1.47 Ratification of Defective Corporate Actions**

- (a) To ratify a defective corporate action under this section (other than the ratification of an election of the initial board of directors under subsection § 1.47(b)), the board of directors shall take action ratifying the action in accordance with section 1.48, stating:
  - (1) the defective corporate action to be ratified and, if the defective corporate action involved the issuance of putative shares, the number and type of putative shares purportedly issued;
  - (2) the date of the defective corporate action;
  - (3) the nature of the failure of authorization with respect to the defective corporate action to be ratified; and
  - (4) that the board of directors approves the ratification of the defective corporate action.
- (b) In the event that a defective corporate action to be ratified relates to the election of the initial board of directors of the corporation under section 2.05(a)(2), a majority of the persons who, at the time of the ratification, are exercising the powers of directors may take an action stating:
  - (1) the name of the person or persons who first took action in the name of the corporation as the initial board of directors of the corporation;
  - (2) the earlier of the date on which such persons first took such action or were purported to have been elected as the initial board of directors; and
  - (3) that the ratification of the election of such person or persons as the initial board of directors is approved.
- (c) If any provision of this Act, the articles of incorporation or bylaws, any corporate resolution or any plan or agreement to which the corporation is a party in effect at the time action under subsection § 1.47(a) is taken requires shareholder approval or would have required shareholder approval at the date of the occurrence of the defective corporate action, the ratification of the defective corporate action approved in the action taken by the directors under subsection § 1.47(a) shall be submitted to the shareholders for approval in accordance with section 1.48.
- (d) Unless otherwise provided in the action taken by the board of directors under subsection § 1.47(a), after the action by the board of directors has been taken and, if required, approved by the shareholders, the board of directors may abandon the ratification at any time before



the validation effective time without further action of the shareholders.

## **CROSS-REFERENCES**

Organization of corporation, see § 2.05.

Requirement for and functions of board of directors, see § § 8.01.

## **OFFICIAL COMMENT**

The information required by section 1.47(a)(1)(a)(1) regarding the listing of putative shares may be satisfied by attaching a table, including a capitalization table, listing the putative shares. Section 1.47(b) permits the ratification of the initial election of the board of directors by the persons who are acting as the current board of directors, recognizing that if the corporation's initial board of directors was defectively appointed, there may be no effective method of ratification because a duly elected board of directors does not exist.

### **§ 1.48 Action on Ratification**

- (a) The quorum and voting requirements applicable to a ratifying action by the board of directors under section 1.47(a) shall be the quorum and voting requirements applicable to the corporate action proposed to be ratified at the time such ratifying action is taken.
- (b) If the ratification of the defective corporate action requires approval by the shareholders under section 1.47(c), and if the approval is to be given at a meeting, the corporation shall notify each holder of valid and putative shares, regardless of whether entitled to vote, as of the record date for notice of the meeting and as of the date of the occurrence of defective corporate action, provided that notice shall not be required to be given to holders of valid or putative shares whose identities or addresses for notice cannot be determined from the records of the corporation. The notice must state that the purpose, or one of the purposes, of the meeting, is to consider ratification of a defective corporate action and must be accompanied by (i) either a copy of the action taken by the board of directors in accordance with section 1.47(a) or the information required by sections 1.47(a)(1) through (a)(4), and (ii) a statement that any claim that the ratification of such defective corporate action and any putative shares issued as a result of such defective corporate action should not be effective, or should be effective only on certain conditions, shall be brought within 120 days from the applicable validation effective time.
- (c) Except as provided in subsection § 1.48(d) with respect to the voting requirements to ratify the election of a director, the quorum and voting requirements applicable to the approval by the shareholders required by section 1.47(c) shall be the quorum and voting requirements applicable to the corporate action proposed to be ratified at the time of such shareholder approval.
- (d) The approval by shareholders to ratify the election of a director requires that the votes cast within the voting group favoring such ratification exceed the votes cast opposing such ratification of the election at a meeting at which a quorum is present.
- (e) Putative shares on the record date for determining the shareholders entitled to vote on any matter submitted to shareholders under section 1.47(c) (and without giving effect to any ratification of putative shares that becomes effective as a result of such vote) shall neither be entitled to vote nor counted for quorum purposes in any vote to approve the ratification of

any defective corporate action.

- (f) If the approval under this section of putative shares would result in an overissue, in addition to the approval required by section 1.47, approval of an amendment to the articles of incorporation under chapter 10 to increase the number of shares of an authorized class or series or to authorize the creation of a class or series of shares so there would be no overissue shall also be required.

## **CROSS-REFERENCES**

Notices and other communications, see § 1.41.

Quorum and voting requirements for the board of directors, see § 8.24.

Quorum and voting requirements for voting groups, see § 7.25.

## **OFFICIAL COMMENT**

Notwithstanding the shareholder notice required by section 1.48(b), only valid shares are entitled to vote on the ratification action or counted for quorum purposes. The retroactive effect of a ratification of putative shares does not invalidate the quorum or voting result of the ratification.

For matters other than the election of directors, the quorum and voting requirements applicable to shareholder approval of ratification are the quorum and voting requirements applicable to the corporate action being ratified at the time of such approval. For example, if the defective corporate action being ratified is an amendment to the articles of incorporation, whether in connection with an overissue or otherwise, the vote required would be governed by section 10.03. If the defective corporate action involves a merger, the vote required would be the vote required by section 11.04.

### **§ 1.49 Notice Requirements**

- (a) Unless shareholder approval is required under section 1.47(c), prompt notice of an action taken under section 1.47 shall be given to each holder of valid and putative shares, regardless of whether entitled to vote, as of (i) the date of such action by the board of directors and (ii) the date of the defective corporate action ratified, provided that notice shall not be required to be given to holders of valid and putative shares whose identities or addresses for notice cannot be determined from the records of the corporation.
- (b) The notice must contain (i) either a copy of the action taken by the board of directors in accordance with section 1.47(a) or (b) or the information required by sections 1.47(a)(1) through (a)(4) or sections 1.47(b)(1) through (b)(3), as applicable, and (ii) a statement that any claim that the ratification of the defective corporate action and any putative shares issued as a result of such defective corporate action should not be effective, or should be effective only on certain conditions, shall be brought within 120 days from the applicable validation effective time.
- (c) No notice under this section is required with respect to any action required to be submitted to shareholders for approval under section 1.47(c) if notice is given in accordance with section 1.48(b).
- (d) A notice required by this section may be given in any manner permitted by section 1.41 and, for any corporation subject to the reporting requirements of section 13 or 15(d) of the

Securities Exchange Act of 1934, may be given by means of a filing or furnishing of such notice with the United States Securities and Exchange Commission.

## **CROSS REFERENCES**

Corporate records, see § 16.01.

Householding, see § 1.44.

Notices and other communications, see § 1.41.

### **§ 1.50 Effect of Ratification**

From and after the validation effective time, and without regard to the 120-day period during which a claim may be brought under section 1.52:

- (a) Each defective corporate action ratified in accordance with section 1.47 shall not be void or voidable as a result of the failure of authorization identified in the action taken under section 1.47(a) or (b) and shall be deemed a valid corporate action effective as of the date of the defective corporate action;
- (b) The issuance of each putative share or fraction of a putative share purportedly issued pursuant to a defective corporate action identified in the action taken under section 1.47 shall not be void or voidable, and each such putative share or fraction of a putative share shall be deemed to be an identical share or fraction of a valid share as of the time it was purportedly issued; and
- (c) Any corporate action taken subsequent to the defective corporate action ratified in accordance with this subchapter in reliance on such defective corporate action having been validly effected and any subsequent defective corporate action resulting directly or indirectly from such original defective corporate action shall be valid as of the time taken.

## **OFFICIAL COMMENT**

Ratification is effective as of the validation effective time and is not dependent on the expiration of the 120-day time period in which an action challenging the ratification must be brought. The ratification of a defective corporate action has the additional effect of ratifying corporate actions that are defective as a result of the original defective corporate action. For example, an overissue which results in subsequent director elections being invalid calls into question all actions by the invalidly elected board members. The ratification of the overissue, however, would cure any such additional defects.

### **§ 1.51 Filings**

- (a) If the defective corporate action ratified under this subchapter would have required under any other section of this Act a filing in accordance with this Act, then, regardless of whether a filing was previously made in respect of such defective corporate action and in lieu of a filing otherwise required by this Act, the corporation shall file articles of validation in accordance with this section, and such articles of validation shall serve to amend or substitute for any other filing with respect to such defective corporate action required by this Act.
- (b) The articles of validation must set forth:

- (1) the defective corporate action that is the subject of the articles of validation (including, in the case of any defective corporate action involving the issuance of putative shares, the number and type of putative shares issued and the date or dates upon which such putative shares were purported to have been issued);
  - (2) the date of the defective corporate action;
  - (3) the nature of the failure of authorization in respect of the defective corporate action;
  - (4) a statement that the defective corporate action was ratified in accordance with section 1.47, including the date on which the board of directors ratified such defective corporate action and the date, if any, on which the shareholders approved the ratification of such defective corporate action; and
  - (5) the information required by subsection § 1.51(c).
- (c) The articles of validation must also contain the following information:
- (1) if a filing was previously made in respect of the defective corporate action and no changes to such filing are required to give effect to the ratification of such defective corporate action in accordance with section 1.47, the articles of validation must set forth (i) the name, title and filing date of the filing previously made and any articles of correction to that filing and (ii) a statement that a copy of the filing previously made, together with any articles of correction to that filing, is attached as an exhibit to the articles of validation;
  - (2) if a filing was previously made in respect of the defective corporate action and such filing requires any change to give effect to the ratification of such defective corporate action in accordance with section 1.47, the articles of validation must set forth (i) the name, title and filing date of the filing previously made and any articles of correction to that filing and (ii) a statement that a filing containing all of the information required to be included under the applicable section or sections of the Act to give effect to such defective corporate action is attached as an exhibit to the articles of validation, and (iii) the date and time that such filing is deemed to have become effective; or
  - (3) if a filing was not previously made in respect of the defective corporate action and the defective corporate action ratified under section 1.47 would have required a filing under any other section of the Act, the articles of validation must set forth (i) a statement that a filing containing all of the information required to be included under the applicable section or sections of the Act to give effect to such defective corporate action is attached as an exhibit to the articles of validation, and (ii) the date and time that such filing is deemed to have become effective.

## **CROSS-REFERENCES**

Correcting filed documents, see § 1.24.

Effective time and date of filing, see § 1.23.

## **OFFICIAL COMMENT**

Section 1.51 requires that in the event any filing is or would have been required under the Act to effect the defective corporate action, such filing (if no filing was previously made), such corrected filing (if correction to a previous filing is required), or such original filing (if no correction to a previous filing is required) be attached as an exhibit to the articles of validation. This is intended to provide a clear public record of the actions relating to the ratification.

### **§ 1.52 Judicial Proceedings Regarding Validity of Corporate Actions**

- (a) Upon application by the corporation, any successor entity to the corporation, a director of the corporation, any shareholder, beneficial shareholder or unrestricted voting trust beneficial owner of the corporation, including any such shareholder, beneficial shareholder or unrestricted voting trust beneficial owner as of the date of the defective corporate action ratified under section 1.47, or any other person claiming to be substantially and adversely affected by a ratification under section 1.47, the [name or describe court] may:
  - (1) determine the validity and effectiveness of any corporate action or defective corporate action;
  - (2) determine the validity and effectiveness of any ratification under section 1.47;
  - (3) determine the validity of any putative shares; and  
it modify or waive any of the procedures specified in section 1.47 or 1.48 to ratify a defective corporate action.
- (b) In connection with an action under this section, the court may make such findings or orders, and take into account any factors or considerations, regarding such matters as it deems proper under the circumstances.
- (c) Service of process of the application under subsection § 1.52(a) on the corporation may be made in any manner provided by statute of this state or by rule of the applicable court for service on the corporation, and no other party need be joined in order for the court to adjudicate the matter. In an action filed by the corporation, the court may require notice of the action be provided to other persons specified by the court and permit such other persons to intervene in the action.
- (d) Notwithstanding any other provision of this section or otherwise under applicable law, any action asserting that the ratification of any defective corporate action and any putative shares issued as a result of such defective corporate action should not be effective, or should be effective only on certain conditions, shall be brought within 120 days of the validation effective time.

#### **CROSS-REFERENCES**

“Beneficial shareholder” defined, see § 1.40.

“Shareholder” defined, see § 1.40.

“Unrestricted voting trust beneficial owner” defined, see § 1.40.

#### **OFFICIAL COMMENT**

Section 1.52 confers plenary jurisdiction on a designated court to hear and determine claims regarding the validity of any corporate action or any shares, rights, options or warrants. The court’s jurisdiction is not limited to reviewing corporate actions ratified or purportedly ratified under section 1.47, and includes the ability of a corporation or other permitted person to obtain a declaration regarding the validity of any corporate actions or shares that are potentially defective. In determining the validity of a corporate action or reviewing a corporate action ratified under section 1.47, the court may consider any factors or considerations it deems proper under the circumstances. These might include whether the person originally taking the defective corporate action believed that the action complied with corporate requirements, whether the corporation and board of directors has treated the defective corporate action as a valid action, whether any person has acted in reliance on the public record that such defective corporate action was valid

and whether any person will be or was harmed by the ratification of the defective corporate action or will be harmed by the failure to ratify or validate the defective corporate action.

## CHAPTER 2

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# Incorporation

- § 2.01 Incorporators
- § 2.02 Articles of Incorporation
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- § 2.04 Liability for Preincorporation Transactions
- § 2.05 Organization of Corporation
- § 2.06 Bylaws
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### § 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

- Effective time and date of filing, see § 1.23.
- Filing requirements, see § 1.20.
- Organization of corporation, see § 2.05.
- “Person” defined, see § 1.40.

#### OFFICIAL COMMENT

The only functions of incorporators under the Act are (i) to sign the articles of incorporation, (ii) to deliver them to the secretary of state for filing, and (iii) to complete the formation of the corporation to the extent set forth in section 2.05. “Person” is defined in section 1.40 and includes both individuals and entities.

The Act does not require that articles of incorporation be acknowledged or verified. See the Official Comment to section 1.20 with respect to execution and filing requirements.

### § 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 and mailing addresses 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; or
    - (v) the imposition of interest holder liability on shareholders;
  - (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 (i) the amount of a financial benefit received by a director to which the director is not entitled; (ii) an intentional infliction of harm on the corporation or the shareholders; (iii) a violation of section 8.32; or (iv) an intentional violation of criminal law;
  - (5) a provision permitting or making obligatory indemnification of a director for liability as defined in section 8.50 to any person for any action taken, or any failure to take any action, as a director, except liability for (i) receipt of a financial benefit to which the director is not entitled, (ii) an intentional infliction of harm on the corporation or its shareholders, (iii) a violation of section 8.32, or (iv) an intentional violation of criminal law; and
  - (6) a provision limiting or eliminating any duty of a director or any other person to offer the corporation the right to have or participate in any, or one or more classes or categories of, business opportunities, before the pursuit or taking of the opportunity by the director or other person; provided that any application of such a provision to an officer or a related person of that officer (i) also requires approval of that application by the board of directors, subsequent to the effective date of the provision, by action of qualified directors taken in compliance with the same procedures as are set forth in section 8.62, and (ii) may be limited by the authorizing action of the board.
- (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).
- (e) As used in this section, “related person” has the meaning specified in section 8.60.

## **CROSS-REFERENCES**

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

Classes of shares, see § 6.01.

Corporate powers, see § 3.02.

Duration of corporate existence, see § § 3.02.

Filing requirements, see § 1.20.

Incorporators, see § 2.01.



Indemnification, see ch. 8E.

“Interest holder liability” defined, see § 1.40.

Liability of shareholders, see § 6.22.

Powers, see § 3.02.

Purposes, see § 3.01.

Restated articles of incorporation, see § 10.07.

## **OFFICIAL COMMENT**

### *1. Introduction*

A corporation will have perpetual duration unless a special provision is included in its articles of incorporation providing for a shorter period. See section 3.02. Similarly, a corporation with articles of incorporation which do not contain a purpose clause will 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)(i) and 3.01, with the effect described in the Official Comment to section 3.01.

### *2. Required Provisions*

If a single class of shares is authorized, only the number of shares authorized need be stated; 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.

The corporation’s initial registered office and agent must be included, and a mailing address alone, such as a post office box, is not sufficient since the registered office is the designated location for service of process. See chapter 5.

No reference need be made to a variety of other matters such as preemptive rights. See section 6.30 and its Official Comment. Generally, no substantive effect should be given to the absence of a specific reference to such matters in section 2.02. They are referred to in other sections of the Act that usually provide an “opt in” privilege. See particularly the list of optional provisions set forth in parts 4 and 5 of this Official Comment.

### *3. Optional Provisions*

Section 2.02(b) allows the articles of incorporation to contain optional provisions deemed sufficiently important to be of public record or subject to amendment only by the processes applicable to amendments of articles of incorporation.

#### **A. BUSINESS OR AFFAIRS**

Provisions relating to the business or affairs of the corporation that may be included in the articles may be subdivided into four general classes:

- provisions that under the 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 Official Comment);
- provisions that under the Act may be elected by specific inclusion in either the articles of incorporation or the bylaws, as listed in part 5 of this Official Comment;
- other provisions not referred to in the Act, including any provision that the Act requires

- or permits to be set forth in the bylaws (see section 2.02(b)(b)(3)); and
- 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, if the requirements of that section are met.

#### **B. CORPORATE POWERS**

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

#### **C. PAR VALUE**

Although par value is no longer a mandatory statutory concept under the Act, section 2.02(b)(b)(2)(iv) permits optional "par value" provisions with regard to shares. Other than being permitted by section 2.02(b)(b)(2)(iv), however, "par value" is not mentioned in the Act. Special provisions may be included to give effect or meaning to "par value" essentially as a matter of contract between the parties. These provisions, whether appearing in the articles of incorporation 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 of incorporation establishing an optional par value may also be of use to corporations which are to be qualified or registered in foreign jurisdictions that compute franchise or other taxes upon the basis of par value.

For a general discussion of capitalization, see the Official Comment to section 6.21.

#### **D. SHAREHOLDER LIABILITY**

The basic tenet of corporation law is that shareholders are not liable for the corporation's liabilities by reason of their status as shareholders. Section 2.02(b)(b)(2)(iv) 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 liabilities except to the extent they become liable by reason of their own conduct or acts. See section 6.22(b).

#### **E. LIMITATIONS OF 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 section is optional rather than self-executing and does not apply 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 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 also officers, employees or controlling shareholders, to the extent they are acting in their capacity as directors.

Shareholders are given considerable latitude in limiting directors' liability for money damages. The statutory exceptions to permitted limitations of director liability are few and narrow and are discussed below.

#### *Financial Benefit*

Corporate law subjects transactions from which a director could benefit personally to special scrutiny. The financial benefits exception is limited to the amount of the benefit actually received. Thus, liability for punitive damages could be eliminated, except in cases of intentional infliction of harm or for violation of criminal law (as described below) where, in a particular case (for example, theft), punitive damages may be available. The benefit must be financial rather than in less easily measured 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, the director 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 entitled to reasonable compensation for the performance of services or to an increase in the value of stock or stock options held by the director; on the other hand, a director is not entitled to a bribe, a kick-back, or the profits from a corporate opportunity improperly taken by the director. See section 8.70 as to procedures for disclaiming the corporation’s interest in a business opportunity by action of qualified directors or shareholders. See section 2.02(b)(6) for optional provisions permitted in the articles of incorporation to limit or eliminate, in advance, any duty of directors and others to bring business opportunities to the corporation. If the corporation declines the opportunity after it has been presented to the corporation by the director in accordance with the provisions of section 8.70(a)(1)(i) or (ii), or if a provision under section 2.02(b)(6) limits or eliminates the duty to bring the particular opportunity to the corporation, the corporation will have no right to participate in any financial benefit arising from the opportunity if the director pursues or takes the opportunity.

#### *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.

#### *Unlawful Distributions*

Section 8.32(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. Accordingly, the exception in section 2.02(b)(4)(iii) prohibits the shareholders from eliminating or limiting the liability of directors for a violation of section 8.32.

#### *Intentional Violation of Criminal Law*

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 an intentional violation of criminal law, 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.

#### **F. DIRECTOR INDEMNIFICATION**

Section 2.02(b)(5) specifically prohibits provisions for indemnification of director 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 "E. Limitations of Director Liability" above. Officers are not included in the language of section 2.02(b)(5) because the expansion of indemnification for directors that section permits must be set forth in the articles of incorporation as required by section 8.51(a)(2); section 8.56 allows a similar expansion of indemnification for officers to be set forth also in the bylaws, resolutions or contracts.

#### **G. BUSINESS OPPORTUNITIES**

Section 2.02(b)(6) authorizes the inclusion of a provision in the articles of incorporation to limit or eliminate, in advance, the duty of a director or other person to bring a business opportunity to the corporation. The limitation or elimination may be blanket in nature and apply to any business opportunities, or it may extend only to one or more specified classes or categories of business opportunities. The adoption of such a provision constitutes a curtailment of the duty of loyalty which includes the doctrine of corporate opportunity. If such a provision is included in the articles, taking advantage of a business opportunity covered by the provision of the articles without offering it to the corporation will not expose the director or other person to whom it is made applicable either to monetary damages or to equitable or any other relief in favor of the corporation upon compliance with the requirements of section 2.02(b)(6).

This provision may be useful, for example, in the context of a private equity investor that wishes to have a nominee on the board but conditions its investment on an advance limitation or elimination of the corporate opportunity doctrine because of the uncertainty over the application of the corporate opportunity doctrine inherent when investments are made in multiple enterprises in specific industries. Another example is a joint venture in corporate form where the participants in the joint venture want to be sure that the corporate opportunity doctrine would not apply to their activities outside the joint venture.

The focus of the advance limitation or elimination is on the duty of the director which extends indirectly to the investor through the application of the related party definition in section 8.60. This provision also permits extension of the limitation or elimination of the duty to any other persons who might be deemed to have a duty to offer business opportunities to the corporation. For example, courts have held that the corporate opportunity doctrine extends to officers of the corporation. Although officers may be included in a provision under this subsection, the limitation or elimination of corporate opportunity obligations of officers must be addressed by the board of directors in specific cases or by the directors' authorizing provisions in employment agreements or other contractual arrangements with such officers. Accordingly, section 2.02(b)(6) requires that the application of an advance limitation or elimination of the duty to offer a business opportunity to the corporation to any person who is an officer of the corporation or a related person of an officer also requires action by the board of directors acting through qualified directors. This action must be taken subsequent to the inclusion of the provision in the articles of incorporation and may limit the application. This means that if the

advance limitation or elimination of the duty of an officer to offer business opportunities to the corporation is included in the articles by an amendment recommended by the directors and approved by the shareholders, that recommendation of the directors does not serve as the required authorization by qualified directors; rather, separate authorization by qualified directors after the amendment is included in the articles is necessary to apply the provision to a particular officer or any related person of that officer. See sections 1.43(a)(1) and 8.60 for the definition of “qualified directors” and “related persons,” respectively.

Whether a provision for advance limitation or elimination of duty in the articles of incorporation should be a broad “blanket” provision or one more tailored to specific categories or classes of transactions deserves careful consideration given the particular circumstances of the corporation.

Limitation or elimination of the duty of a director or officer to present a business opportunity to the corporation does not limit or eliminate the director’s or officer’s duty not to make unauthorized use of corporate property or information or to compete unfairly with the corporation.

#### *4. List of Options in the Act That May Be Elected Only in the Articles of Incorporation*

##### **A. OPTIONS WITH RESPECT TO DIRECTORS**

- Board of directors may be dispensed with entirely, § 7.32, or its functions may be restricted, § 8.01.
- Power to compensate directors may be restricted or eliminated, § 8.11.
- Election of directors by cumulative voting may be authorized, § 7.28.
- Election of directors by greater than plurality vote may be authorized, § 7.28.
- Directors may be elected by classes or series of shares, § 8.04.
- Director’s term may be limited by failure to receive specified vote for election, § 8.05.
- Power to remove directors without cause may be restricted or eliminated, § 8.08.
- Terms of directors may be staggered so that all directors are not elected in the same year, § 8.06.
- Power to fill vacancies may be limited to the shareholders, § 8.10.
- Power to indemnify directors, officers, and employees may be limited, §§ 8.50 through 8.59.
- Prohibition on adoption of bylaw provision under § 10.22.

##### **B. OPTIONS WITH RESPECT TO SHAREHOLDERS**

- Action by shareholders may be taken without a meeting, § 7.04.
- Special voting groups of shareholders may be authorized, § 7.25.
- Elimination or restriction of separate voting groups for mergers and share exchanges, § 11.04, and for domestications, § 9.21.
- Quorum for voting groups of shareholders may be increased or reduced, §§ 7.25, 7.26, and 7.27.
- Quorum for voting by voting groups of shareholders may be prescribed, see § 7.26.
- Greater than majority vote may be required for action by voting groups of shareholders, § 7.27.

##### **C. OPTIONS WITH RESPECT TO SHARES**

- Shares may be divided into classes and classes into series, §§ 6.01 and 6.02.
- Cumulative voting for directors may be permitted, § 7.28.
- Distributions may be restricted, § 6.40.
- Share dividends may be restricted, § 6.23.
- Voting rights of classes or series of shares may be limited or denied, § 6.01.
- Classes or series of shares may be given more or less than one vote per share, § 7.21.
- Terms of a class or series of shares may vary among holders of the same class or series, so long as such variations are expressly set forth in the articles, § 6.01.
- The board of directors may allocate authorized but unissued shares of a class or series of shares to another class or series without shareholder approval, § 6.02.
- Shares may be redeemed at the option of the corporation or the shareholder, § 6.01.
- Reissue of acquired or redeemed shares may be prohibited, § 6.31.
- Shareholders may be given preemptive rights to acquire unissued shares, § 6.30.
- Redemption preferences may be ignored in determining lawfulness of distributions, § 6.40.

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

A. OPTIONS WITH RESPECT TO DIRECTORS

- Number of directors may be fixed or changed within limits, § 8.03.
- Qualifications for directors may be prescribed, § 8.02.
- Notice of regular or special meetings of board of directors may be prescribed, § 8.22.
- Power of board of directors to act without meeting may be restricted, § 8.21.
- Quorum for meeting of board of directors may be increased or decreased (down to one-third) from majority, § 8.24.
- Action at meeting of board of directors may require a greater than majority vote, § 8.24.
- Power of directors to participate in meeting without being physically present may be prohibited, § 8.20.
- Board of directors may create board committees and specify their powers, § 8.25.
- Board of directors may create safe harbor for consideration of corporate opportunities, § 8.70.
- Power of board of directors to amend bylaws may be restricted, §§ 10.20 and 10.21.
- Election of directors may be governed by the optional rules under section 10.22.

B. OPTIONS WITH RESPECT TO SHARES

- Shares may be issued without certificates, § 6.26.
- Procedure for treating beneficial owner of street name shares as record owner may be prescribed, § 7.23.
- 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**

Effective time and date of filing, see § 1.23.

Evidentiary effect of certified copy of filed document, see § 1.27.

Filing requirements, see § 1.20.

Liability for preincorporation transactions, see § 2.04.

### **OFFICIAL COMMENT**

Section 2.03(a) fixes the beginning of corporate existence as the date and time the articles are filed by the secretary of state, as provided in section 1.23, unless the articles of incorporation provide that the corporation's existence will begin at a time later than the time of filing, to the extent permitted by section 1.23.

Under section 2.03(b) the filing of the articles of incorporation is conclusive proof that all conditions precedent to incorporation have been met, except in specified proceedings brought by the state.

See Chapter 1, which contains rules for the filing and effective dates of documents, all of which are applicable to articles of incorporation and other documents.

### **§ 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**

Ordinarily, only the filing of articles of incorporation should create the privilege of limited liability. Situations may arise, however, in which the protection of limited liability arguably should be recognized even though the simple incorporation process established by the Act has not been completed.

As a result, the Act imposes liability only on persons who act as or on behalf of corporations “knowing” that no corporation exists. In addition, section 2.04 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 execution in the name of the corporation.

## § 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; or
  - (2) if initial directors are not named in the articles of incorporation, the incorporator or incorporators shall hold an organizational meeting at the call of a majority of the incorporators:
    - (i) to elect initial 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

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.

Section 2.05 allows alternative methods of completing the organization of the corporation. First, section 2.05(a)(1) contemplates that if initial directors are named in the articles of incorporation, the persons so named will organize the corporation. 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. In routine incorporations, the first alternative is often elected, although 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 that will continue to serve the organization beyond its incorporation.

Section 2.05(b) is limited to incorporators because section 8.21 permits action by written consent by the board of directors.

## § 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 that is not inconsistent with law or the articles of incorporation.
- (c) The bylaws may contain one or both of the following provisions:



- (1) a requirement that if the corporation solicits proxies or consents with respect to an election of directors, the corporation include in its proxy statement and any form of its proxy or consent, to the extent and subject to such procedures or conditions as are provided in the bylaws, one or more individuals nominated by a shareholder in addition to individuals nominated by the board of directors; and
  - (2) a requirement that the corporation reimburse the expenses incurred by a shareholder in soliciting proxies or consents in connection with an election of directors, to the extent and subject to such procedures and conditions as are provided in the bylaws, provided that no bylaw so adopted shall apply to elections for which any record date precedes its adoption.
- (d) Notwithstanding section 10.20(b)(2), the shareholders in amending, repealing, or adopting a bylaw described in subsection § 2.06(c) may not limit the authority of the board of directors to amend or repeal any condition or procedure set forth in or to add any procedure or condition to such a bylaw to provide for a reasonable, practical, and orderly process.

### **CROSS-REFERENCES**

Amendment of bylaws, see § 10.20, 10.21 and 10.22.

Emergency bylaws, see § 2.07.

“Expenses” defined, see § 1.40.

Organizing corporation, see § 2.05.

### **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) permits any bylaw provision that is not inconsistent with law or the articles of incorporation. This limitation precludes bylaw provisions that limit the managerial authority of directors established by section 8.01(b). For a list of provisions that may be included in the bylaws, see the Official Comment to section 2.02.

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

Section 2.06(c) expressly authorizes bylaws that require the corporation to include individuals nominated by shareholders for election as directors in its proxy statement and proxy cards (or consents) and that require the reimbursement by the corporation of expenses incurred by a shareholder in soliciting proxies (or consents) in an election of directors, in each case subject to such procedures or conditions as may be provided in the bylaws. Expenses reimbursed under section 2.06(c)(2) must be reasonable as contemplated in the definition of expenses set forth in section 1.40.

Examples of the procedures and conditions that may be included in bylaws contemplated by section 2.06(c) include provisions that relate to the ownership of shares (including requirements as to the duration of ownership); informational requirements; restrictions on the number of directors to be nominated or on the use of the provisions by shareholders seeking to acquire control; provisions requiring the nominating shareholder to indemnify the corporation; limitations on reimbursement based on the amount spent by the corporation or the proportion of votes cast for the nominee; and limitations concerning the election of directors by cumulative voting.

Section 2.06(c) clarifies that proxy access and expense reimbursement provisions do not infringe upon the scope of authority granted to the board of directors of a corporation under section 8.01(b). Section 2.06(c) underscores the model of corporate governance embodied by the Act and reflected in section 8.01, but recognizes that different corporations may wish to grant shareholders varying rights in selecting directors through the election process.

Section 2.06(d) limits the rule set forth in section 10.20(b)(2) that shareholder adopted bylaws may limit the authority of directors to amend bylaws, by specifying that such a limit will not apply absolutely to conditions and procedures set forth in access or reimbursement bylaws authorized by section 2.06(c). Section 2.06(d) allows directors to ensure that such bylaws adequately provide for a reasonable, practical, and orderly process, but is not intended to allow the board of directors to frustrate the purpose of a shareholder-adopted proxy access or expense reimbursement provision.

## **§ 2.07 Emergency Bylaws**

- (a) Unless the articles of incorporation provide otherwise, the board of directors may adopt bylaws to be effective only in an emergency defined in subsection § 2.07(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 not inconsistent 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 director, officer, employee, or agent of the corporation.
- (d) An emergency exists for purposes of this section if a quorum of the board of directors cannot readily be assembled because of some catastrophic event.

## **CROSS-REFERENCES**

Amendment of bylaws, see § 10.20 and 10.21.

Bylaws, see § 2.06.

Emergency powers without bylaw provision, see § 3.03.

## **OFFICIAL COMMENT**

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 section 2.07(d) includes any catastrophic event that makes it difficult or impossible for a quorum of the board of directors to be assembled. 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 directors, officers, employees, and agents of the corporation from liability as a result of these actions. The phrase “action taken in good faith in accordance with the emergency bylaws” is designed to conform to the standard for immunity elsewhere in the Act.

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).

## **§ 2.08 Forum Selection Provisions**

- (a) The articles of incorporation or the bylaws may require that any or all internal corporate claims shall be brought exclusively in any specified court or courts of this state and, if so specified, in any additional courts in this state or in any other jurisdictions with which the corporation has a reasonable relationship.
- (b) A provision of the articles of incorporation or bylaws adopted under subsection § 2.08(a) shall not have the effect of conferring jurisdiction on any court or over any person or claim, and shall not apply if none of the courts specified by such provision has the requisite personal and subject matter jurisdiction. If the court or courts of this state specified in a provision adopted under subsection § 2.08(a) do not have the requisite personal and subject matter jurisdiction and another court of this state does have such jurisdiction, then the internal corporate claim may be brought in such other court of this state, notwithstanding that such other court of this state is not specified in such provision, and in any other court specified in such provision that has the requisite jurisdiction.
- (c) No provision of the articles of incorporation or the bylaws may prohibit bringing an internal corporate claim in the courts of this state or require such claims to be determined by arbitration.
- (d) “Internal corporate claim” means, for the purposes of this section, (i) any claim that is based upon a violation of a duty under the laws of this state by a current or former director, officer, or shareholder in such capacity, (ii) any derivative action or proceeding brought on behalf of the corporation, (iii) any action asserting a claim arising pursuant to any provision of this Act or the articles of incorporation or bylaws, or (iv) any action asserting a claim governed by the internal affairs doctrine that is not included in (i) through (iii) above.

## **CROSS-REFERENCES**

Derivative proceedings, see ch. 7D.

## **OFFICIAL COMMENT**

Section 2.08(a) authorizes a provision in either the articles of incorporation or the bylaws creating an exclusive forum or forums for the adjudication of internal corporate claims. Under section 2.08(a), the provision must specify at least one court of this state (*i.e.*, a state court rather than a federal court). The provision may also include additional specified courts or all courts of this state or courts in this state (such as federal courts) or in one or more additional jurisdictions with a reasonable relationship to the corporation. In addition, the provision may prioritize among the specified courts. For example, the provision may specify that the claim shall be brought

exclusively in a particular court of this state unless such court does not have the requisite personal and subject matter jurisdiction, in which case the claim shall be brought in other specified courts.

Under the last sentence of section 2.08(b), an internal corporate claim will always be permitted to be brought in at least one court of this state unless there is no court of this state that has the requisite personal and subject matter jurisdiction. For example, if the articles of incorporation or the bylaws provide that an internal corporate claim may only be brought in a specified court of this state and in the courts of another state with a reasonable relationship to the corporation, and the specified court of this state does not have the requisite personal and subject matter jurisdiction, then the claim can be brought in any other court of this state that does have the requisite jurisdiction or in the courts of the specified other state (so long as those courts have the requisite jurisdiction). Similarly, if the articles of incorporation or the bylaws provide that an internal corporate claim may only be brought in a specified court of this state and in the federal courts in this state, and the specified court of this state does not have the requisite personal and subject matter jurisdiction, then the claim can be brought in any other court of this state that does have the requisite jurisdiction or in the federal courts in this state (so long as the federal court has the requisite jurisdiction). In each of the foregoing examples, (i) if the specified court of this state does have the requisite personal and subject matter jurisdiction, then such court would be the only court of this state in which the internal corporate claim could be brought, and (ii) if no court of this state has the requisite personal and subject matter jurisdiction, then the courts of the other state (in the first example) or the federal courts in this state (in the second example) would become the exclusive forum for such internal corporate claim, in each case so long as such court has the requisite jurisdiction.

If no court of this state has the requisite personal and subject matter jurisdiction, and none of the other courts, if any, specified in the provision of the articles of incorporation or the bylaws has the requisite jurisdiction, then the provision will have no effect and the internal corporate claim may be brought in any court that does have the requisite jurisdiction.

## CHAPTER 3

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# Purposes and Powers

- § 3.01 Purposes
- § 3.02 General Powers
- § 3.03 Emergency Powers
- § 3.04 Lack Of Power to Act

### § 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

Statement of purpose in articles of incorporation, see § 2.02.

### OFFICIAL COMMENT

The choice of an “any lawful business” clause has become nearly universal in states that permit the clause. Even if the articles of incorporation limit lines of business in which the corporation may engage, 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 or registration purposes in some states.

Section 3.01(b) recognizes that certain state statutes may preclude incorporation under the Act or limit the purpose of or otherwise regulate the business or affairs of corporations formed to, or actually engaging in, certain lines of business.

- Some of these statutes, particularly those relating to banking and insurance, establish a separate incorporation process and incorporating agency. These special incorporating statutes may refer to or incorporate by reference portions of the Act. Other statutes provide for incorporation for the purpose of practicing a profession.
- Other statutes may permit incorporation under the 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.

- Other types of entities, such as nonprofit corporations, cooperatives, and unions, usually may not incorporate under the Act. Special statutes may apply to these entities, such as the Model Nonprofit Corporation Act.

### **§ 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 power:

- (a) to sue and be sued, complain and defend in its corporate name;
- (b) 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;
- (c) 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;
- (d) 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;
- (e) to sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of all or any part of its property;
- (f) 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;
- (g) to make contracts and guarantees, incur liabilities, borrow money, issue its notes, bonds, and other securities and 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;
- (h) to lend money, invest and reinvest its funds, and receive and hold real and personal property as security for repayment;
- (i) to be a promoter, partner, member, associate, or manager of any partnership, joint venture, trust, or other entity;
- (j) to conduct its business, locate offices, and exercise the powers granted by this Act within or without this state;
- (k) to elect directors and appoint officers, employees, and agents of the corporation, define their duties, fix their compensation, and lend them money and credit;
- (l) 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;
- (m) to make donations for the public welfare or for charitable, scientific, or educational purposes;
- (n) to transact any lawful business that will aid governmental policy; and
- (o) 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**

- 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 § 15.01.
- Indemnification, see ch. 8E.
- Lack of power to act, see § 3.04.
- Share rights, options, warrants and awards, see § 6.24.

## **OFFICIAL COMMENT**

The general philosophy of section 3.02 is that corporations formed under the Act 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 corporation.

The powers of a corporation under the 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 within the corporation’s powers even if 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. These issues do not 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 § 3.03(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 § 3.03(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; 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 director, officer, employee, or agent.
- (d) An emergency exists for purposes of this section if a quorum of the board of directors cannot readily be assembled because of some catastrophic event.

### **CROSS-REFERENCES**

Corporate powers, see § 5.02.

Emergency bylaws, see § 2.07.

Notices and other communications, 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 bylaws. Section 3.03 grants every corporation limited powers to act in an emergency even though it has failed to adopt emergency bylaws under section 2.07.

### **§ 3.04 Lack Of Power to Act**

- (a) Except as provided in subsection § 3.04(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.

“Employee” defined, see § 1.40.

“Proceeding” defined, see § 1.40.



## OFFICIAL COMMENT

Under section 3.04, 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 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 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 duty. For example, a misuse of corporate assets for personal purposes by an officer or director is a breach of 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 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 duty, not because the transaction exceeds the powers or purposes of the corporation.

Section 3.04(b) permits challenges to the corporation’s lack of power in three limited classes of cases:

- 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). Section 3.04(c) 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. 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” is used 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).

- 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 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.
- In a suit by the attorney general under section 14.30. This provision does not answer the question whether 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.

## CHAPTER 4

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# Name

- § 4.01. Corporate Name
- § 4.02. Reserved Name
- § 4.03. Registered 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 in this state which is not administratively dissolved;
  - (2) a corporate name reserved or registered under section 4.02 or § 4.03 or any similar provision of the law of this state;
  - (3) the name of a foreign corporation registered to do business in this state or an alternate name adopted by a foreign corporation registered to do business in this state because its corporate name is unavailable;
  - (4) the corporate name of a nonprofit corporation incorporated in this state which is not administratively dissolved;
  - (5) the name of a foreign nonprofit corporation registered to do business in this state or an alternate name adopted by a foreign nonprofit corporation registered to conduct activities in this state because its real name is unavailable;
  - (6) the name of a domestic filing entity or limited liability partnership which is not administratively dissolved;
  - (7) the name of a foreign unincorporated entity registered to do business in this state or an alternate name adopted by such an entity registered to conduct activities in this state because its real name is unavailable; and
  - (8) an assumed name registered under [state’s assumed name statute].
- (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 § 4.01(b). The secretary of state shall authorize use of the name applied for if:

- (1) the other corporation or unincorporated entity 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) This Act does not control the use of fictitious names.

## **CROSS-REFERENCES**

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

Effective time and date of filing, see § 1.23.

“Filing entity” defined, see § 1.40.

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 of incorporation, see § 2.02.

## **OFFICIAL COMMENT**

Section 4.01 establishes two basic name requirements: the name must (i) indicate “corporateness,” and (ii) be distinguishable upon the records of the secretary of state.

### *1. Indication of Corporateness*

Although the words “company” and “limited” are commonly used by partnerships, limited partnerships or limited liability companies, and therefore do not uniquely indicate corporateness, their use by corporations is widespread and is therefore permitted in section 4.01(a).

### *2. Names That Are “Distinguishable upon the Records of the Secretary of State”*

Section 4.01 is based on the fundamental premise that each corporation should have a sufficiently distinctive name so that it may be distinguished from other corporations and entities upon the records of the secretary of state. The Act should not be a partial substitute for a general assumed name, unfair competition or antifraud statute. As a result, the 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. Principles of unfair competition, not the Act, provide the limits on the competitive use of similar names.

The principal justifications for requiring a distinguishable official name are (i) to prevent confusion within the secretary of state’s office and the tax office and (ii) 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 Act, not the competitive relationship between the corporations, which is the test for fraud or unfair competition. 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 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,” the Act does not prohibit it from assuming the fictitious name “ABC Corporation” to import goods in New York City, although it must file 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. Unless filings under the assumed name statute become part of the secretary of state’s corporate records, the secretary of state simply maintains an alphabetical list of corporate names as they appear from corporate records and decides whether a proposed name is distinguishable from other corporate names by comparing the proposed name with those on the list.

### *3. Fictitious, Assumed or Alternate Names*

The secretary of state becomes involved with fictitious, assumed or alternate names only in the situation where a foreign corporation, planning to do business in a state, discovers that its corporate name is not available in that state. To register to do business it must adopt an alternate name that complies with section 4.01. See section 15.06. The alternate name is thereafter unavailable to others to the same extent as any other name described in section 4.01(b) is unavailable.

### *4. Consent to Use*

The authority of the secretary of state in section 4.01(c)(1) to accept a name that is indistinguishable from the name of another corporation may be important in a number of contexts, such as an acquisition transaction 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 described in section 4.01(c)(1) to specify the new name to be adopted and the time period within which the change will be made. Such 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 or alternate 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**

Alternate name for foreign corporations, see § 15.06.

Availability of names, § 4.01.

Consent to use corporate name, see § 4.01.

Effective time and date of filing, see § 1.23.

Filing requirements, see § 1.20.

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 registration of a foreign corporation. By reserving a name, the persons considering such formation or registration 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, because 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. To use the name to register to do business under section 15.06 or incorporate, the name must comply with section 4.01.

Reasons to reserve a corporate name include:

- formation of a new domestic corporation;
- formation of a corporation in another state and the registration of that new corporation in this state; and
- a foreign corporation planning to do business in this state. The name reserved may be the foreign corporation's corporate name (if that name is available) or another name. The foreign corporation may thereafter use the reserved name as the name of a subsidiary it incorporates in this state or, if its corporate name is unavailable, as an alternate name for its registration under section 15.03.

Only a single, one-time 120-day reservation is provided for in section 4.02, although after that period expires, the name becomes available again and anyone may reserve the name. 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 the addition of any word or abbreviation listed in section 4.01(a)(1) if necessary for the corporate name to comply with section 4.01(a)(1)) 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 permitted by subsection (a)) by delivering to the secretary of state for filing an application setting forth that name, the state or country and date of its incorporation, and a brief description of the nature of the business which is to be conducted in this state.
- (c) The name is registered for the applicant's exclusive use upon the effective date of the application and for the remainder of the calendar year, unless renewed.
- (d) A foreign corporation whose name 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 name registration is effective may thereafter (i) register to do business as a foreign corporation under the registered name (if it complies with section 4.01(a)(2) or (ii) consent in writing to the use of that name by a domestic corporation thereafter incorporated under this Act or by another foreign corporation. The registration terminates when the domestic corporation is incorporated or the foreign corporation registers to do business under that name.

## **CROSS-REFERENCES**

Alternate name for foreign corporations, see § 15.06.

Certificate of existence or foreign registration, see §§ 1.28 and § 15.03.

Consent to use corporate name, see § 4.01.

Effective time and date of filing, see § 1.23.

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 registered to do business in the state, can preserve the right to use its unique corporate name if it decides later to register in the state. In effect, registration ensures corporate name availability in areas of potential future expansion.

Section 4.03 is limited to this purpose and is not for the preservation of trademarks, trade names, or possible assumed names. For this reason, generally only corporate names of foreign corporations may be registered (with the exception 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 corporate name is permitted if the corporate name of a foreign corporation does not comply with section 4.01(a)(1) solely because it does not contain the words “corporation,” “incorporated,” “company” or “limited,” or an abbreviation of one of these words. In that case, the corporation may add one of these words or abbreviations and register its corporate name as so modified. To use the name to register to do business under section 15.06, the name must comply with section 4.01. See also the Official Comment to section 4.01.

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 register as a foreign corporation and finds that its name is available in the state may either reserve or register the name. Often a foreign corporation will have to decide whether to register in the state or to create a domestic subsidiary. This 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 reserves its name, that name will be kept for 120 days and then become available again; if the corporation registers its name, that name will be kept for the remainder of the calendar year, unless renewed. 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 corporate name is unavailable, a foreign corporation may reserve any available name—including one that is assumed or fictitious rather than the corporation’s corporate name—for 120 days under section 4.02, but it may not register this type of name in light of the policy against allowing the name provisions of the 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.



## CHAPTER 5

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# Office and Agent

§ 5.01. Registered Office and Agent of Domestic and Registered Foreign Corporations

§ 5.02. Change of Registered Office or Registered Agent

§ 5.03. Resignation of Registered Agent

§ 5.04. Service on Corporation

### **§ 5.01 Registered Office and Agent of Domestic and Registered Foreign Corporations**

- (a) Each corporation shall 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, which may be:
    - (i) an individual who resides in this state and whose business office is identical with the registered office; or
    - (ii) a domestic or foreign corporation or eligible entity whose business office is identical with the registered office and, in the case of a foreign corporation or foreign eligible entity, is registered to do business in this state.
- (b) As used in this chapter, “corporation” means both a domestic corporation and a registered foreign corporation.

### **CROSS-REFERENCES**

Annual report, see § 16.21.

Changing registered office or agent, see § 5.02.

Effect of dissolution of corporation, see § 14.02.

“Eligible entity” defined, see § 1.40.

Foreign corporation:

defined, see § 1.40.

generally, see ch. 15.

Involuntary dissolution for failure to appoint and maintain registered agent or office, see § 14.20.

Naming registered agent and office in articles of incorporation, see § 2.02.

“Registered foreign corporation” defined, see § 1.40.

Resignation of registered agent, see § 5.03.

Service on corporation, see § 5.04.

## **OFFICIAL COMMENT**

The requirements that a corporation organized under the Act or a registered foreign corporation continuously maintain a registered office and a registered agent at that office are based on the premises that at all times such a corporation should have an office where it may be found and a registered agent at that office to receive any notice or process required or permitted by law to be served. The street and mailing addresses of the registered office must appear in the public records maintained by the secretary of state. A mailing address alone, such as a post office box, is not sufficient since the registered office is the designated location for service of process. See section 2.02. 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. Because most of the communication to the registered agent at the registered office deals with legal matters, however, corporations sometimes 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.

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.

### **§ 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 and mailing addresses of its current registered office;
  - (3) if the current registered office is to be changed, the street and mailing addresses 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 and mailing addresses of its registered office and of the business office of its registered agent will be identical.
- (b) If the street or mailing address of a registered agent’s business office changes, the agent shall change the street or mailing address of the registered office of any corporation for which the agent is the registered agent by delivering a signed written notice of the change to the corporation and delivering to the secretary of state for filing a signed statement that complies with the requirements of subsection § 5.02(a) and states that the corporation has been notified of the change.

## **CROSS-REFERENCES**

“Corporation” defined for purposes of ch. 5, see § 5.01.

Deletion of initial agent and office from articles of incorporation, see § 10.05.

“Deliver” defined, see § 1.40.

Effect of dissolution of corporation, see § 14.05.

Effective time and date of filing, see § 1.23.

Filing requirements, see § 1.20.

Involuntary dissolution for failure to file notice of change of registered agent or office, see § 14.20.

Notices and other communications, see § 1.41.

Registered foreign corporation subject to ch. 5, see § 5.01.

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 section 5.02 is to permit these changes without an amendment of the articles of incorporation or an approval of the board of directors or of the shareholders.

### **§ 5.03 Resignation of Registered Agent**

- (a) A registered agent may resign as agent for a corporation by delivering to the secretary of state for filing a statement of resignation signed by the agent which states:
  - (1) the name of the corporation;
  - (2) the name of the agent;
  - (3) that the agent resigns from serving as registered agent for the corporation; and
  - (4) the address of the corporation to which the agent will deliver the notice required by subsection § 5.03(c).
- (b) A statement of resignation takes effect on the earlier of:
  - (1) 12:01 a.m. on the 31st day after the day on which it is filed by the secretary of state; or
  - (2) the designation of a new registered agent for the corporation.
- (c) A registered agent promptly shall deliver to the corporation notice of the date on which a statement of resignation was delivered to the secretary of state for filing.
- (d) When a statement of resignation takes effect, the person that resigned ceases to have responsibility under this Act for any matter thereafter tendered to it as agent for the corporation. The resignation does not affect any contractual rights the corporation has against the agent or that the agent has against the corporation.
- (e) A registered agent may resign with respect to a corporation regardless of whether the corporation is in good standing.

## **CROSS-REFERENCES**

Annual report, see § 16.21.

Change of registered agent, see § 5.02.

“Corporation” defined for purposes of ch. 5, see § § 5.01.

“Deliver” defined, see § § 1.40.

Effect of dissolution of corporation, see § § 14.05.

Effective time and date of filing, see § 1.23.

Filing requirements, see § 1.20.

## **OFFICIAL COMMENT**

Section 5.03 permits the discontinuation of the registered office as well as the resignation of the agent and sets forth procedures for doing so.

#### **§ 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 at the corporation's 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 United States mail, as evidenced by the postmark, if mailed postpaid and correctly addressed.
- (c) If process, notice, or demand (i) cannot be served on a corporation pursuant to subsection (a) or (b), or (ii) is to be served on a registered foreign corporation that has withdrawn its registration pursuant to section 15.07 or 15.09, or the registration of which has been terminated pursuant to section 15.11, then the secretary of state shall be an agent of the corporation upon whom process, notice, or demand may be served. Service of any process, notice, or demand on the secretary of state as agent for a corporation may be made by delivering to the secretary of state duplicate copies of the process, notice, or demand. If process, notice, or demand is served on the secretary of state, the secretary of state shall forward one of the copies by registered or certified mail, return receipt requested, to the corporation at the last address shown in the records of the secretary of state. Service is effected under this subsection § 5.04(c) at the earliest of:
  - (1) the date the corporation receives the process, notice, or demand;
  - (2) the date shown on the return receipt, if signed on behalf of the corporation; or
  - (3) five days after the process, notice, or demand is deposited with the United States mail by the secretary of state.
- (d) This section does not prescribe the only means, or necessarily the required means, of serving a corporation.

#### **CROSS-REFERENCES**

Annual report, see § 16.21.

"Corporation" defined for purposes of ch. 5, see § 5.04.

"Notice" defined, see § 1.41.

"Principal office":

defined, see § 1.40.

designated in annual report, see § 16.21.

Registered foreign corporations:

defined, see § 1.40.

subject to ch. 5, see § 5.01.

Registered office and agent:

disclosed in annual report, see § 16.21.

required, see § 5.01.

“Secretary” defined, see § 1.40.

#### **OFFICIAL COMMENT**

By providing for service by registered or certified mail addressed to the secretary at the principal office if the corporation has no registered agent or the registered agent cannot be found, section 5.04 alleviates the problem of service on an agent that is no longer serving the corporation or registered foreign corporation.

Because section 5.04(c) does not prescribe the exclusive means of serving a corporation or registered foreign 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.

## CHAPTER 6

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# Shares and Distributions

### **Subchapter A.**

#### **SHARES**

- § 6.01. Authorized Shares
- § 6.02. Terms of Class or Series Determined by Board Of Directors
- § 6.03. Issued and Outstanding Shares
- § 6.04. Fractional Shares

### **Subchapter B.**

#### **ISSUANCE OF SHARES**

- § 6.20. Subscription for Shares Before Incorporation
- § 6.21. Issuance of Shares
- § 6.22. Liability of Shareholders
- § 6.23. Share Dividends
- § 6.24. Share Rights, Options, Warrants and Awards
- § 6.25. Form and Content of Certificates
- § 6.26. Shares Without Certificates
- § 6.27. Restriction on Transfer of Shares

### **Subchapter C.**

#### **SUBSEQUENT ACQUISITION OF SHARES BY SHAREHOLDERS AND CORPORATION**

- § 6.30. Shareholders' Preemptive Rights
- § 6.31. Corporation's Acquisition of its Own Shares

### **Subchapter D. .**

#### **DISTRIBUTIONS**

- § 6.40. Distributions to Shareholders

### **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, before the issuance of shares of a class or series, describe 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 full voting rights, and
  - (2) one or more classes or series of shares (which may be the same class, classes or series 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 § 6.01(c) is not exhaustive.

## **CROSS-REFERENCES**

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

Certificateless shares, see § 6.26.

Certificates for shares, see § 6.25.

Classes and series of shares, see §§ 6.01 and 6.02.

Consideration for shares, see § 6.21.

Distributions, see § 6.40.

Extrinsic facts, see § 1.20.

Fractional shares, see § 6.04.

Options, see § 6.24.

Outstanding shares, see § 6.03.

Preemptive rights, see § 6.30.

Redemption, see § 6.31.

Voting by nonvoting shares, see § 10.04.

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

Voting rights, see § 7.21.

## OFFICIAL COMMENT

### 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 of incorporation 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” but no specific designation is required by the 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.

The preferences, rights and limitations of each class or series of shares constitute the “contract” of the holders of those classes and series of shares with respect to the holders’ 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 of incorporation, 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 a series within a class 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 in the aggregate have the two fundamental characteristics of full voting rights and the right to receive the net assets of the corporation upon its dissolution. The phrase “full voting rights” refers to the right to vote on all matters for which voting is required by either the Act or the articles of incorporation.

The 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 having in the aggregate these two characteristics, and section 6.03 requires that shares having in the aggregate these characteristics always be outstanding.

3. *Section 6.01(c)*

Section 6.01(c) provides a non-exhaustive list of the principal features that are customarily incorporated into classes or series of shares.

**A. IN GENERAL**

Section 6.01(c) authorizes creation of classes or series of shares with a range of preferences, rights and limitations as further described below. The Act permits the creation of shares convertible into, or redeemable in exchange for, cash, other property, or shares or debt securities of the corporation ranking senior to the shares, at the option of either the holder or the corporation. Such a conversion or redemption is subject to the restrictions on distributions under section 6.40.

**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 Act that permit shares which 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 (see sections 7.26 and 10.04). In addition, shares may be given voting rights that are limited or conditional (*e.g.*, voting rights triggered by the failure to pay specified dividends).

**C. REDEMPTION AND CONVERSION OF SHARES**

Section 6.01(c)(2) permits 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 be authorized and that at least one or more shares which together have those rights must be outstanding under section 6.03).

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 permits 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 market reference rates, 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).

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.

#### **D. EXTRINSIC FACTS**

Section 6.01(d) permits the creation of classes or series of shares with terms that are dependent upon facts objectively ascertainable outside the articles of incorporation. See section 1.20(k) 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 a “variable rate” class or series of shares would be intended to respond to current market conditions, it would most often be used with “blank check” provisions in the articles of incorporation with the terms of shares 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.

#### **E. VARIATION AMONG HOLDERS**

Section 6.01(e) permits the creation of classes or series of shares with terms that may vary among holders of the same class or series of shares. An example of such variation 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. In addition, section 6.24(b) expressly permits the issuance of rights, options or warrants for the purchase of shares or other securities of the corporation that contain terms and conditions which vary the rights of the holders of such rights, warrants or options based on a holder’s ownership of, or offer to acquire, a specified number or percentage of the outstanding shares or other securities of the corporation.

#### *4. Examples of Classes or Series of Shares Permitted by section 6.01*

Section 6.01 is enabling rather than restrictive given that corporations often find it necessary to create new classes or series of shares for a variety of reasons, for instance in connection with raising debt or equity capital. Classes or series of shares may also be used in connection with desired control relationships among the participants in a venture. Under section 7.21, only securities classified as “shares” in the articles of incorporation can have the power to vote.

Examples of such classes and series of shares include:

- 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.

- 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.
- Shares of one class or series may be nonvoting or may be given multiple or fractional votes per share.
- Shares of one class or series may be entitled to different dividend rights or rights on dissolution than shares of another class or series.
- Shares of one class or series may be created to include some characteristics of debt securities.

A corporation has power to issue debt securities under section 3.02. 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 does not limit the development of hybrid securities, and equity securities may be created under the Act that embody any characteristics of debt. As noted above, however, the Act restricts the power to vote to securities classified 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 § 6.02(a), it shall 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 shall deliver to the secretary of state for filing articles of amendment setting forth the terms determined under subsection § 6.02(a).

## **CROSS-REFERENCES**

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

Class or series of shares as voting group, see § 1.40, 7.25, 7.26 and 10.04.

Distributions, see § 6.40.

Effective time and date of filing, see § 1.23.

Filing requirements, see § 1.20.

Terms of shares, see § 6.01.

Voting by voting group, see §§ 7.25 and 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 of incorporation, to determine the terms of a class of shares or of a series of shares within a class to meet corporate needs, including current requirements of the securities markets or the flexibility needed for acquisitions, without the necessity of holding a shareholders’ meeting to amend the articles of incorporation. If given that authority, the board of directors may create new series within a class and may also determine the terms of a class or series if there are no outstanding shares of that class or series.

A provision in the articles of incorporation authorizing shares to be issued in different classes or series with terms to be set by the board of directors is sometimes referred to as a “blank check” provision. The power to make the terms of shares so created dependent on facts objectively ascertainable outside the articles of incorporation and to vary their terms among holders of the same class or series extends to all the permitted provisions set forth in section 6.01(c).

Sections 6.02(a) and (b) make it clear that the board of directors has the same broad flexibility with regard to setting the terms of a class or series under this section as is permitted under section 6.01(c). Section 6.02(c) requires a filing to amend the articles of incorporation 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(h).

## **§ 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 § 6.03(c) and to section 6.40.
- (c) At all times that shares of the corporation are outstanding, one or more shares that together have full 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 and series of shares, see §§ 6.01 and 6.02.

Consideration for shares, see § 6.21.

Reacquisition of shares, see § 6.31.

Redemption of shares, see §§ 6.01 and § 6.31.

Share dividends, see § 6.23.

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

“Voting group” defined, see § 1.40.

## **OFFICIAL COMMENT**

The determination of the number of shares to be issued under section 6.03 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 or series of shares be overissued and that one or more shares of a class, classes or series that together have full voting rights and one or more shares of a class, classes or series that together are entitled to the net assets of the corporation upon dissolution at all times must be outstanding.

The corporation may acquire outstanding shares pursuant to a voluntary transaction between a shareholder and the corporation. Also, shares may be made subject to transfer restrictions that may result in contractual obligations by the corporation to reacquire shares. See section 6.27. Further, the corporation may reacquire shares pursuant to a right of redemption (or an obligation to redeem) established in the articles of incorporation. See section 6.01§ 6.01(c)(2). All voluntary or contractual reacquisitions are subject to the limitations set forth in section 6.03(c) and to section 6.40.

The provisions of the 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 or series 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 outstanding.

## **§ 6.04 Fractional Shares**

- (a) A corporation may issue fractions of a share or in lieu of doing so may:
  - (1) pay in cash the value of fractions of a share;
  - (2) issue scrip in registered or bearer form entitling the holder to receive a full share upon surrendering enough scrip to equal a full share; or
  - (3) arrange for disposition of fractional shares by the holders of such shares.
- (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 rights to vote, to receive dividends and to receive distributions upon dissolution. 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, including that:
  - (1) the scrip will become void if not exchanged for full shares before a specified date; and
  - (2) the shares for which the scrip is exchangeable may be sold and the proceeds paid to the scripholders.

## **CROSS-REFERENCES**

Issuance of shares, see § 6.21.

## **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 other corporate actions, such as fractional stock splits, reverse splits, and 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 may create administrative difficulties, particularly for voting and dividend purposes.

Section 6.04 authorizes handling fractional shares in the following ways:

- The corporation may pay in cash the value of the fractional shares.
- The corporation may issue scrip instead of fractional shares. Unless otherwise specified in the scrip, 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. To protect shareholders against forfeiture of their interest, 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 certificates.
- The corporation may authorize the immediate sale of all fractional share interests, typically by an agent on behalf of the holders, thereby avoiding the expense and delay of other methods of dealing with fractional shares. Although this procedure denies shareholders the benefit of any subsequent rise in the market price of the shares, it protects them against any subsequent decline and ensures them of recognition based on market prices at the time of the transaction.

Under section 6.04, 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 subscriptions 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 cash 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 delivers a written demand for payment to the subscriber.

## **CROSS-REFERENCES**

Consideration for shares, see § 6.21.

Notices and other communications, see § 1.41.

## **OFFICIAL COMMENT**

Because of the uncertainty of the legal enforceability of preincorporation agreements to purchase shares, section 6.20 provides a simple set of rules applicable to the enforcement of preincorporation subscriptions 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 as a default that preincorporation subscriptions are irrevocable for six months but the subscription agreement may provide otherwise or all the subscribers to shares may agree otherwise. 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(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 for any unpaid subscription price, or 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.

### **§ 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 shall 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 therefor 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 benefits are received, or the note is paid. If the services are not performed, the benefits are not received, or the note is not paid, 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 a majority (or such greater number as the articles of incorporation may prescribe) of the votes entitled to be cast on the matter exists, if:
- (i) the shares, other securities, or rights are to be 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 or other securities convertible into or rights exercisable for 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 only 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 board of directors, see § 8.25.
- 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” defined, see § 1.40.

## **OFFICIAL COMMENT**

Because a statutory structure embodying “par value” and “stated capital” concepts does not protect creditors and senior security holders from payments to junior security holders, section 6.21 does not use these concepts.

### *1. Consideration*



Because shares need not have a par value under section 6.21, there is no minimum price at which shares must be issued. Section 6.21(b) specifically validates “any tangible or intangible property or benefit to the corporation,” as consideration for the present issue of shares, specifically including contracts for future services (including promoters’ services) and promissory notes. The term “benefit” should be broadly construed also to include, for example, a reduction of a liability, a release of a claim, or intangible gain obtained by a corporation. Business judgment should determine what kind of property or benefit should be obtained for shares, and a determination by the directors meeting the requirements of section 8.30 to accept a specific kind of property or benefit for shares should be accepted and not circumscribed by artificial or arbitrary rules.

## *2. Board Determination of Adequacy*

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 benefit is provided by the requirements of section 8.30 applicable to a determination that the consideration received for shares is adequate.

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 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. Likewise, section 6.21 does not require the board of directors to determine an exact value of the consideration to be entered on the books of the corporation.

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. 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 Act does not address the remedies that may be available for issuances that are subject to challenge. See subchapter E subchapter E of chapter 1 regarding ratification of defective issuance of shares.

The Act also does not address 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 contracts for future services or benefits or for promissory notes to be placed in escrow, or their transfer otherwise restricted, until the services are performed, the benefits are received or the notes are paid. In addition, any distributions on such shares may be credited against payment, or other agreed performance, of the consideration for the shares. Under section 6.21(e), 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 section 6.21(e), they are validly issued in so far as the adequacy of consideration is concerned. See section 6.22 and its Official Comment.

Section 6.24(c) provides express authority for delegation by the board of directors to officers for the issuance of shares as compensatory awards within limitations established by the board.

### *3. Shareholder Approval Requirement for Certain Issuances*

The shareholder approval requirement of section 6.21(f) is generally patterned after the listing standards of national securities exchanges. 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.

In making the 20% determination under section 6.21(f), shares that are issuable in a transaction of any kind, including a merger, share exchange, or acquisition of assets, 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 must 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 9 for domestications and conversions, chapter 10 for amendments of the articles of incorporation, chapter 11 for mergers and share exchanges, chapter 12 for dispositions of assets that require shareholder approval, and chapter 14 for voluntary dissolutions. The quorum rule under section 6.21(f) is also the same as the quorum rule under chapters 9, 10, 11, 12, and 14.

Section 6.21(f) does not apply to an issuance for cash or cash equivalents, regardless of whether in connection with a public offering. "Cash equivalents" are generally short-term investments that are both readily convertible to known amounts of cash and present insignificant

risk of changes in interest rates. 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 as the current power to vote in the election of directors. See also the Official Comment to that section. Because transactions are integrated within the meaning of section 6.21(f) only where consummation of one transaction is made contingent on consummation of one or more of the other transactions, 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, section 6.21(f) does not require shareholder approval for share dividends or for shareholder rights plans. See section 6.23 and its Official Comment.

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

1. C corporation, which has 2,000,000 shares of Class A voting common stock outstanding (carrying one vote per share), proposes to issue 600,000 shares of authorized but unissued 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 stock, each share of which carries one vote and is convertible into 1.5 shares of Class A voting common stock. 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 shares 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 shares, 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 stock issuable upon conversion of the preferred shares (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 the corporation's 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 or specified in the subscription agreement.
- (b) A shareholder of a corporation is not personally liable for any liabilities of the corporation (including liabilities arising from acts of the corporation) except (i) to the extent provided in a provision of the articles of incorporation permitted by section 2.02(b)(2)(v), and (ii) that a shareholder may become personally liable by reason of the shareholder's own acts or conduct.

### **CROSS-REFERENCES**

Articles of incorporation, see § 2.02.

Consideration for shares, see § 6.21.

Subscriptions for shares, see § 6.20.

### **OFFICIAL COMMENT**

The sole obligation of a purchaser of shares from the corporation is to pay the consideration determined by the board of directors (or the consideration specified in the subscription agreement, in the case of preincorporation subscriptions). 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," although 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 Act leaves to the Uniform Commercial Code questions with respect to the rights of subsequent purchasers of shares if the consideration is not paid when due. See sections 8-202 and 8-302 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 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, although the last clause of section 6.22(b) 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 of shares. 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 (i) the articles of incorporation so authorize, (ii) a majority of the votes entitled to be cast by the class or series to be issued approve the issue, or (iii) there are no outstanding shares of the class or series to be issued.
- (c) The board of directors may fix the record date for determining shareholders entitled to a share dividend, which date may not be retroactive. If the board of directors does not fix the record date for determining shareholders entitled to a share dividend, the record date is the date the board of directors authorizes the share dividend.

### **CROSS-REFERENCES**

Classes and series of shares, see §§ 6.01 and 6.02.

Consideration for shares, see § 6.21.

“Distribution” defined, see § 1.40.

Distributions, see § 6.40.

Fractional shares, see § 6.04.

Record date for distributions, see § 6.40.

### **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 excludes it from the definition of a “distribution.”

### **§ 6.24 Share Rights, Options, Warrants and Awards**

- (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 and conditions 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 may include 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.
- (c) The board of directors may authorize one or more officers to (i) designate the recipients of rights, options, warrants, or other equity compensation awards that involve the issuance of

shares and (ii) determine, within an amount and subject to any other limitations established by the board of directors and, if applicable, the shareholders, the number of such rights, options, warrants, or other equity compensation awards and the terms of such rights, options, warrants or awards to be received by the recipients, provided that an officer may not use such authority to designate himself or herself or any other persons as the board of directors may specify as a recipient of such rights, options, warrants, or other equity compensation awards.

## **CROSS-REFERENCES**

Committees of board of directors, see § 8.25.

Compensation, see § 3.02.

Consideration for shares, see § 6.21.

Director's conflicting interest transactions, see ch. 8F.

Distributions, see § 6.40.

## **OFFICIAL COMMENT**

Section 6.24 specifically authorizes the creation of rights, options and warrants and confirms the broad discretion of the board of directors in determining the consideration to be received by the corporation for their issuance, including the creation of compensation plans for directors, officers, agents, and employees.

Section 6.24(a) does not require shareholder approval of rights, options, warrants or compensation plans. Of course, prior shareholder approval may be sought as a discretionary matter, or required to comply with the rules of national securities exchanges or to acquire federal income tax benefits that may be conditioned upon shareholder approval of such plans.

Section 6.24(b) confirms that the issuance of rights, options or warrants as part of a shareholder rights plan is permitted. The permissible scope of shareholder rights plans may, however, be limited by the courts.

Section 6.24(c) provides express authority for the delegation to officers of the designation of recipients of compensatory awards involving the issuance of shares, either directly or upon exercise of rights to acquire shares, and the determination of the amount and other terms of the awards, subject to any applicable limitations established by the board of directors or the shareholders. A board of directors (or a board committee with authority delegated to it under section 8.25, typically a compensation committee) may decide whether to exercise the authority under section 6.24(c) and, to the extent it does so, the board must specify the total amount that may be awarded and may impose any other limits it desires as part of the board's oversight of the award process. A board or committee delegating authority under section 6.24(c) would typically include appropriate limits. These limits might include, for example, the amount or range of shares to be awarded to different classes of employees, the timing and pricing of awards, and the vesting terms or other variable provisions of awards.

### **§ 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 regardless of whether their shares are represented by certificates.

- (b) At a minimum each share certificate must state on its face:
  - (1) the name of the 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 corporation is authorized to issue different classes of shares or series of shares within a class, the front or back of each certificate must summarize (i) the preferences, rights, and limitations applicable to each class and series, (ii) any variations in preferences, rights, and limitations among the holders of the same class or series, and (iii) the authority of the board of directors to determine the terms of future classes or series. 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 must be signed by two officers designated in the bylaws.
- (e) If the person who signed 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 and series of shares, see §§ 6.01 and 6.02.

“Conspicuous” defined, see § 1.40.

Descriptions of classes, see § 6.01.

Officers, see § 8.40.

Share transfer restrictions, see § 6.27.

### **OFFICIAL COMMENT**

Section 6.25 sets forth the minimum requirements for share certificates. Shares without certificates are permitted under section 6.25(a) upon compliance with section 6.26. There are no differences in the rights and obligations of shareholders by reason of shares being represented by certificates or not being 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.

All signatures on a share certificate may be facsimiles. See the definition of “sign” in section 1.40. This recognizes that a purchaser of publicly traded shares will rarely 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.

### **§ 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 issuance 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 issuance or transfer of shares without certificates, the corporation shall deliver to the shareholder a written statement of the information required on certificates by sections 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 shares without certificates either by original issue or in substitution for shares previously represented by certificates. This section 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. 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 shares without certificates 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 shares without certificates before purchase.

### **§ 6.27 Restriction on Transfer of Shares**

- (a) The articles of incorporation, the 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; or
  - (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 or series of its shares, or other persons to approve the transfer of the restricted shares, if the requirement is not manifestly unreasonable; or
  - (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**

Certificateless shares, see § 6.26.

Certificates for shares, see § 6.25.

Classes and series of shares, see §§ 6.01 and 6.02.

“Conspicuous” defined, see § 1.40.

Information statement, see § 6.26.

## **OFFICIAL COMMENT**

Share transfer restrictions are used by corporations for a variety of purposes. Section 6.27(c) enumerates certain purposes for which share transfer restrictions may be imposed, but does not limit the purposes given that section 6.27(c)(3) permits restrictions “for any other reasonable purpose.” Examples of the “status” referred to in section 6.27(c)(1) include 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.

Examples of the uses of share transfer restrictions include:

- a corporation with few shareholders may impose share transfer restrictions to ensure that shareholders do not transfer their shares to a person not acceptable to the corporation or other shareholders;
- a corporation with few shareholders may impose share transfer restrictions to establish the value of the shares of deceased shareholders;
- a professional corporation may impose share transfer restrictions to ensure that its treatment of departing, retiring or deceased shareholders is consistent with rules applicable to the profession in question;
- 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
- a corporation issuing securities pursuant to an exemption from federal or state securities 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.

Section 6.27(d) describes the types of restrictions that may be imposed. The types of restrictions referred to in sections 6.27(d)(1) (rights of first offer) and (d)(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 clauses sections 6.27(d)(3) and (d)(4) may permanently limit the market for shares by disqualifying all or some potential purchasers. The restrictions imposed by these two provisions must not be “manifestly unreasonable.”

## **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 effect) 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 unissued shares upon the decision of the board of directors to issue them.
  - (2) A preemptive right may be waived by a shareholder. 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, employees or agents of the corporation, its subsidiaries or affiliates;
    - (ii) shares issued to satisfy conversion or option rights created to provide compensation to directors, officers, employees or agents of the corporation, its subsidiaries or affiliates;
    - (iii) shares authorized in the articles of incorporation that are issued within six months from the effective date of incorporation; or
    - (iv) shares sold otherwise than for cash.
  - (4) Holders of shares of any class or series without voting power but with preferential rights to distributions have no preemptive rights with respect to shares of any class or series.
  - (5) Holders of shares of any class or series with voting power but without preferential rights to distributions have no preemptive rights with respect to shares of any class or series with preferential rights to distributions unless the shares with preferential rights are convertible into or carry a right to subscribe for or acquire the 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.

Classes and series of shares, see §§ 6.01 and § 6.02.

Share options, see § 6.24.

“Voting power” defined, see § 1.40.

## **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.

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). A corporation may qualify or limit any of the rules set forth in this section by express provisions in the articles of incorporation. The purposes of this standard model for preemptive rights are (i) to simplify drafting articles of incorporation and (ii) 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.

Section 6.30(b) establishes rules for most of the problems involving preemptive rights. 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 problems created when preemptive rights are recognized in corporations with more than a single class or series 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.

Preemptive rights can protect the voting power and 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 capital structures, the issuance of additional shares of one class or series typically does not adversely affect other classes or series. For example, the issuance of additional shares with voting power but 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 voting power should therefore have no preemptive rights with respect to shares with voting power but without preferential rights. See sections 6.30(b)(4) and (b)(5). Classes or series 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 or series of nonvoting shares without preferential rights and classes or series of shares with both voting power and preferential rights to distributions. These conflicts can be dealt with by specific provisions in the articles of incorporation.

### **§ 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 of own shares by corporation as “distribution,” see § 1.40.

Amendment of articles of incorporation by board, see § 10.05.

Annual report, see § 16.21.

Distributions, see § 6.40.

Issued and outstanding shares, see § 6.03.

Liability for unlawful distributions, see § 8.32.

Voting entitlement of shares, see § 7.21.

## **OFFICIAL COMMENT**

Shares that are acquired by the corporation become authorized but unissued shares under section 6.31 unless the articles of incorporation prohibit reissue, in which event the shares are cancelled and the number of authorized shares is automatically reduced.

If the number of authorized shares of a class is reduced as a result of the operation of section 6.31(b), the board of directors should amend the articles of incorporation under section 10.05(f) 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(g) to delete the class from the classes of shares authorized by the 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 § 6.40(c).
- (b) The board of directors may fix the record date for determining shareholders entitled to a distribution, which date may not be retroactive. If the board of directors does not fix a record date for determining shareholders entitled to a distribution (other than one involving a purchase, redemption, or other acquisition of the corporation’s shares), the record date 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 § 6.40(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 § 6.40(g), the effect of a distribution under subsection § 6.40(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 cash or other property is transferred or debt to a shareholder is 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 § 6.40(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 such 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.
- Distribution in liquidation, see § 14.05.
- Liability for unlawful distributions, see § 8.32.
- “Record date” defined, see § 1.40.
- Redemption, see §§ 6.01 and 6.31.
- Share dividends, see § 6.23.

## **OFFICIAL COMMENT**

### *1. The Scope of section 6.40*

Section 6.40 imposes a single, uniform test on all distributions other than distributions in liquidation under chapter 14. Section 1.40 defines “distribution” broadly to include transfers of cash and other property (excluding a corporation's own shares) to a shareholder in respect of the corporation's shares. Examples of such transfers are cash or property dividends, payments by a corporation to purchase its own shares, and distributions of promissory notes or indebtedness. The financial provisions of the Act do not use the concept of surplus but do have restrictions on distributions built around both equity insolvency and balance sheet tests.

## 2. *Equity Insolvency Test*

In most cases involving a corporation operating as a going concern in the normal course, it will be apparent from information generally available that no particular inquiry concerning the equity insolvency test in section 6.40(c)(1) is needed. Although 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. 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(d), may need to address the issue. Because of the overall judgment required in evaluating the equity insolvency test, no "bright line" test is provided. 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 (i) 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 (ii) 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, as provided in section 8.30(e), 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.

## 3. *Balance Sheet Test*

The determination of a corporation's assets and liabilities for purposes of the balance sheet test of section 6.40(c)(c)(2) 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 as provided in section 8.30(e) upon information, opinions, reports, and 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.

In a corporation with subsidiaries, the board of directors may rely on unconsolidated statements prepared on the basis of the equity method of accounting as to the corporation's investee corporations, including corporate joint ventures and subsidiaries, although other evidence would be relevant in the total determination. The board of directors is entitled to rely as provided by section 8.30(e) upon reasonably current financial statements in determining whether the balance sheet test of section 6.40(c)(c)(2) has been met, unless the board has knowledge that makes such reliance unwarranted. 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. Although corporations subject to registration under the Securities Exchange Act of 1934 must, and many other corporations in fact do, use 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). A statutory standard of reasonableness, rather than stipulating generally accepted accounting principles as the normative standard, is appropriate 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.

Section 6.40(d) specifically permits determinations to be made under section 6.40(c)(c)(2) on the basis of a fair valuation or other method that is reasonable in the circumstances. The statute authorizes departures from historical cost accounting and permits 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, as different methods may have validity depending upon the circumstances, including the type of enterprise and the purpose for which the determination is made. 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, regardless of whether they are 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)(c)(2) of a method of determining the aggregate amount of assets and liabilities that is reasonable in the circumstances.

The phrase "other method that is reasonable in the circumstances" means that under section 6.40(c)(c)(2) a wide variety of methods may be considered reasonable in a particular case even if any such method might not be a "fair valuation" or "current value" method.

#### *4. Relationship to the Federal Bankruptcy Code and Other Fraudulent Conveyance Statutes*

The 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 8.32. The federal bankruptcy laws 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. Accordingly, the tests of section 6.40 are different from the tests for insolvency under those statutes.

#### *5. Preferential Dissolution Rights and the Balance Sheet Test*

Section 6.40(c)(c)(2) 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. 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 preferential rights upon dissolution and other nonpreferential rights, only the preferential rights should be taken into account. The treatment of preferential dissolution rights of classes or series of shares set forth in section 6.40(c)(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 section 6.40(c)(c)(2) may always be eliminated by an appropriate provision in the articles of incorporation.

#### *6. Application to Acquisition of Shares*

In an acquisition of its shares, a corporation may transfer property or incur debt to the former holder of the shares. Share repurchase agreements involving payment for shares over a period of time are of special importance in closely held corporations. 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).

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 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 apply 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 may 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, net worth will usually be anticipated to 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 section 6.40(c) if the indebtedness were not counted in making the determination.



## CHAPTER 7

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# Shareholders

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#### **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 at which directors shall be elected.
- (b) Annual 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 so stated or fixed, 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.
- Annual election of directors, see § 8.03.
- 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 through § 7.28.
- Shareholders' list for meeting, see § 7.20.
- Special meeting, see § 7.02.
- Voting entitlement of shares, see § 7.21.
- “Voting group” defined, see § 1.40.

#### **OFFICIAL COMMENT**

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 by the Act. 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 (i) demand that an annual meeting be held and (ii) 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, because 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 unanimous written consent under section 7.04 (or by less than unanimous written consent if the articles of incorporation so provide). Directors, once duly elected, remain in office until their successors are elected or they resign or are removed. See sections 8.05 and 8.07 through 8.09.

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 state a time and place for the annual meeting, authority to fix them may be delegated to the board of directors or to a specified officer. This section thus gives corporations the flexibility to hold annual meetings in varying places at varying times as convenience may dictate.

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 as defined in section 1.40, which may or may not be its registered office under section 5.01.

## **§ 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 shareholders holding 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 before 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 shall be the first date on which a signed shareholder demand is delivered to the corporation. No written demand for a special meeting shall be effective unless, within 60 days of the earliest date on which such a demand delivered to the corporation as required by this section was signed, written demands signed by shareholders holding at least the percentage of votes specified in or fixed in accordance with subsection § 7.02(a)(2) have been delivered to the corporation.
- (c) Special meetings of shareholders 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 so stated or fixed, 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 meeting of shareholders.

## **CROSS-REFERENCES**

Action without meeting, see § 7.04.

Annual meeting, see § 7.01.

Court-ordered meeting, see § 7.03.

“Deliver” defined, see § 1.40.

Delivery to corporation, see § 1.41.

Notice of meeting, see § 7.05.

Objection to meeting or certain business at meeting, see § 7.06.

“Principal office”:

defined, see § 1.40.

designated in annual report, see § 16.21.

Quorum and voting requirements, see §§ 7.25 through 7.28.

Shareholders' list for meeting, see § 7.20.

Voting entitlement of shares, 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 differences between an annual meeting and a special meeting are that at an annual meeting directors are elected and, subject to any applicable special notice requirement prescribed by the Act or by the articles of incorporation, any relevant issue pertaining to the corporation may be considered, while at a special meeting only matters within the specific purposes for which the meeting is called may be considered.

### *1. Who May Call a Special Meeting*

A special meeting may be called by the board of directors, a person or persons authorized to do so by the articles of incorporation or bylaws, or upon written demand by shareholders as described below. 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 shareholders holding at least 10% of all 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 document, 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 and received before the corporation receives the requisite number of demands requiring that a special meeting be called. Revocations received after that time will have no effect. Upon receipt of demands from 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 belongs to the corporation. If no meeting is held within the time periods specified in section 7.03, a shareholder, as defined in section 7.05(c), who signed the demand may seek judicial relief under that section requiring that the meeting be held.

## 2. *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] may summarily order a meeting to be held:
  - (1) on application of any shareholder of the corporation if an annual meeting was not held or action by written consent in lieu of an annual meeting did not become effective within the earlier of six months after the end of the corporation's fiscal year or 15 months after its last annual meeting; or
  - (2) on application of one or more shareholders 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 first day on which the requisite number of such demands have been delivered to the corporation; 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 or dates 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 shares 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.
- (c) For purposes of subsection (a)(1), "shareholder" means a record shareholder, a beneficial shareholder, and an unrestricted voting trust beneficial owner.

### **CROSS-REFERENCES**

Annual meeting, see § 7.01.

"Beneficial shareholder," "record shareholder" and "unrestricted voting trust beneficial owner" defined, see § 1.40.

Notice of meeting, see § 7.05.

Notices and other communications, see § 1.41.

Quorum and voting requirements, see §§ 7.25 through 7.28.

Shareholders' list for meeting, see § 7.20.

Voting entitlement, see § 7.21.

## **OFFICIAL COMMENT**

Section 7.03 provides the remedy for shareholders if the corporation refuses or fails to hold a shareholders' meeting as required by section 7.01 or 7.02. Because 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 Discretion of the Court to Order a Meeting*

The court has broad discretion under section 7.03 whether to order that a meeting be held, since the language of the statute is that the court "may summarily 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. 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 to permit the corporation to do so.

### *2. Notice, Time, Place, and Quorum and Other Requirements*

If the court orders that a meeting be held, the court has wide discretion over the terms of the order, including the matters set forth in section 7.03(b). The discretion of the court with respect to quorum requirements 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. 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.

### *3. 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 filing by the corporation with the minutes or 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; 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 written consent. A written consent must bear the date of signature of the shareholder who signs the consent and be delivered to the corporation for filing by the corporation with the minutes or corporate records.
  - (c) If not otherwise fixed under section 7.07 and if prior action by the board of directors 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 action by the board of directors 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 of directors 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 have been 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 have been 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 shall 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 shall 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.

## **CROSS-REFERENCES**

Acceptance of consents, see § 7.24.

“Deliver” defined, see § 1.40.

Notices and other communications, see § 1.41.

“Sign” defined, see § 1.40.

Voting entitlement of shares, see § 7.21.

## **OFFICIAL COMMENT**

Section 7.04(a) permits shareholders to act by unanimous written consent without holding a meeting. This applies to any shareholder action, including election of directors, approval of mergers, domestications, conversions, sales of the corporation’s assets requiring shareholder approval, amendments of articles of incorporation, and dissolution. Unanimous written consent is generally 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), however, a corporation may include in its articles of incorporation a provision that permits shareholder action by less than unanimous written consent except with respect to the election of directors by written consent where cumulative voting applies. See section 7.28. 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.

### *1. Form of Written Consent*

To be effective, consents must be in writing, dated and sent to the corporation in any manner authorized by section 1.41, including electronic transmission if the applicable conditions of section 1.41 are met.

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 (“electronic,” “sign,” and “signature”) and 1.41(d).

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, for a corporation with 1,000 shares eligible to vote, unrevoked consents from the holders of at least 501 shares are necessary to take action by written consent under the default quorum and voting requirement provisions of section 7.25. In contrast, at a meeting at which the minimum quorum is present, the same action



could be taken with the vote of the holders of 251 shares, or even fewer if not all shares present are voted. Where the 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" in section 7.04 makes it clear that shareholders do not need to sign the same document. 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, section 7.04(f) requires that notice be given to nonconsenting shareholders entitled to vote on the matter. Section 7.04(e) also requires such notice to shareholders not entitled to vote on the matter if the Act requires that they be given notice of a proposed action. By requiring notice only after shareholder action has been taken, the 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. A corporation may provide for advance notice in its articles of incorporation.

## *3. Revocation of Consent*

Before shareholder action by written consent is effective, a shareholder may withdraw a consent by delivering a written revocation of the consent to the corporation.

## **§ 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. If the board of directors has authorized participation by means of remote communication pursuant to section 7.09 for holders of any class or series of shares, the notice to the holders of such class or series of shares must describe the means of remote communication to be used. The notice must include the record date for determining the shareholders entitled to vote at the meeting, if such date is different from the record date for determining shareholders entitled to notice of the meeting. 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 as of the record date for determining the shareholders entitled to notice of the meeting.
- (b) Unless this Act or the articles of incorporation require otherwise, the notice of an annual meeting of shareholders need not include a description of the purpose or purposes for which the meeting is called.
- (c) Notice of a special meeting of shareholders 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 shall be given under this section to shareholders entitled to vote at such adjourned meeting as of the record date fixed for notice of such adjourned meeting.

## **CROSS-REFERENCES**

Annual meeting, see § 7.01.

“Deliver” defined, see § 1.40.

Notice otherwise required:

amendment of articles of incorporation, see § 10.03.

appraisal rights, see §§ 13.20 and 13.22.

conversion, see § 9.32.

disposition of assets, see § 12.02.

dissolution, see § 14.02.

domestication, see § 9.21.

merger and share exchange, see § 10.04.

Notices and other communications, see § 1.41.

Remote participation in shareholders’ meetings, see § 7.09.

Special meeting, see § 7.02.

Waiver of notice, see § 7.06.

## **OFFICIAL COMMENT**

The 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. Section 7.05(b) recognizes, however, that other provisions of the Act or the corporation’s articles of incorporation may require that specific reference to a proposed action appear in the notice of meeting. See sections 9.21, 9.32, 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. If a notice of an annual meeting refers specifically to one or more purposes, the meeting is not limited to those purposes. Although the corporation is not required to give notice of the purpose or purposes of an annual meeting unless the Act or the articles of incorporation so provide, a shareholder, in order to raise a matter at an annual meeting (for example, to nominate an individual for election as a director or to propose a resolution for adoption), may have to comply with any advance notice provisions in the corporation’s articles of incorporation or bylaws. Such provisions might include requirements that shareholder nominations for election to the board of directors or resolutions intended to be voted on at the annual meeting be submitted in writing and received by the corporation a prescribed number of days in advance of the meeting.

The selection of the day before the notice is delivered as the catch-all record date under section 7.05(d) is intended to permit the corporation to deliver 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 consistent with the general principle set forth in section 7.07(b) that the board of directors may not fix a retroactive record date.

Section 7.05(e) provides rules for adjourned meetings and determines whether new notice must be given to shareholders. If a new record date is or must be fixed under section 7.07, the 10- to 60-day notice requirement and all other requirements of section 7.05 must be complied with because notice must be given to the persons who are shareholders as of the new record date. In such circumstances, a new quorum for the adjourned meeting must also be established. See section 7.25, which 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 or 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 filing by the corporation with the minutes or 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; and
  - (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 votes and other instruments, see § 7.24.

Action without meeting, see § 7.04.

Notice of meeting, see § 7.05.

Notices and other communications, see § 1.41.

Proxies, see § 7.22.

Remote participation in shareholders' meetings, see § 7.09.

“Sign” defined, see § 1.40.

### **OFFICIAL COMMENT**

A notice of shareholders' meeting serves two principal purposes: (i) it advises shareholders of the date, time, and place of the annual or special meeting, and (ii) in the case of a special shareholders' meeting (or an annual meeting at which fundamental changes may be made), it advises shareholders of the purposes of the meeting. 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 shareholder must state at the beginning of the meeting an objection to holding the meeting or transacting any business or the objection is waived. 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 or, if authorized in accordance with section 7.09(b), the shareholder or proxy may attend by means of remote communication. A shareholder who attends a meeting solely for the purpose of objecting to the notice is counted as present for purposes of determining whether a quorum is present. See section 7.25 and its Official Comment.

In the case of special shareholders’ meetings, or annual meetings at which certain fundamental corporate changes are considered, a second purpose of the notice is to inform shareholders of the matters to be considered at the meeting. An objection that a particular matter is not within the stated purposes of the meeting 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 when the matter is 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. 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.

Other sections of the Act require that shareholders who are not entitled to vote be given notice of meetings at which certain fundamental corporate changes are to be considered. See sections 9.21, 9.32, 10.03, 11.04, 12.02, and 14.02. 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 but not entitled to vote, as well as from the shareholders entitled to vote.

### **§ 7.07 Record Date for Meeting**

- (a) The bylaws may fix or provide the manner of fixing the record date or dates for one or more voting groups 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 may fix 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 and may not be retroactive.
- (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 or dates, which it shall 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 or dates continues in effect or it may fix a new record date or dates.
  - (e) The record dates for a shareholders' meeting fixed by or in the manner provided in the bylaws or by the board of directors shall be the record date for determining shareholders entitled both to notice of and to vote at the shareholders' meeting, unless in the case of a record date fixed by the board of directors and to the extent not prohibited by the bylaws, the board, at the time it fixes the record date for shareholders entitled to notice of the meeting, fixes a later record date on or before the date of the meeting to determine the shareholders entitled to vote at the meeting.

### **CROSS-REFERENCES**

Annual meeting, see § 7.01.

Court-ordered meeting, see § 7.03.

Other record date provisions:

    action without meeting, see § 7.04.

    distributions to shareholders, see § 6.40.

    liquidating distributions, see § 14.08.

    notice of meeting, see § 7.05.

    share dividends, see § 7.23.

    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 determining shareholders entitled to take any action unless the bylaws themselves fix or otherwise 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 fixes a record date for a specific action, the section of the 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 and to vote at 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.

After a record date is fixed, if a new record date subsequently is or must be fixed under section 7.07, 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.

Section 7.07(e) provides a board of directors with flexibility to align shareholders' voting and economic interests and addresses, in part, concerns over the separation of ownership and voting by permitting a board of directors to set a record date for voting closer to the meeting date. This provision does not restrict how close a record date for voting can be to the meeting date, but a board

of directors would need to consider the practical issues in fixing the voting record date, including the requirement of section 7.20(c) that a list of shareholders entitled to vote be available at the meeting. The board may fix a separate record date for voting only at the time it fixes the record date for notice, and, as provided in section 7.05, notice of the separate record date must be included in the notice of meeting. If the board fixes separate record dates, section 16.02(e) provides for shareholders entitled to vote at the meeting who were not shareholders on the record date for notice to have access to the information provided by the corporation to shareholders in connection with the meeting. If the board does not fix separate record dates, the normal provisions for fixing a single record date for notice and voting will apply.

## **§ 7.08 CONDUCT OF 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 of directors.
- (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 to such ballots, proxies or votes may be accepted.

## **CROSS-REFERENCES**

Annual meeting, see § 7.01.

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. Inherent in the chair's power in section 7.08(b) 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. The rules for conduct of the meeting 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 chair should be fair in determining the order of business and in establishing rules for the conduct of the meeting so as not 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 before 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 7.02(d) and § 7.05(c). In

addition, in order to raise a matter at an annual meeting (for example, to nominate an individual for election as a director or to propose a resolution for adoption), a shareholder may be required to comply with any advance notice provision in the articles of incorporation or bylaws. See the Official Comment to section 7.05.

### **§ 7.09 Remote Participation in Shareholders' Meetings**

- (a) Shareholders of any class or series of shares may participate in any meeting of shareholders by means of remote communication to the extent the board of directors authorizes such participation for such class or series. Participation as a shareholder by means of remote communication shall be subject to such guidelines and procedures as the board of directors adopts, and shall be in conformity with subsection § 7.09(b).
- (b) Shareholders participating in a shareholders' meeting by means of remote communication shall be deemed present and may vote at such a meeting if the corporation has implemented reasonable measures:
  - (1) to verify that each person participating remotely as a shareholder is a shareholder; and
  - (2) to provide such shareholders a reasonable opportunity to participate in the meeting and to vote on matters submitted to the shareholders, including an opportunity to communicate, and to read or hear the proceedings of the meeting, substantially concurrently with such proceedings.

### **OFFICIAL COMMENT**

Section 7.09 permits shareholders to participate in annual and special shareholders' meetings by means of remote communication, such as over the Internet or through telephone conference calls, subject to the conditions set forth in section 7.09(b) and any other guidelines and procedures that the board of directors adopts. This would include the use of electronic ballots to the extent authorized by the board of directors. This authorization extends as well to anyone to whom such shareholder has granted a proxy appointment. Section 7.09(a) ensures that the board of directors has the sole discretion to determine whether to allow shareholders to participate by means of remote communication.

Section 7.09 allows the board of directors to limit participation by means of remote communication to all shareholders of a particular class or series, but does not permit the board of directors to limit such participation to particular shareholders within a class or series.

Section 7.09 is not intended to expand the rights to participate in meetings or otherwise alter the ability of the board of directors or the chair to conduct meetings, pursuant to section 7.08, in a manner that is fair. For example, many corporations limit shareholder comments and, if such practice is fair to shareholders consistent with section 7.08, such practice is not changed by section 7.09. The two requirements under section 7.09(b) reflect the minimum deemed necessary to safeguard the integrity of the shareholders' meeting. Section 7.09 specifically gives the board of directors the flexibility and discretion to adopt additional guidelines and procedures for allowing shareholders to participate in a meeting by means of remote communication.

To give corporations the flexibility to choose the most efficient means of remote communication, under section 7.09(a), the board of directors may require that shareholders communicate their desire to participate by a certain date and condition the provision of remote communication or the form of communication to be used on the affirmative response of a certain number or proportion of shareholders eligible to participate. If the board of directors authorizes

shareholder participation by means of remote communication pursuant to this section, such authorization and the process for participating by remote means of communication must be included in the meeting notice required by section 7.05.

## **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. If the board of directors fixes a different record date under section 7.07(e) to determine the shareholders entitled to vote at the meeting, a corporation also shall prepare an alphabetical list of the names of all its shareholders who are entitled to vote at the meeting. A 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. Nothing contained in this subsection shall require the corporation to include on such list the electronic mail address or other electronic contact information of a shareholder.
- (b) The shareholders' list for notice shall 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 shareholders' list for voting shall be similarly available for inspection promptly after the record date for voting. 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 a 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 list of shareholders entitled to vote 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 a shareholders' list before or at the meeting (or copy a list as permitted by subsection § 7.20(b)), the [name or describe court], 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.

Inspection of corporate records, see ch. 16A.

Notices and other communications, 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.

“Shareholder” defined, see § 1.40.

Special meeting, see § 7.02.

Voting entitlement of shares, see § 7.21.

“Voting group” defined, see § 1.40.

## **OFFICIAL COMMENT**

The list of shareholders required by section 7.20 must include the names, addresses and number of shares of those shareholders entitled to vote at the meeting. The list must also include the names, addresses and number of shares of holders 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.

### *1. When the List Must Be Available*

Sections 7.20(b) and (c) govern when the list of shareholders must generally be available for inspection. The requirement of availability for continuous inspection permits the corporation and others soliciting votes to be on a relatively equal footing. 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*

Sections 7.20(b) and (c) also govern where the corporation must maintain the list. If the corporation changes the location of the meeting, it thus may correspondingly change the location of the list under section 7.20(b).

### *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 section 7.20.

### *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 for a summary order as contemplated by section 7.20(d). 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 in the Act for violation of section 7.20 given that 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 may be satisfied at the corporation's option, if reasonable, by furnishing to the shareholder 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 right of shareholders to inspect corporate records under chapter 6. A shareholder may obtain the right to inspect the list of shareholders as provided in chapter 16 without regard to the provisions relating to the pendency of a meeting in section 7.20, and similarly the limitations of chapter 16 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 16 is also broader in the sense that the shareholder may make or receive copies of the documents the shareholder is entitled to 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 or series, is entitled to one vote on each matter voted on at a shareholders' meeting. Only shares are entitled to vote.
- (b) Shares of a corporation are not entitled to vote if they are owned by or otherwise belong to the corporation directly, or indirectly through an entity of which a majority of the voting power is held directly or indirectly by the corporation or which is otherwise controlled by the corporation.
- (c) Shares held by the corporation in a fiduciary capacity for the benefit of any person are entitled to vote unless they are held for the benefit of, or otherwise belong to, the corporation directly, or indirectly through an entity of which a majority of the voting power is held directly or indirectly by the corporation or which is otherwise controlled by the corporation.
- (d) Redeemable shares are not entitled to vote after delivery of written notice of redemption is effective 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.
- (e) For purposes of this section, "voting power" means the current power to vote in the election of directors of a corporation or to elect, select or appoint governors of another entity.

## **CROSS-REFERENCES**

- Acceptance of votes, see § 7.24.
- Classes and series of shares, see §§ 6.01 and § 6.02.
- Cumulative voting, see § 7.28.
- Director establishment of voting rights, see § 6.02.
- “Governor” defined, see § 1.40.
- Notices and other communications, see § 1.41.
- Proxy voting, see § 7.22.
- Redeemable shares, see § 6.01.
- Shareholders’ meetings, see §§ 7.01 through 7.03.
- Status of shares belonging to the corporation, see § 6.31.
- Voting by nominees, see § 7.23.
- Voting by voting groups, see §§ 1.40, 7.25 and 7.26.
- “Voting power” defined, see § 1.40.

## **OFFICIAL COMMENT**

### *1. Voting Power of Shares*

Section 7.21(a) provides that each outstanding share, regardless of class or series, is entitled to one vote per share unless otherwise provided in the articles of incorporation. The articles of incorporation may provide for multiple or fractional votes per share and may provide that some classes or series of shares are nonvoting on some or all matters, or that some classes or series have a single vote per share or different multiple or fractional votes per share, or that some classes or series constitute one or more separate voting groups and are entitled to vote separately on the matter. To reflect the possibility that shares may have multiple or fractional votes per share, the provisions relating to quorums, voting, and similar matters in the Act are phrased in terms of votes represented by shares.

### *2. Voting Power of Nonshareholders*

Under the last sentence of section 7.21(a), the power to vote may only be vested in shares. For example, bondholders may not be given the direct power to vote under the Act. They may, however, be given the power to vote by issuing them special classes or series of shares. See the Official Comment to section 7.22.

### *3. Circular Holdings*

The purpose of the prohibition in section 7.21(b) is to prevent a board of directors or management from using a corporate investment to perpetuate itself in power. While shares acquired by a corporation cease to be outstanding under section 6.31, except as provided in that section, and therefore are not entitled to vote, other arrangements may be devised seeking to obtain the benefits of ownership without actually acquiring the shares at all or not acquiring the shares at the time the right to vote is determined. The concept of shares that “otherwise belong to” is included in addition to “owned by” to ensure that courts will have the flexibility to apply public policy considerations to arrangements under which shares are not technically “owned,” or

under which shares may or will be owned at a later time, but which have a similar effect. For example, if the corporation or a controlled entity has entered into a forward purchase contract for shares with the right to vote or direct the vote of the shares, a court could find that the shares belong to the corporation and are not entitled to be voted under section 7.21. Similarly, if the voting power is exercised by someone acting on behalf of the corporation or by a member of management of the corporation, a court could find that the shares otherwise belong to the corporation, and are not entitled to vote under section 7.21. Section 7.21(c), however, makes the prohibition of section 7.21(b) against voting of shares inapplicable to shares held in a fiduciary capacity where the beneficiaries are persons other than the corporation directly or through an entity controlled by the corporation.

#### 4. *Redeemable Shares*

Redeemable shares are often redeemed in connection with a transaction such as a merger or the issuance of a new senior class or series of shares that requires shareholder approval. Section 7.21(d) avoids subjecting a transaction to approval by a class or series 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 the recipient can determine the date of the transmission and that the transmission was authorized by the sender or the sender's agent or attorney-in-fact.
- (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 count votes. An appointment is valid for the term provided in the appointment form, and, if no term is provided, is valid for 11 months unless the appointment is irrevocable under subsection § 7.22(d).
- (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 § 7.22(d) is revoked when the interest with which it is coupled is extinguished.
- (g) Unless it otherwise provides, an appointment made irrevocable under subsection § 7.22(d) continues in effect after a transfer of the shares and a transferee takes subject to the appointment, except that 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.

Notices and other communications, see § 1.41.

“Sign” defined, see § 1.40.

## **OFFICIAL COMMENT**

### *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 Act, the word “proxy” is used only in the last sense; the terms “proxy appointment,” “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.

Sections 7.22(b) and 1.41(d) permit the practice by which shareholders who have been provided in proxy materials with a personal identification number may submit 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.

Sections 1.41(f) through (i) govern when an electronic transmission is “received” and “effective.” If 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 the corporation must count the votes in a manner consistent with that limitation or direction. See section 7.22(h).

### *2. Duration of Appointment*

An appointment form that contains no expiration date is valid for 11 months unless it is irrevocable. See section 7.22(c). This ensures that in the normal course a new appointment will be solicited at least once every 12 months. An appointment form may validly specify its term if

the parties agree, which may be longer or shorter than 11 months. An irrevocable appointment is valid for so long as it is irrevocable unless it terminates earlier in accordance with its terms.

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). 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.

Although 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 appointment or its manner of exercise as between the proxy and the personal representatives of the decedent or incompetent.

### 3. *Irrevocable Appointment of 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.” section 7.22(d) provides considerable certainty as 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 “coupled with an interest.”

Section 7.22(f) provides that an irrevocable appointment is revoked when the interest with which it was coupled is extinguished—for example, by repayment of the loan or release of the pledge.

Section 7.22(g) clarifies the default rule that an irrevocable appointment survives a transfer, but that the grantor may modify that rule. It also clarifies that both the appointment and the irrevocable nature of the appointment must conspicuously appear on the certificate or information statement to continue to be irrevocable against a transferee for value that does not know of the existence of the appointment.

## **§ 7.23 Shares Held by Intermediaries and Nominees**

- (a) A corporation’s board of directors may establish a procedure under which a person on whose behalf shares are registered in the name of an intermediary or nominee may elect to be treated by the corporation as the record shareholder by filing with the corporation a beneficial ownership certificate. The terms, conditions, and limitations of this treatment shall be specified in the procedure. To the extent such person is treated under such procedure as having rights or privileges that the record shareholder otherwise would have, the record shareholder shall not have those rights or privileges.
- (b) The procedure must specify:
  - (1) the types of intermediaries or nominees to which it applies;
  - (2) the rights or privileges that the corporation recognizes in a person with respect to whom a beneficial ownership certificate is filed;

- (3) the manner in which the procedure is selected which must include that the beneficial ownership certificate be signed or assented to by or on behalf of the record shareholder and the person on whose behalf the shares are held;
  - (4) the information that must be provided when the procedure is selected;
  - (5) the period for which selection of the procedure is effective;
  - (6) requirements for notice to the corporation with respect to the arrangement; and
  - (7) the form and contents of the beneficial ownership certificate.
- (c) The procedure may specify any other aspects of the rights and duties created by the filing of a beneficial ownership certificate.

### **CROSS-REFERENCE**

“Shareholder” defined, see § 1.40.

### **OFFICIAL COMMENT**

Traditionally, a corporation recognizes only the person in whose name shares are registered as the owner of the shares. It is a common practice for persons purchasing shares of a public company to hold them in “street name” through a broker-dealer or other financial institution. In addition, a securities depository system exists under which financial institutions deposit securities with the depository, whose nominee becomes the registered owner of the shares or the “record shareholder.” Transfers between depository participants are accomplished by book entry of the depository. As a result, there may be several entities interposed between the corporation and 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 the depository and its intermediary participants or other intermediaries and nominees. The adoption of this procedure is discretionary with each corporation and affirmative action by the corporation’s board of directors is necessary to accomplish it. The procedure is also discretionary with the ultimate beneficial owner, who must elect, and the intermediary or nominee who holds on behalf of the beneficial owner as record shareholder, who must assent to, the applicable procedure established by the corporation.

The signature or assent of the record shareholder and the person or persons on whose behalf the shares are held, as required by section 7.23(b)(3), can be provided on behalf of any such person by another person authorized to do so. In a typical situation where the record shareholder is Cede & Co., the nominee of Depository Trust Company, and the shares are ultimately beneficially owned by a shareholder who has an account with a broker-dealer that is a participant in the Depository Trust Company, a beneficial ownership certificate could be signed by both the ultimate beneficial owner and the broker-dealer shown on the position list of Depository Trust Company, acting under authority granted to it by Cede & Co., as the record shareholder. The statute does not prescribe the notices that must be provided to the corporation, but provides that the procedure shall specify whatever notice provisions will be required. For example, the corporation may wish to include provisions for notice to it by the ultimate beneficial owner and the broker-dealer upon the sale or other disposition of the shares, which normally should be accompanied by notice to the corporation of termination or modification of the effect of the beneficial ownership certificate.

The corporation also may limit or qualify the procedure as it deems appropriate. For example, the corporation may:

- limit the procedure to certain classes of shareholders, such as depositories, broker-dealers and banks, and their nominees, or make the procedure available to all shareholders, and define requirements to be a beneficial owner eligible to use the procedure;
- permit a record shareholder and beneficial owner to adopt the procedure with respect to some but not all of the shares registered or held on behalf of the beneficial owner in the record shareholder's name (and in that case the record shareholder continues to be treated as the shareholder with respect to the balance);
- specify the purpose or purposes for which the beneficial ownership certificate 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;
- specify the form of the beneficial ownership certificate, *e.g.*, a writing or an electronic record;
- specify the type of information that must be provided, *e.g.*, the name, address, and taxpayer identification number of the person for whose benefit a beneficial ownership certificate is filed, and the number of shares registered directly in the shareholder's name;
- establish deadlines for receipt of the beneficial ownership certificate in connection with the establishment of a record date by the corporation; or
- provide that a new beneficial ownership certificate is required in connection with each record date or that a beneficial ownership certificate as of a certain date may continue until changed by the certifying person or persons.

The validity of a procedure adopted under section 7.23 is to be determined by the terms of the section as in effect at the time the procedure is adopted.

The definition of "record shareholder" in section 1.40 includes beneficial owners to the extent they obtain the rights of record shareholders through the filing of a beneficial ownership certificate pursuant to the procedure authorized by section 7.23.

#### **§ 7.24 Acceptance of Votes and Other Instruments**

- (a) If the name signed on a vote, ballot, consent, waiver, shareholder demand, or proxy appointment corresponds to the name of a shareholder, the corporation, if acting in good faith, is entitled to accept the vote, ballot, consent, waiver, shareholder demand, or proxy appointment and give it effect as the act of the shareholder.
- (b) If the name signed on a vote, ballot, consent, waiver, shareholder demand, 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, ballot, consent, waiver, shareholder demand, 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, ballot, consent, waiver, shareholder demand, 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, ballot, consent, waiver, shareholder demand, 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, ballot, consent, waiver, shareholder demand, or proxy appointment; or
  - (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, ballot, consent, waiver, shareholder demand, or proxy appointment if the person authorized to accept or reject such instrument, 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) Neither the corporation or any person authorized by it, nor an inspector of election appointed under section 7.29, that accepts or rejects a vote, ballot, consent, waiver, shareholder demand, or proxy appointment in good faith and in accordance with the standards of this § 7.24 or section 7.22(b) is 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, ballot, consent, waiver, shareholder demand, or proxy appointment under this section is valid unless a court of competent jurisdiction determines otherwise.
  - (f) If an inspector of election has been appointed under section 7.29, the inspector of election also has the authority to request information and make determinations under subsections § 7.24(a), § 7.24(b), and (c). Any determination made by the inspector of election under those subsections is controlling.

## **CROSS-REFERENCES**

Consents, see § 7.04.

Demand for special meeting, see § 7.02.

“Entity” defined, see § 1.40.

Officers, see § 8.40.

Proxies, see § 7.22.

“Shareholder” defined, see § 1.40.

“Sign” defined, 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 ballots, waivers of notice, consents to action without a meeting, demands for a special meeting of shareholders, and other demands by 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 public corporations.

Section 7.24 establishes general rules permitting the corporation and any inspector of election appointed under section 7.29 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 is requested. Section 7.24 also establishes general rules for rejecting these instruments. The rules set forth in this section are not exclusive and may be supplemented by additional rules established by the corporation pursuant to section § 2.062.06(b). If an inspector of election has been appointed under section 7.29, the inspector has the authority under section 7.24, as well as the corporation. If there is a difference in a determination by the corporation and the inspector, the inspector's determination controls as against the corporation.

A purpose of section 7.24 is to protect the corporation and any inspector of election from liability for damages to the shareholder if action is taken in accordance with the section. Under section 7.24(d) there is no liability to the shareholder if the corporation or inspector of election, 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 signature or transmission was invalid or unauthorized. Similarly, no liability exists if an instrument is rejected in accordance with section 7.24(c) because the corporation or inspector of election, again acting in good faith, has a "reasonable basis for doubt," even though it turns out that the instrument was properly signed by the shareholder. This protection extends to officers and other persons who are authorized by the corporation to accept or reject an instrument identified in section 7.24. Section 7.24 does not, however, address the question whether an action was properly taken or approved, and section 7.24(e) makes clear that the validity of corporate action is ultimately a matter for judicial resolution through review of the results of a vote in a suit to enjoin or compel corporate action. Section 7.49 provides a mechanism for seeking such judicial resolution. It is contemplated that any such proceeding 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 proceeding 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.

A corporation may wish to establish guidelines that it will follow in determining whether to accept a vote, ballot, consent, waiver, shareholder demand, or proxy appointment to provide consistency in the corporation's application of the general rules set forth in section 7.24.

### **§ 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 provide otherwise, shares representing 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. Whenever this Act requires a particular quorum for a specified action, the articles of incorporation may not provide for a lower quorum.
- (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 fixed 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 the articles of incorporation adding, changing, or deleting a quorum or voting requirement for a voting group greater than specified in subsection § 7.25(a) or (c) is governed by section 7.27.
- (e) The election of directors is governed by section 7.28.
- (f) Whenever a provision of this Act provides for voting of classes or series as separate voting groups, the rules provided in section 10.04(c) for amendments of the articles of incorporation apply to that provision.

### **CROSS-REFERENCES**

Adjourned meeting record date, see § 7.07.

Election of directors, see § 7.28.

Multiple voting groups, see § 7.26.

Proxy voting, see § 7.22.

Record date, see § 7.07.

Remote participation in shareholders' meetings, see § 7.09.

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 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 separately) are a single voting group. 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).

Section 7.25 covers 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 or series of shares is entitled to vote under the articles of incorporation, for example, when a class with preferential rights may vote to elect directors because of a default in the payment of dividends (a vote which is often described as a “class vote”). Finally, section 7.25 also covers quorum and voting requirements for a matter on which both common and preferred shares or separate classes or series of common or preferred shares are entitled to vote, either together as a single voting group under the articles of incorporation or separately as two or more voting groups under either the articles of incorporation or the Act. See section 7.26(b).

#### *1. Determination of Voting Groups under the Act*

Under the 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 9.21, 9.32, 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(c) further provides that when two or more classes or series are affected by an amendment covered by section 10.04 in essentially the same way, the classes or series are grouped together and must vote as a single voting group rather than as multiple voting groups on the matter, unless otherwise provided in the articles of incorporation or required by the board of directors. Section 7.25(f) provides that the group voting rule of section 10.04(c), including the ability to vary that rule in the articles of incorporation or by action of the board of directors, also applies to the group voting provisions in sections 9.21, 9.32, and 11.04. Under the 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 an amendment to the articles of incorporation that affects the class or series in a designated way. See section 10.04(d).

In addition to the provisions of the Act, separate voting by voting group may be authorized by the articles of incorporation (except that the statutory privilege of voting by separate voting groups cannot be diluted or reduced). On some matters, the board of directors may condition its 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*

A corporation's determination of the voting groups entitled to vote, and the quorum and voting requirements applicable to that determination, should 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 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. To reflect the possibility that shares may have multiple or fractional votes per share, the provisions relating to quorums are phrased in terms of votes represented by shares.

## *3. Quorum Requirements for Action by Voting Group*

Under section 7.25(b), 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.

The shares owned by a shareholder who comes to the meeting to object on grounds of lack of notice are considered present for purposes of determining the presence of a quorum. Similarly, shares owned by a shareholder who attends a meeting solely for purposes of raising the objection that a quorum is not present are considered present for purposes of determining 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).

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 as of the new record date.

#### *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, unless the articles of incorporation require a greater number of votes. This default rule differs from a formulation appearing in some 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. That formulation in effect treats abstentions as negative votes; the Act treats them truly as abstentions. For example, if a corporation (that has not, through the articles of incorporation, modified quorum and voting requirements) has 1,000 shares of a single class outstanding, each share entitled to cast one vote, a quorum consists of 501 shares; if 600 shares are represented at the meeting and the vote on a proposed action is 280 in favor, 225 opposed, and 95 abstaining, the action would not be approved in a state following the formulation that treats abstentions as negative votes because fewer than a majority of the 600 shares attending voted in favor of the action. Under section 7.25(c) the action would be approved and not be defeated by the 95 abstaining votes.

#### *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, subject to 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, subject to section 7.25(a) and section 7.27.

### **§ 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 different voting groups on a matter at different times.

### **CROSS-REFERENCES**

Change of voting group requirements, see § 7.27.

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, a single voting group will consist of all the shares of the class or classes or series 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.

Implicit in section 7.26(b) are the concepts that (i) different quorum and voting requirements may be applicable to different matters considered at a single meeting and (ii) 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. Each group entitled to vote must independently meet the quorum and voting requirements established by section 7.25. 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, even though their vote alone will not be sufficient for the matter to be approved.

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 might 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 might include the election of directors and the ratification of the appointment of an auditor, both matters on which the preferred shares may 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 ratify the appointment of the auditor. The common shares voting group may also vote to approve the proposed amendment to the articles of incorporation, but that amendment will not be approved until the preferred shares voting group also votes to approve the amendment, which could occur at a different time.

Normally, each class or series of shares will participate in only a single voting group. But because 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 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 common shares, 500 shares issued and outstanding, and one class of preferred shares, 100 shares issued and outstanding, 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.

<b>Yes</b>	Common	230
	Preferred	80
<b>No</b>	Common	270
	Preferred	20

Both the preferred and the common are entitled to vote on the amendment to the articles of incorporation because 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)(3). 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.

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 Modifying Quorum or Voting Requirements**

An amendment to the articles of incorporation that adds, changes, or deletes a quorum or voting requirement shall 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, see § 7.25.

Voting by voting group, see § 7.26.

“Voting group” defined, see § 1.40.

### **OFFICIAL COMMENT**

Section 7.27 permits the articles of incorporation to change the quorum or voting requirements for approval of an action by shareholders up to any desired amount so long as the change is adopted in accordance with the requirements of section 7.27. For example, 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 two-thirds of the total votes must be present in person or by proxy, both the 80% voting requirement and the two-thirds quorum requirement are immune from reduction except at a meeting of the voting group at which the two-thirds 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 two-thirds quorum requirement is met; if the proposal is to increase the two-thirds quorum requirement to three-quarters 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 three-quarters 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 the shareholder’s 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

“Conspicuous” defined, see § 1.40.

Notice of meeting, see § 7.05.

Notices and other communications, 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

As used in section 7.28(a), election by 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 factions are competing within a voting group, an individual may be elected with votes of fewer than a majority of the votes cast. The articles of incorporation of the corporation may, however, provide a different vote requirement for the 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 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 written consent unless that consent is unanimous. See section 7.04(b).

Section 7.28(c) describes the mechanics of cumulative voting. By casting all of the shareholder's votes for a single candidate or a limited number of candidates, a minority shareholder's voting power with respect to a given candidate can be increased, and such shareholder may be able to elect one or more directors.

Section 7.28(d), which applies only if cumulative voting is potentially available under section 7.28(b), covers a notice 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. 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.

## **§ 7.29 Inspectors of Election**

- (a) A corporation that has a class of equity securities registered pursuant to section 12 of the Securities Exchange Act of 1934 shall, and any other corporation may, appoint one or more inspectors to act at a meeting of shareholders in connection with determining voting results. Each inspector shall verify in writing that the inspector will faithfully execute the duties of inspector with strict impartiality and according to the best of the inspector's ability. An inspector may be an officer or employee of the corporation. The inspectors may appoint or retain other persons to assist the inspectors in the performance of the duties of inspector under subsection § 7.29(b), and may rely on information provided by such persons and other persons, including those appointed to tabulate votes, unless the inspectors believe reliance is unwarranted.
- (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 proxy appointments and ballots;
  - (4) count the votes; and
  - (5) make a written report of the results.
- (c) In performing their duties, the inspectors may examine (i) the proxy appointment forms and any other information provided in accordance with section 7.22(b), (ii) any envelope or related writing submitted with those appointment forms, (iii) any ballots, (iv) any evidence or other information specified in section 7.24 and (v) the relevant books and records of the corporation relating to its shareholders and their entitlement to vote, including any securities position list provided by a depository clearing agency.
- (d) The inspectors also may consider other information that they believe is relevant and reliable for the purpose of performing any of the duties assigned to them pursuant to subsection § 7.29(b), including for the purpose of evaluating inconsistent, incomplete or erroneous

information and reconciling information submitted on behalf of banks, brokers, their nominees or similar persons that indicates more votes being cast than a proxy authorized by the record shareholder is entitled to cast. If the inspectors consider other information allowed by this subsection, they shall in their report under subsection § 7.29(b) specify the information considered by them, including the purpose or purposes for which the information was considered, 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 relevant and reliable.

- (e) Determinations of law by the inspectors of election are subject to de novo review by a court in a proceeding under section 7.49 or other judicial proceeding.

### **CROSS-REFERENCES**

Officers, see § 8.40.

Proxies, see § 7.22.

### **OFFICIAL COMMENT**

“Street name” holdings, the use of a securities depository system and the involvement of intermediaries complicate the vote counting process. See Official Comment to section 7.23. This complexity limits the role of inspectors of election in the case of corporations subject to the federal proxy rules. Such inspectors have a limited role because federal law requires multiple steps to be taken by various parties before shares are voted. The inspectors may not have access to information pertaining to each of those steps or from each of the parties involved in the process, such as the voting instruction forms given by beneficial shareholders that lead to voting by the record shareholders. For these reasons, section 7.29 generally permits inspectors to rely on information provided by others.

The selection of inspectors of election should usually 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 is unable or fails to act. The requirement of a written report is to facilitate judicial review of determinations made by inspectors. The ability of inspectors to retain other persons to assist them does not limit the ability of the corporation also to appoint others, such as a vote tabulator to assist in the vote counting process.

In the case of corporations subject to the federal proxy rules, inspectors should generally be independent persons who are neither employees nor officers if there is a contested matter to be considered. The use of independent inspectors in these circumstances enhances shareholder perception of the fairness of the voting process, and the report of independent inspectors can be expected to be given greater evidentiary weight by any court reviewing a contested vote.

To determine the validity of proxy appointments and ballots, depending on the issues presented, the inspectors of election may be required to determine whether appointment forms have been validly executed by the record shareholder, to identify the latest executed appointment form and to determine whether the proxy cast more votes than the record shareholder was entitled to cast. The inspectors are expected to apply the provisions of chapter 7 regarding acceptance of proxy appointments and voting, including those in sections 7.08(d), 7.22(h), and 7.24. In the event of a challenge of any determination by the inspectors in a court of competent jurisdiction, including in a proceeding under section 7.49, the court should give such weight to

determinations of fact by the inspectors as it deems 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 consistent and reasonable, and such other circumstances as the court regards as relevant. As provided in section 7.29(e), the court may review de novo all determinations of law made by the inspectors.

Section 7.29(d) gives the inspectors broad discretion with respect to the information they may consider but does not require that they take any specific action with respect to such information other than to specify in their report the information they considered and the other details listed in section 7.29(d).

## **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 voting trust beneficial owners, together with the number and class of shares each transferred to the trust, and deliver copies of the list and agreement to the corporation at its 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.
- (c) Limits, if any, on the duration of a voting trust shall be as set forth in the voting trust. A voting trust that became effective when this Act provided a 10-year limit on its duration remains governed by the provisions of this section concerning duration then in effect, unless the voting trust is amended to provide otherwise by unanimous agreement of the parties to the voting trust.

#### **CROSS-REFERENCES**

Delivery to corporation, see § 1.41.

Inspection of shareholder lists, see § 7.20 and 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” defined, see § 1.40.

Voting agreements, see § 7.23.

“Voting trust beneficial owner” defined, see § 1.40.

#### **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. Section 7.30(a) provides a straightforward procedure for the creation of an enforceable voting trust and does not impose narrow or technical requirements. Typically, the voting trust provides that all attributes of beneficial ownership other than the power to vote are retained by the voting trust beneficial owners. In addition, the voting trustees may issue to the voting trust beneficial owners voting trust certificates which may be transferable in the same way as shares. Section 7.30 does not limit the duration of a voting trust, consistent with section 7.32 governing shareholder agreements generally. Section 7.30 permits participants to specify limits but does not establish an automatic sunset provision as a matter of law. Section 7.30(c) addresses voting trusts entered into when the Act limited their duration to 10 years.

### **§ 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.

“Sign” defined, see § 1.40.

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. 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 like any other contract.

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. Section 7.31(b) recognizes that damages are not likely to be an appropriate remedy for breach of a voting agreement.

### **§ 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, regardless of whether they are 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 (i) in the articles of incorporation or bylaws and approved by all persons who are shareholders at the time of the agreement, or (ii) 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; and
  - (2) subject to amendment only by all persons who are shareholders at the time of the amendment, 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 before the time of purchase of the shares. An action to enforce the right of rescission authorized by this subsection shall 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) 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.
  - (h) Limits, if any, on the duration of an agreement authorized by this section must be set forth in the agreement. An agreement that became effective when this Act provided for a 10-year limit on duration of shareholder agreements, unless the agreement provided otherwise, remains governed by the provisions of this section concerning duration then in effect.

### **CROSS-REFERENCE**

- Certificateless shares, see § 6.26.
- Certificates for shares, see § 6.25.
- “Conspicuous” defined, see § 1.40.
- Standards of conduct for directors, see § 8.30.

### **OFFICIAL COMMENT**

Shareholders of some corporations, especially those that are closely held, frequently enter into agreements that govern the operation of the enterprise.

Section 7.32 provides, within the context of the traditional corporate structure, legal certainty to such 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 Act were designed with an eye towards corporations whose management and share ownership are distinct. These functions are often conjoined in some corporations, such as the close corporation. Thus, section 7.32 validates 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 Act. If an agreement is not in conflict with another section of the Act, no resort need be made to section 7.32 with its requirement of unanimity. For example, special provisions may 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.

*1. Section 7.32(a)*

An agreement authorized by section 7.32 is “not inconsistent with law” within the meaning of sections 2.02(b)(2) and 2.06(b) of the Act.

The range of agreements validated by section 7.32(a) is expansive though not unlimited. Section 7.32 defines the types of agreements that can be validated largely by illustration. The seven specific categories that are listed are designed to cover some of the most frequently used arrangements. There are numerous other arrangements that may be made, and section 7.32(a)(8) provides an additional category for any provisions that, in a manner inconsistent with any other provision of the Act, otherwise govern the exercise of the corporate powers or 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, and are not contrary to public policy.

Section 7.32(a) validates virtually all types of shareholder agreements that, in practice, normally concern shareholders and their advisors. Given that breadth, 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 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.

Although the limits of section 7.32(a)(8) are left uncertain, there are provisions of the Act that may not be overridden if they reflect core principles of public policy with respect to corporate affairs. For example, a provision of a shareholder agreement that purports to eliminate all of the standards of conduct established under section 8.30 might be viewed as contrary to public policy and thus not validated under section 7.32(a)(8). Similarly, a provision that exculpates directors from liability more broadly than permitted by section 2.02(b)(4), or indemnifies them more broadly than permitted by section 2.02(b)(5), might not be validated under section 7.32 because of strong public policy reasons for the statutory limitations on the right to exculpate directors from liability and to indemnify them. The validity of some provisions may depend upon the circumstances. For example, a provision of a shareholder agreement that limited inspection rights under section 16.02 or the right to financial statements under section 16.20 might, as a general matter, be valid, but that provision might not be given effect if it prevented shareholders from obtaining information necessary to determine whether directors of the corporation have satisfied the standards of conduct under section 8.30. The foregoing are examples and are not intended to be exclusive.

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, it is not necessary to "opt in" to a special class of close corporations 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 regardless of whether section 7.32 is specifically referenced in the agreement. 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 of incorporation 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 to establish unequivocally their agreement. Similarly, although transferees are bound by a valid shareholder agreement, subject to section 7.32(c), it may be desirable to obtain the affirmative written assent of the transferee at the time of the transfer. Section 7.32(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 of the shareholder agreement 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 section 7.32(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 of incorporation or bylaws, the corporation will necessarily have notice. In the case of a shareholder agreement outside the articles of incorporation or bylaws, the requirement of signatures by all of the shareholders should in virtually all cases be sufficient to make the corporation aware of the agreement, 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, 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 affected. 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. Under section 7.32(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 may not proceed with the purchase and still obtain the benefit of the remedies in section 7.32(c). Under contract principles and the securities laws, a failure to disclose the existence of a shareholder agreement may 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 of 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 laws outside the 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 apply 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).

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. 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 before 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 Article 8 of the Uniform Commercial Code permit delivery of statements after a transfer of shares.

#### *4. Section 7.32(d)*

Section 7.32(d) recognizes that the terms of a shareholder agreement may provide for its termination upon the happening of a specified event or condition. An example may be when the corporation undergoes an initial public offering. This approach is consistent with the broad freedom of contract provided to participants in such enterprises.

*5. Sections 7.32 through (g)*

Section 7.32(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 under the shareholder agreement. A shareholder agreement which provides for such a shift of responsibility, with the concomitant shift of liability provided by subsection § 7.32(e), could also provide for exculpation from that liability to the extent otherwise authorized by the Act. The transfer of liability provided by subsection § 7.32(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.

Section 7.32(f) provides that shareholders shall not have personal liability for the debts of a corporation arising out of acts or omissions taken pursuant to a shareholder agreement validated by section 7.32. Section 7.32(g) authorizes shareholder agreements for corporations that are in the process of being organized and do not yet have shareholders.

*6. Section 7.32(h)*

Section 7.32 does not limit the duration of a shareholder agreement. This approach is consistent with the wide freedom of contract provided to participants in such enterprises. For agreements entered into during a time that section 7.32 provided for a 10-year term if no other time limit was specified, section 7.32(h) provides that its duration will be governed by the provisions of section 7.32 concerning duration in force at the time the agreement became effective. This would include, for example, both the default termination rule and the authority under former section 7.32(b)(2) that such an agreement’s automatic 10-year term could be amended by all shareholders (unless the agreement had prohibited such amendment).

## **Subchapter D. DERIVATIVE PROCEEDINGS**

### **§ 7.40 Subchapter Definitions**

In this subchapter:

“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.

“Shareholder” means a record shareholder, a beneficial shareholder, and an unrestricted voting trust beneficial owner.

## **CROSS-REFERENCES**

“Beneficial shareholder,” “record shareholder” and “unrestricted voting trust beneficial owner” defined, see § 1.40.

Shares held by nominees, see § 7.23.

Voting trusts, see § 7.30.

## **OFFICIAL COMMENT**

The definition of “shareholder,” for purposes of chapter 7D, extends the right to bring a derivative proceeding to a beneficial shareholder and an unrestricted voting trust beneficial owner. The inclusion of beneficial shareholder and unrestricted voting trust beneficial owner recognizes that these persons have or hold on behalf of others an economic interest in the shares.

### **§ 7.41 Standing**

A shareholder may not commence or maintain a derivative proceeding unless the shareholder (i) 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 (ii) 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**

Section 7.41 requires (i) the plaintiff to be a shareholder and therefore does not permit, for example, creditors or holders of options, warrants, or conversion rights to commence a derivative proceeding, and (ii) that the plaintiff fairly and adequately represent the interests of *the corporation*, rather than *shareholders similarly situated* as provided in some rules of procedure, because the reference to the corporation more clearly 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 (i) a written demand has been made upon the corporation to take suitable action and (ii) 90 days have expired from the date delivery of 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**

“Deliver” defined, see § 1.40.

“Derivative proceeding” defined, see § 7.40.

Notices and other communications, see § 1.41.

“Shareholder” defined, see § 7.40.

## **OFFICIAL COMMENT**

Section 7.42 requires a written demand for two reasons. First, even though no director may be “qualified” (see section 1.43), the demand will give the corporation the opportunity to re-examine the act complained of in the light of a potential lawsuit and take corrective action. Second, the provision eliminates the time and expense of litigating whether demand is required. Requiring a demand in all cases does not impose an onerous burden given the relatively short waiting period and that this period may be shortened if irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.

### *1. Form of Demand*

Section 7.42 specifies only that the demand shall be in writing. Detailed pleading is not required given that the corporation can contact the shareholder for clarification if there are any questions, and cases have noted that a demand which sets forth the facts concerning share ownership and is sufficiently specific should apprise the corporation of the action sought to be taken and the grounds for that action so that the demand can be evaluated.

### *2. Upon Whom Demand Should Be Made*

To ensure that the demand reaches the appropriate person for review, it should be addressed to the board of directors, chief executive officer, or secretary at the corporation’s principal office. In most cases the board of directors will be the appropriate body to review the demand but 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.

### *3. The 90-Day Period*

The 90-day period in section 7.42 was chosen as a reasonable time within which the board of directors can meet, conduct the necessary inquiry into the charges, receive the results of the inquiry and make its decision. A fixed time period also eliminates litigation over what is or is not a reasonable time. If additional time is needed, the corporation may request counsel for the shareholder to delay filing suit until the inquiry has been 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 before the end of the 90 days. The standard under the second exception for irreparable injury to the corporation is intended to be the same as that governing the entry of a preliminary injunction. 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.

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 normally ends unless it can be shown that the corporation will not adequately pursue the matter.

### **§ 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 § 7.42.

“Derivative proceeding” defined, see § 7.40.

### **OFFICIAL COMMENT**

A stay may be appropriate where, for example, 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 any case, the court will likely monitor the course of the inquiry to ensure that the corporation 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 § 7.44(b) or subsection § 7.44(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 § 7.44(e), the determination in subsection § 7.44(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 § 7.44(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 § 7.44(a) have not been met; if not, the corporation shall have the burden of proving that the requirements of subsection § 7.44(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 § 7.44(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 § 7.42.

“Derivative proceeding” defined, see § 7.40.

“Qualified director” defined, see § 1.43.

“Shareholder” defined, see § 7.40.

## **OFFICIAL COMMENT**

The procedures set forth in section 7.44 are not intended to be exclusive. Discretion is left with the courts to determine when a derivative action should be dismissed under circumstances other than those set forth in section 7.44. For example, 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 and Timing*

The determination under section 7.44(b) that the maintenance of the proceeding is not in the best interests of the corporation can be made before commencement of the derivative action in response to a demand or after commencement of the action upon examination of the allegations of the complaint. Section 7.44(b) allows the determination to be made by “qualified directors” as defined in section 1.43. These provisions parallel the mechanics for authorizing an officer’s pursuit of a business opportunity pursuant to a provision in the articles of incorporation (section 2.02(b)(6)), 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). Section 7.44(e) provides for the appointment of a panel only upon motion by the corporation. This would not, however, prevent the court on its own initiative from appointing a special master if permitted under applicable state rules of procedure.

This panel procedure may be desirable in a number of circumstances, particularly if there are no qualified directors available. In addition, even if there are qualified directors, they may not be in a position to conduct the inquiry.

## 2. *Standards to Be Applied*

Section 7.44(a) contemplates that the court will examine the “good faith” of the persons making the determination. Both the determination and the inquiry in section 7.44(a) must be made in “good faith.” section 7.44(a) does not authorize the court to review the reasonableness of the determination to reject a demand or seek a dismissal. The “good faith” standard, which is also found in section 8.30 (general standards of conduct for directors) and § 8.51 (authority to indemnify), is a subjective one, meaning “honestly or in an honest manner.”

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 within the knowledge of the group so that extensive additional investigation is not necessary. In other cases, the group may need to engage counsel and possibly other professionals to conduct an investigation and assist the group in its evaluation of the issues.

The phrase “upon which its conclusions are based” requires that the conclusions follow logically from the inquiry. The burden of convincing the court about this issue lies with whichever party has the burden under section 7.44(d). This phrase does not require the persons making the determination to prepare a written report that sets forth their determination and its bases, as circumstances will vary as to the need for such a report.

Section 7.44 is not intended to modify the general standards of conduct for directors set forth in section 8.30 but rather to make those standards 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.

### **§ 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 or series 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’s requirement that all proposed settlements and discontinuances receive judicial approval supports the proposition that a derivative suit is brought for the benefit of all shareholders and thus should not be settled privately.

By requiring that notice be given to all affected shareholders if the court determines that the proposed settlement may substantially affect their interests, section 7.45 permits the court to decide whether notice to shareholders (or holders of a class or series of shares) need be given. For example, the court may decide not to require notice of dismissal if, in the court’s judgment, the proceeding is frivolous or has become moot. Section 7.45 also makes a distinction between classes or series of shareholders, an approach that could be used, for example, to eliminate the costs of notice to

preferred shareholders where the settlement does not have an effect on their rights, such as their rights to dividends or a liquidation preference.

Section 7.45 does not address the issue of which party should bear the cost of giving this notice, which is 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 (i) 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 or (ii) 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**

The requirement in section 7.46(1) that the court may order the corporation to pay the plaintiff's expenses if it finds that the proceeding has resulted in a “substantial” benefit to the corporation, should discourage a plaintiff from proposing inconsequential matters to justify the payment of counsel fees. The provision does not specify the method for calculating attorneys' fees given that there is a substantial body of case law that delineates this issue, which usually includes taking into account the amount or character of the benefit to the corporation.

The standard under section 7.46(2) for the court to require the plaintiff to pay the defendants' expenses if the action was commenced without reasonable cause or for an improper purpose is intended to discourage proceedings brought for the sole purpose of obtaining early settlement payments by defendants to avoid significant defense costs, while also protecting plaintiffs whose suits have a reasonable foundation. This test is similar to but not identical to 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.

Section 7.46(3) addresses 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. This provision may be unnecessary if these abuses are already addressed under applicable rules of civil procedure.



### **§ 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 corporation” defined, see § 1.40.

Foreign corporations, see ch. 15.

#### **OFFICIAL COMMENT**

Section 7.47 clarifies the application of the provisions of chapter 7D to foreign corporations by setting forth a choice of law provision for derivative proceedings involving foreign corporations. It provides, subject to three exceptions, that the matters covered by the chapter 7D shall be governed by the laws of the jurisdiction of incorporation of the foreign corporation.

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. JUDICIAL PROCEEDINGS**

### **§ 7.48 Shareholder Action to Appoint a Custodian or Receiver**

- (a) The [name or describe court] 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 (registered to do 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.
- (g) In this section, "shareholder" means a record shareholder, a beneficial shareholder, and an unrestricted voting trust beneficial owner.

### **CROSS-REFERENCES**

"Beneficial shareholder," "record shareholder" and "unrestricted voting trust beneficial owner" defined, see § 1.40.

"Expenses" defined, see § 1.40.

### **OFFICIAL COMMENT**

Section 7.48 provides procedures for shareholders to bring an action for the appointment of a custodian or receiver in two situations, both requiring a showing of actual or threatened irreparable injury, as specified in section 7.48(a)(1) and (a)(2). These two grounds are narrower than those found in a 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 relied upon by a shareholder of a nonpublic corporation in lieu of involuntary dissolution under section 14.30(a)(2).

Section 7.48(g) extends the right to seek court appointment of a custodian or receiver to a beneficial shareholder and an unrestricted voting trust beneficial owner. This recognizes that these persons have or hold on behalf of others an economic interest in the shares.

### **§ 7.49 Judicial Determination of Corporate Offices and Review of Elections and Shareholder Votes**

- (a) Upon application of or in a proceeding commenced by a person specified in subsection (b), the [name or describe court] may determine:
- (1) the result or validity of the election, appointment, removal or resignation of a director or officer of the corporation;
  - (2) the right of an individual to hold the office of director or officer of the corporation;
  - (3) the result or validity of any vote by the shareholders of the corporation;
  - (4) the right of a director to membership on a committee of the board of directors; and
  - (5) the right of a person to nominate or an individual to be nominated as a candidate for election or appointment as a director of the corporation, and any right under a bylaw

- adopted pursuant to section 2.06(c) or any comparable right under any provision of the articles of incorporation, contract, or applicable law.
- (b) An application or proceeding pursuant to subsection (a) of this section may be filed or commenced by any of the following persons:
    - (1) the corporation;
    - (2) any record shareholder, beneficial shareholder or unrestricted voting trust beneficial owner of the corporation;
    - (3) a director of the corporation, an individual claiming the office of director, or a director whose membership on a committee of the board of directors is contested, in each case who is seeking a determination of his or her right to such office or membership;
    - (4) an officer of the corporation or an individual claiming to be an officer of the corporation, in each case who is seeking a determination of his or her right to such office; and
    - (5) a person claiming a right covered by subsection (a)(5) and who is seeking a determination of such right.
  - (c) In connection with any application or proceeding under subsection (a), the following shall be named as defendants, unless such person made the application or commenced the proceeding:
    - (1) the corporation;
    - (2) any individual whose right to office or membership on a committee of the board of directors is contested;
    - (3) any individual claiming the office or membership at issue; and
    - (4) any person claiming a right covered by subsection (a)(5) that is at issue.
  - (d) In connection with any application or proceeding under subsection (a) service of process may be made upon each of the persons specified in subsection (c) either by:
    - (1) service of process on the corporation addressed to such person in any manner provided by statute of this state or by rule of the applicable court for service on the corporation; or
    - (2) service of process on the person in any manner provided by statute of this state or by rule of the applicable court.
  - (e) When service of process is made upon a person other than the corporation by service upon the corporation pursuant to subsection (d)(1), the plaintiff and the corporation or its registered agent shall promptly provide written notice of such service, together with copies of all process and the application or complaint, to the person at the person's last known residence or business address, or as permitted by statute of this state or by rule of the applicable court.
  - (f) In connection with any application or proceeding under subsection (a), the court shall dispose of the application or proceeding on an expedited basis and also may:
    - (1) order such additional or further notice as the court deems proper under the circumstances;
    - (2) order that additional persons be joined as parties to the proceeding if the court determines that such joinder is necessary for a just adjudication of matters before the court;
    - (3) order an election or meeting be held in accordance with the provisions of section 7.03(b) or otherwise;
    - (4) appoint a master to conduct an election or meeting;

- (5) enter temporary, preliminary or permanent injunctive relief;
  - (6) resolve solely for the purpose of this proceeding any legal or factual issues necessary for the resolution of any of the matters specified in subsection (a), including the right and power of persons claiming to own shares to vote at any meeting of the shareholders; and
  - (7) order such other relief as the court determines is equitable, just and proper.
- (g) It is not necessary to make shareholders a party to a proceeding or application pursuant to this section unless the shareholder is a required defendant under subsection (c)(4), relief is sought against the shareholder individually, or the court orders joinder pursuant to subsection (f)(2).
- (h) Nothing in this section limits, restricts, or abolishes the subject matter jurisdiction or powers of the court as existed before the enactment of this section, and an application or proceeding pursuant to this section is not the exclusive remedy or proceeding available with respect to the matters specified in subsection (a).

### **CROSS-REFERENCES**

Notices and other communications , see § 1.41.

Officers, see § 8.40.

Qualifications for directors and nominations, see § 8.02.

“Registered agent” defined, see §§ 2.02, 5.01, 5.02, 5.03 and 16.21.

“Registered office” defined, see §§ 2.02, 5.01, 5.02 and 16.21.

“Shareholder” defined, see § 1.40.

### **OFFICIAL COMMENT**

Section 7.49 establishes a procedure for judicial resolution of disputes with respect to the identity of the corporation’s directors or officers, the identity of the members of any committee of its board of directors, the validity of nominations for director or the results or validity of shareholder votes. It confers subject matter jurisdiction on the specified court to resolve these disputes. That jurisdiction may be exercised either in a new proceeding or by an application made in an already pending proceeding. Section 7.49 also requires an expedited review of disputes to prevent them from immobilizing the corporation.

#### *1. The Court with Jurisdiction to Administer section 7.49*

Subject to any special rules that may be adopted by the specified court, a proceeding instituted pursuant to section 7.49 is governed by the otherwise applicable rules of civil procedure that apply in the specified court, including rules relating to the filing or initiation of an action, service of process, discovery, injunctive relief, motions, and judgments.

The grant of jurisdiction under section 7.49 is permissive, not mandatory. The court has the discretion to decline to resolve a matter, for example, because a justiciable controversy is not present, the court lacks jurisdiction over a party that the court determines is necessary to the resolution of the dispute, a prior action seeking the same relief is pending in another forum, or for other reasons generally applicable under the law of the enacting state. In view of the section’s purpose to provide a prompt remedy for corporate governance disputes, the court ought to decline to exercise the jurisdiction provided under section 7.49 only in a rare and unusual case.

An action under section 7.49 should be promptly filed. A delay in resolving disputes concerning corporate governance can result in prejudice to the corporation and its shareholders. The doctrine of laches provides an appropriate basis for determining whether there has been an unreasonable delay in commencing an action, and that doctrine should be applicable to an action pursuant to this section.

### *2. The Matters or Disputes Covered*

Section 7.49(a) specifies five types of disputes that the court will have jurisdiction to resolve. Section 7.49(a)(3) relates to disputes concerning the result or validity of any shareholder vote on any matter, which would include election of directors, a merger, dissolution, amendment to the articles of incorporation, or any other matter on which a shareholder vote is required or held. A shareholder vote would be taken at a meeting or by written consent. Section 7.49(a)(5) covers disputes concerning the right to nominate or be nominated for election or appointment as a director, which includes whether an individual meets any applicable qualifications to be nominated or serve as a director established under the authority of section 8.02. Section 7.49(a)(5) also extends to disputes concerning rights under a bylaw adopted pursuant to section 2.06(c) to have a nominee appear on the corporation's proxy appointment form or to be reimbursed for expenses incurred in a proxy contest or any comparable rights under any provision of the articles of incorporation, contracts, or applicable law.

The ability to resolve disputes under section 7.49 over who shall serve as a director or officer of the corporation is not intended to reach a dispute concerning an employment contract relating to one of those positions, such as a claim for money damages for breach of the contract, because resolution of a contractual dispute generally will not affect who is entitled to serve as a director or an officer.

### *3. Person Who May Initiate a Proceeding*

Section 7.49(b) specifies that the corporation or a shareholder of the corporation has standing to seek resolution of any of the disputes covered by the section. The standing of any other person is limited to a dispute in which that person's rights are directly at issue. For example, directors or officers of the corporation, or an individual claiming the right to be a director or officer of the corporation, may only initiate a proceeding under section 7.49 with respect to a claim to resolve his or her right to such office or, in the case of directors, his or her right to membership on a committee of the board of directors. A director, officer, or an individual claiming the right to be a director or officer does not have standing as a director or officer to bring an action seeking the resolution of a contest over the right of some other director or officer to serve, the right of some other individual claiming some other office, or the result or validity of any shareholder vote unrelated to the individual's own election. Similarly, a person who has a disputed right to nominate someone for election will not have standing to initiate a proceeding under section 7.49 to resolve some other dispute covered by this section unless that person has standing to raise that other matter, such as where the person also is a shareholder. Similarly, a person who has a disputed right to nominate someone for election will not have standing to initiate a proceeding under section 7.49 to resolve some other dispute covered by this section unless that person has standing to raise that other matter separately, such as where the person also is a shareholder.

### *4. Necessary Defendants*

Section 7.49(c) specifies the persons that must be named as defendants in an action pursuant to section 7.49. The corporation whose affairs are at issue must always be named as a defendant in the action unless the corporation initiates the proceeding. If the corporation initiates a proceeding to resolve the result or validity of a shareholder vote, section 7.49(c) does not require that any particular person be named as a defendant. There is no assurance that whoever is named as the defendant will take a position adverse to the corporation. The court, therefore—pursuant to its power under section 7.49(f)(2)—may order that some adverse party be added as a defendant to assure that the requisite adversity between parties exists and that both sides of any dispute are fairly presented. Section 7.49(d) does not provide a method for serving process on a shareholder who is named as a defendant in an action under section 7.49. Consequently, any shareholder joined as a defendant either will be required to consent to the personal jurisdiction of the court or be subject to service of process pursuant to some other statute of the state or rule of the applicable court.

Section 7.49(g) provides that it is unnecessary to make shareholders a party except, among other circumstances, when relief is sought against any of the shareholders individually. A proceeding to resolve a shareholder vote, for instance, does not mean that relief is being sought against the shareholders individually, even where the vote of particular shareholders may be the determinative factor, so long as the resolution of any issues pertaining to that vote are solely for the purpose of resolving a governance issue under section 7.49 and are not binding on the shareholder individually. Nonetheless, the court has the power to order the joinder of a shareholder whose vote is at issue if the court determines the joinder is necessary for the just adjudication of the matter. If the shareholder is not subject to the personal jurisdiction of the court, the usual rules of the court will apply in determining whether the shareholder is an indispensable party whose absence requires the dismissal of the action. In determining whether such a shareholder is indispensable party whose absence requires the dismissal of the action, a relevant factor for the court to consider is that any judicial determinations—such as a resolution of share ownership—are solely for the purpose of resolving the result or validity of the vote or election and will not be binding on the absent shareholder for any other purpose.

##### *5. Service of Process on and Notice to Required Defendants*

Section 7.49(d) provides the methods to serve process on those persons who are required to be joined as defendants under section 7.49(c) and, among other things, permits service upon specified persons by service upon the corporation. If service is accomplished by service on the corporation, notice must be provided to the defendant as required by section 7.49(e) and must be provided both by the plaintiff and by the corporation or its registered agent. This duplicative requirement is intended to increase the likelihood that the defendant receives actual notice of the filing of the lawsuit. Under section 7.49(f)(f)(1), the court may require additional notice.

Section 7.49(e) does not specify the manner by which written notice must be delivered or communicated to the defendant. Section 1.41 contains various provisions dealing with notice and will be applicable to notice pursuant to section 7.49(e) except to the extent that section specifies certain requirements, in which case those requirements will govern. Although section 1.41 provides that notice must be in writing unless oral notice is reasonable under the circumstances, the requirement in subsection § 7.49(e) that notice be in writing will govern. Section 1.41 also provides that electronic transmission constitutes written notice and contains various other provisions concerning notice.

## 6. *Powers of the Court*

Section 7.49(f) lists various nonexclusive powers of the court in connection with a proceeding under section 7.49. Powers of the court provided by statute, rule, or applicable law may also be available in a proceeding under section 7.49. Section 7.49(f) requires that a proceeding be expedited, but the degree of expedition will be determined by the court and may vary depending upon the circumstances of the corporation and the nature of the dispute.

One of the powers granted to the court under section 7.49(f)(6) is to resolve legal or factual issues necessary to the resolution of the corporate governance dispute at issue. The resolution of the disputes specified in section 7.49(a) may require the court to resolve related legal or factual issues, such as whether a shareholder who voted the shares at a meeting is the rightful owner of the shares. However, the determination of such legal or factual matters must be “necessary” for the resolution of the dispute over which the court is granted subject matter jurisdiction in section 7.49(a), and the resolution of these issues must be “solely for the purpose of” the proceeding pursuant to this section. Consequently, for example, the resolution of the rightful owner of shares will be controlling with respect to a section 7.49 determination of the result of the shareholder vote, but that resolution will not be binding on the shareholder whose shares are at issue, unless that shareholder is properly subject to the personal jurisdiction of the court and is made a party to the proceeding. Such a shareholder would not, however, need to be made a party to the proceeding to determine whether the shares were properly voted or counted.

The types of legal or factual issues that it may be necessary for the court to determine to resolve a matter specified in section 7.49(a) may be quite varied. The proper scope of a proceeding under this section is a case-specific inquiry not subject to precise statutory rules. Those issues may include, for example, the interpretation of the bylaws or articles of incorporation, the validity of a share issuance, the validity of a proxy appointment, voting rights pursuant to a contract between shareholders, the power of a beneficial shareholder to direct the voting of shares, the right of the record shareholder to vote shares without direction from the beneficial shareholder, the voting rights of preferred shareholders, whether notice and quorum requirements have been met, and the propriety of the inspectors’ tabulation of the vote.

The issues “necessary” to resolve a matter specified in section 7.49(a) may turn upon the type of claim or contest made or identified by the plaintiff in the action. A proceeding under section 7.49 must be pursued primarily to resolve a matter specified in subsection § 7.49(a) and not to seek adjudication of an issue that is not covered by the section. Issues not covered by section 7.49 might include breach of duty claims against directors (unless those claims are central to the vote, election, appointment, or resignation at issue), claims that persons elected intend to breach their duties in the future, and breach of duty claims in connection with the approval of a particular transaction.

The court’s power under sections 7.49(f)(1) and (2) to order additional or further notice may be used to assure that persons with a particular interest in the matter being adjudicated have notice of the proceeding and are given the opportunity to intervene. The court’s power to order joinder of additional parties may be used to assure adversity of the parties or to join a person who is directly affected by the resolution of subsidiary legal or factual issues under section 7.49(f)(6).

Although the issues presented in a proceeding under section 7.49 may not require a new meeting or election, in some situations the court may be unable to determine the proper result without conducting a new election or meeting or the matter may be so uncertain that a new meeting or election is the fairest means of resolving the dispute. Sections 7.49(f)(3) and (4) permit the court to order a new meeting or election without necessarily determining that the prior

meeting or election was invalid. The new meeting or election may be held in accordance with the provisions of section 7.03(b) or otherwise. Under section 7.03(b), the court, among other matters, may fix the time and place of the meeting, determine the shares entitled to participate in the meeting, specify the record date, prescribe the notice of the meeting, set the quorum and “enter other orders necessary to accomplish the purpose or purposes of the meeting.” However, the court’s power to control a new meeting or election is not limited to the powers specified in section 7.03(b).

The court might use its injunctive power under section 7.49(f)(5) to address a wide variety of circumstances. It might, for example, (i) enter a temporary or preliminary injunction against action outside the ordinary course unless the opposing parties consent to the action or the court approves, thereby maintaining the status quo until the proceeding can be resolved, (ii) delay a meeting or election until issues can be resolved in advance of the meeting, (iii) delay the closing of a transaction subject to a shareholder vote until the result of the vote is determined, or (iv) restrain a person from exercising the powers of a director or officer until the person’s claim to office can be resolved. Once the dispute is resolved, the court may need to enter permanent injunctive relief to implement its decision.

Under section 7.49(f)(7), the court, for example, may consider relief to assure that the shareholder franchise is not improperly manipulated and that the vote of the shareholders is counted and implemented in accordance with the wishes of those entitled to vote or direct the voting of the shares.



## CHAPTER 8

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# Directors and Officers

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**Subchapter A.**

**BOARD OF DIRECTORS**

**§ 8.01 Requirement for and Functions of Board of Directors**

- (a) Except as may be provided in an agreement authorized under section 7.32, each corporation shall have a board of directors.
- (b) Except as may be provided in an agreement authorized under section 7.32, and subject to any limitation in the articles of incorporation permitted by section 2.02(b), all corporate powers shall be exercised by or under the authority of the board of directors, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of the board of directors.

**CROSS-REFERENCES**

Director standards of conduct, see § 8.30.

Indemnification, see §§ 8.50 through 8.59.

**OFFICIAL COMMENT**

As provided in section 8.01(a), the board of directors is the traditional form of governance, but the shareholders of a corporation may, in an agreement that satisfies the requirements of section 7.32, dispense with a board of directors and structure the corporation's management and governance to address specific needs of the enterprise.

In section 8.01(b), 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 corporations, particularly 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. In many other corporations, including most public corporations, the business and affairs are managed “under the direction, and subject to the oversight, of” the board of directors, and operational management is delegated to executive officers and other professional managers.

Section 8.01(b) often is considered to constitute the heart of the governance provisions of the Act. Giving the board of directors the power, and the responsibility, to oversee and direct the business of the corporation permits separation of ownership of the corporation from control of its oversight and direction. The Act's broad grant of authority and responsibility to the board of directors constitutes the rejection of the concept that the directors, having been elected by the shareholders, merely serve as agents to implement the will of the shareholders. See section 8.30.

Section 8.01(b), in providing for corporate powers to be exercised under the direction 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. Although such delegation does not relieve the board of directors from its responsibility to oversee the business and affairs of the corporation, directors are not 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.

The scope of the board's oversight responsibility will vary depending on the nature of the corporation and its business. At least for public corporations, the board's responsibilities generally include oversight of the following:

- business performance, plans and strategy;
- management's assessment of major risks to which the corporation is or may be exposed;
- the performance and compensation of executive officers;
- policies and practices to foster the corporation's compliance with law and ethical conduct;
- management's preparation of the corporation's financial statements;
- management's design and assessment of effectiveness of the corporation's internal controls;
- plans for the succession of the chief executive officer and other executive officers;
- the composition of the board and of board committees; and
- whether the corporation has information and reporting systems in place to provide directors with appropriate information in a timely manner.

In giving attention to the composition of the board, directors of public corporations should consider the corporation's processes for obtaining and evaluating the views of shareholders, including processes for considering individuals proposed by shareholders as nominees for

election as directors. Directors of public corporations also should take into account the important role of independent directors. When ownership is separated from responsibility for oversight and direction, as is the case with public corporations, having nonmanagement independent directors who participate actively in the board's oversight functions increases the likelihood that actions taken by the board, if challenged, will be given deference by the courts. 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 and must be free of significant professional, financial or similar relationships with the corporation, 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 qualifications for disinterestedness required of directors for specific purposes under the Act are similar, but not necessarily identical, to those that are prerequisites to independence. For the requirements for a director to be considered disinterested and qualified to act in those specified situations, see section 1.43. An individual who is an independent director 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 example, a member of management) may be disinterested and qualified to act in a particular case.

Section 8.01(b) recognizes that the powers of the board of directors may be limited by express provisions in the articles of incorporation and in an agreement among all shareholders under section 7.32. In an agreement under section 7.32, board powers also may be assigned to others. Because all of the shareholders must approve a section 7.32 agreement, the only restriction on limiting or assigning board powers is that any limitation or assignment must be provided for in sections 7.32(a)(1) through 7.32(a)(7) or must not be contrary to public policy under section 7.32(a)(8). In contrast, as is provided in section 2.02(b)(2), any limitation on board powers in the articles of incorporation cannot be "inconsistent with law." As a result of this difference in standards, any such limitation under section 2.02 should not, for example, be inconsistent with requirements of section 8.30 regarding standards of conduct for directors or otherwise preclude the directors from fulfilling their duties to the corporation.

## **§ 8.02 Qualifications of Directors**

- (a) The articles of incorporation or bylaws may prescribe qualifications for directors or for nominees for directors. Qualifications must be reasonable as applied to the corporation and be lawful.
- (b) A requirement that is based on a past, prospective, or current action, or expression of opinion, by a nominee or director that could limit the ability of a nominee or director to discharge his or her duties as a director is not a permissible qualification under this section. Notwithstanding the foregoing, qualifications may include not being or having been subject to specified criminal, civil, or regulatory sanctions or not having been removed as a director by judicial action or for cause.
- (c) A director need not be a resident of this state or a shareholder unless the articles of

- incorporation or bylaws so prescribe.
- (d) A qualification for nomination for director prescribed before a person's nomination shall apply to such person at the time of nomination. A qualification for nomination for director prescribed after a person's nomination shall not apply to such person with respect to such nomination.
  - (e) A qualification for director prescribed before a director has been elected or appointed may apply only at the time an individual becomes a director or may apply during a director's term. A qualification prescribed after a director has been elected or appointed shall not apply to that director before the end of that director's term.

### **CROSS-REFERENCES**

Election of directors, see §§ 8.03 through 8.06.

Judicial determination of corporate offices and review of elections and shareholder votes, see § 7.49.

Resignation of directors, see §§ 8.07.

### **OFFICIAL COMMENT**

Some corporations have adopted qualifications for individuals to be directors or to be nominated as directors. One use of qualifications may be by closely held corporations, to ensure representation and voting power on the board of directors. Other provisions of the Act also are designed to accomplish these purposes. See, for example, section 7.32 providing for shareholder agreements. See also section 2.02(b).

Qualifications may apply to all board members or to a specified percentage or number of directors. An example of a qualification applying to fewer than all directors would be a requirement that at least two directors must have specified business or professional experience or a particular educational degree or background. Careful consideration should be given to the intended effect of the application of any qualification that applies to fewer than all directors in the context of an election contest in which only some of the nominees satisfy this qualification. In the event that specified qualifications for some or all directors are not satisfied, remedial steps could be addressed in the articles of incorporation or bylaws, or can be left to other mechanisms available to a corporation and its board and shareholders, such as the provisions permitting changes in the number of directors and providing for the filling of vacancies on the board. See sections 8.03 and 8.10.

The purpose of section 8.02(a) is to permit qualifications that may benefit the corporation by enhancing the board's ability to perform its role effectively. However, this needs to be balanced against the risk that qualifications could be misused for entrenchment purposes by incumbents or for other improper purposes. To address these concerns, section 8.02(a) requires that qualifications must be reasonable as applied to the corporation and must be lawful. For example, a qualification that seeks to favor incumbent directors or distinguish between a director elected from the slate nominated by a corporation's board and a director elected as the result of being nominated by one or more shareholders, including under a bylaw adopted pursuant to section 2.06(c), would not ordinarily be reasonable and thus not ordinarily authorized by section 8.02(a). An example of a qualification that would not be lawful would be a requirement that is impermissibly discriminatory under the Civil Rights Act of 1964.

### *1. Scope of Permitted Qualifications*

Examples of qualifications that may be permissible under section 8.02 are eligibility requirements based on residence, shareholdings, age, length of service, experience, expertise, and professional licenses or certifications.

Under section 8.02(b) a qualification that is based on a past, current, or prospective action, or expression of opinion, by a nominee or director that could limit the ability of a nominee or director to discharge his or her duties as a director is not a permissible qualification. The discharge of duties of a director is referenced in section 8.30. A requirement based on a director's having voted for or against, or expressed an intent to vote for or against, a particular type of resolution, such as a resolution in favor of or against a bylaw pursuant to section 2.06(c) or a resolution in favor of or against a shareholder rights plan, would be impermissible.

A shareholder agreement that meets the requirements of section 7.32 could override the terms of section 8.02, including with respect to the requirement of reasonableness in section 8.02(a) and the limitation on permitted qualifications in section 8.02(b).

### *2. Timing and Applicability of Qualifications*

Sections 8.02(d) and (e) prohibit "springing" qualifications. A qualification for a director that is prescribed during the term of that director shall, assuming it remains in effect, apply to that director upon the start of any additional term of that director.

To avoid ambiguity as to whether a qualification for director only applies at the start of a term or applies during the term, a qualification provision should provide clearly when it applies. In the event that a qualification provision does not so specify, customary principles of interpretation and construction will apply. Examples of qualifications the nature of which would generally indicate an intent that they apply throughout a term would be a citizenship or residence qualification or a qualification that a director have a particular license or government clearance.

A director who ceases to meet a qualification that applies during a term will not satisfy that qualification at that time. For example, if a bylaw provision that is in effect at the start of a director's term requires that all directors be residents of state X during their terms, and that director at the start of his or her term is a resident of state X but during the term becomes a resident of state Y, then that director would cease to satisfy the qualification and, therefore, cease to be a director at the time the director becomes a resident of state Y.

## **§ 8.03 Number and Election of Directors**

- (a) A board of directors shall 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 bylaws.
- (c) Directors are elected at the first annual shareholders' meeting and at each annual shareholders' meeting thereafter unless elected by written consent in lieu of an annual meeting as permitted by section 7.04 or unless their terms are staggered under section 8.06.

## **CROSS-REFERENCES**

Annual shareholders' meeting, see § 7.01.

Classification of board of directors, see § 8.06.

Cumulative voting, see § 7.28.

Deadlocked board of directors as ground for dissolution, see § 14.30.

Staggered terms for directors, see § 8.06.

Terms of directors generally, see § 8.05.

Voting for directors, see § 7.28.

## **OFFICIAL COMMENT**

Section 8.03 prescribes rules for (i) the determination of the size of the board of directors of corporations, and (ii) changes in the number of directors once the board's size has been established.

### *1. Number of Directors*

Under section 8.03(a), the size of the board of directors may 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.

### *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 its 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 board size within a range from a minimum to a maximum, or an unlimited size not fewer than one as determined by the board or the shareholders. If the shareholders or the board of directors want to change the specified size of the board, to change the range established for the size of the board or to change from a board size within a range or of unlimited size to a specified board size or vice versa, board of directors and shareholder action would be required to make those changes by amending the articles of incorporation. Alternatively, the bylaws could provide for a specified number of directors or a size within a stated range or unlimited size, with the number to be fixed by 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 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 of incorporation 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.

In many 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. 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).

#### **§ 8.04 Election of Directors by Certain Classes or Series of Shares**

If the articles of incorporation or action by the board of directors pursuant to section 6.02 authorize dividing the shares into classes or series, the articles of incorporation may also authorize the election of all or a specified number of directors by the holders of one or more authorized classes or series of shares. A class or series (or multiple classes or series) of shares entitled to elect one or more directors is a separate voting group for purposes of the election of directors.

#### **CROSS-REFERENCES**

Classes and series of shares, see § 6.01.

Cumulative voting, see § 7.28.

Removal of directors, see §§ 8.08 and 8.09.

Voting by voting groups, see §§ 7.25 and 7.26.

Voting for directors, see § 7.28.

“Voting group” defined, see § 1.40.

#### **OFFICIAL COMMENT**

Provisions allowing separate classes or series of shares each to elect a specified number of directors are often used in corporations to effect an agreed upon allocation of control, for example, to ensure representation on the board of directors by particular shareholders by issuing to those shareholders a class or series of shares entitled to elect one or more directors. Each class or series (or multiple classes or series) entitled to elect separately one or more directors constitutes a separate voting group for this purpose, and the quorum and voting requirements must be separately met by each voting group as provided in 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.
- Number of directors, see § 8.03.
- Removal of directors, see §§ 8.08 and § 8.09.
- Resignation of directors, see § 8.07.
- Staggered terms for directors, see § 8.06.
- Vacancies on board of directors, 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.

Under section 8.05(d), if terms are staggered, 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 staggered terms established or fixed by the articles of incorporation or bylaws.

Section 8.05(e), with two exceptions, provides for "holdover" directors so that directorships do not automatically become vacant at the expiration of their terms. This means that the power of the board of directors to act continues uninterrupted even if an annual shareholders' meeting is not held or the shareholders are deadlocked or otherwise do not elect directors at the meeting. The articles of incorporation may modify or eliminate this holdover concept. Also, 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 past the abbreviated 90-day 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 half or one-third 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 elected 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, see § 7.28.

Number of directors, see § 8.03.

Removal of directors, see §§ 8.08 and 8.09.

Resignation of directors, see § 8.07.

Terms of directors, see § 8.05.

Vacancies on board of directors, see § 8.10.

## OFFICIAL COMMENT

Section 8.06 permits the practice of “classifying” the board or “staggering” the terms of directors. The requirement that these provisions be in the articles of incorporation ensures that, unless included in the corporation’s original articles, a staggered board may only be implemented with shareholder approval.

### § 8.07 Resignation of Directors

- (a) A director may resign at any time by delivering a written notice of resignation to the board of directors or its chair, or to the secretary.
- (b) A resignation is effective as provided in section 1.41(i) unless the resignation provides for a delayed effectiveness, including effectiveness determined upon a future 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” defined, see § 1.40.

Notices and other communications, see § 1.41.

“Secretary” defined, see § 1.40.

Vacancies on board of directors, see § 8.10.

## OFFICIAL COMMENT

In addition to permitting resignations effective at a date later than the date of delivery of the resignation, section 8.07(b) permits a director resignation to be conditioned upon “future events,” which might include the director failing to achieve a specified vote for reelection, *e.g.*, more votes “for” than “against” coupled with board acceptance of the resignation. Corporations and individual directors may thus 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. Section 8.07(b) also makes 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.

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, but the new director may not take office until the vacancy occurs. Because the individual tendering that resignation 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.

### **§ 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) A director may be removed if the number of votes cast to remove exceeds the number of votes cast not to remove the director, except to the extent the articles of incorporation or bylaws require a greater number; provided that if cumulative voting is authorized, a director may not be removed if, in the case of a meeting, the number of votes sufficient to elect the director under cumulative voting is voted against removal and, if action is taken by less than unanimous written consent, voting shareholders entitled to the number of votes sufficient to elect the director under cumulative voting do not consent to the removal.
- (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 removal of the director is a purpose of the meeting.

### **CROSS-REFERENCES**

Cumulative voting, see § 7.28.

Election of directors by certain classes or series of shares, see § 8.04.

Election of directors, see § 7.28.

Notice of meeting, see § 7.05.

Quorum and voting requirements for voting groups, see § 7.25.

Removal of directors by judicial proceeding, see § 8.09.

Shareholders' meetings, see §§ 7.01 through 7.03.

“Voting group” defined, see § § 1.40.

### **OFFICIAL COMMENT**

Section 8.08(a) provides a default rule that shareholders have the power to change the directors at will. However, that section permits the power to remove directors without cause to be eliminated by a provision in the articles of incorporation. Section 8.08(c) assures 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. In computing whether a director elected by cumulative voting is protected from removal under that section, the votes should be counted as though (i) the vote to remove the director occurred in an election to elect the number of directors normally elected by the relevant voting group along with the director whose removal is sought, (ii) the number of votes cast cumulatively against removal had been cast for election of the director, and (iii) 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.

Although sections 8.08(b) and (c) have specific requirements with respect to removal of directors elected by particular voting groups or by cumulative voting, such directors nevertheless may be removed by court proceeding under section 8.09. Section 8.08(d) acknowledges the seriousness of director removal by requiring the meeting notice to state that removal of specific directors will be proposed. Section 8.08(d) governs removal of directors at a meeting of shareholders, but does not

preclude removal by means of shareholder action by written consent under section 7.04. Unless cumulative voting is authorized, and in the absence of a greater vote requirement in the articles of incorporation or bylaws, removal of a director by less than unanimous written consent would require that a majority of the outstanding shares of the relevant voting group consent to the removal.

### **§ 8.09 Removal of Directors by Judicial Proceeding**

- (a) The [name or describe court] may remove a director from office or may order other relief, including barring the director from reelection for a period prescribed by the court, in a proceeding commenced by or in the right of the corporation if the court finds that (i) 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 (ii) considering the director's course of conduct and the inadequacy of other available remedies, removal or such other relief would be in the best interest of the corporation.
- (b) A shareholder proceeding on behalf of the corporation under subsection § 8.09(a) shall comply with all of the requirements of subchapter 7D, except clause (i) of section 7.41.

### **CROSS-REFERENCES**

Derivative proceedings, see §§ 7.40 through 7.47.

Director standards of conduct, see § 8.03.

“Proceeding” defined, see § 1.40.

Removal of directors 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 removal under section 8.08. A proceeding under section 8.09 may be brought by the corporation or by a shareholder suing derivatively. If an action is brought derivatively, all of the provisions of chapter 7D, including dismissal under section 7.44, are applicable to the action with the exception of the contemporaneous ownership requirement of clause (i) of section 7.41. This extraordinary remedy of judicial removal is only for the kind of misconduct described in clause (i) of section 8.09(a) and does not reach matters falling within an individual director's lawful exercise of business judgment.

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 if shareholder removal under section 8.08 is impracticable because of situations such as the following:

- The director charged with serious misconduct personally owns or controls sufficient shares to block removal.
- 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.
- 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.

### **§ 8.10 Vacancy on Board of Directors**

- (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 are less than a quorum, 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 remaining directors elected by that voting group, even if less than a quorum, 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 of directors by certain classes or series of shares, see § 8.04.

Number of directors, see § 8.03.

Quorum and voting of directors, see § 8.24.

Removal of directors, see §§ 8.08 and 8.09.

Resignation of directors, see § 8.07.

Shareholders' meetings, see §§ 7.01 through 7.03.

Terms of directors, see § 8.05.

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

“Voting group” defined, see § 1.40.

### **OFFICIAL COMMENT**

Section 8.10(a)(a)(3) allows the directors remaining in office to fill director vacancies even though they do not constitute a quorum. The test for the exercise of this power is whether the directors remaining in office are less than a quorum, not whether the directors seeking to act are less 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)(a)(3) at a “meeting” attended by only three directors. Even though the three directors are less than a quorum, section 8.10(a)(3) is not applicable because the number of directors remaining in office—four—is not less than a quorum.

Section 8.10(b) 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).

Under section 8.10(c), the director in the office that will become vacant may participate in the selection of a successor. Such a vacancy typically arises when there is a resignation by a director that is 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 of power the resignation would otherwise cause.

### **§ 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**

Committees of board of directors, see § 8.25.

Director's conflicting interest transaction, see ch. 8F.

Director standards of conduct, see § 8.30.

#### **OFFICIAL COMMENT**

Section 8.11 reflects the view that director compensation is an appropriate function of the board of directors. Board action on directors' compensation and benefits is a director's conflicting interest transaction subject to chapter 8F. See Official Comment to section 8.61, Note on Directors' Compensation.

## **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 restricted by the articles of incorporation or bylaws, any or all directors may participate in any meeting of the board of directors 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.

Notice of meeting, see § 8.22.

Quorum and voting, see § 8.24.

Waiver of meeting notice, see § 8.23.

#### **OFFICIAL COMMENT**

Section 8.20 provides flexibility with respect to holding meetings of directors. Under section 8.20, a meeting in which any or all of the directors participate through any means of communication that complies with section 8.20(b) will meet the statutory requirements. Depending on the nature of the matters to be considered at the meeting, however, a board of directors may wish to consider whether holding an in-person meeting at which some or all directors are physically present provides greater opportunity for interchange.

### **§ 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 a later time as the time at which the action taken is to be effective. A director's consent may be withdrawn by a revocation signed by the director and delivered to the corporation before 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**

Notices and other communications, see § 1.41.

Notice of meeting, see § 8.22.

Waiver of meeting notice, see § 8.23.

### **OFFICIAL COMMENT**

Directors may take action by written consent without a meeting only when approval of an action is unanimous. Accordingly, if a director abstains, is recused or withholds consent on an action, the action could not be authorized by consent, and a meeting would need to be held for the action to be approved.

### **§ 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 shall 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.

Meetings of board of directors, see §§ 8.20 and 8.21.

Notices and other communications, see § 1.41.

Waiver of meeting notice, see § 8.23.

### **OFFICIAL COMMENT**

Unlike regular meetings of the board of directors, special meetings always require notice, the timing of which may be varied by the articles of incorporation or bylaws. The notice may be

written, or oral if oral notice is reasonable in the circumstances. See section 1.41(a). No statement of the purpose of any meeting of the board of directors is necessary in the notice unless required by the articles of incorporation or bylaws. These requirements differ from the requirements applicable to meetings of shareholders because of the fundamental differences in the roles and involvement of directors and shareholders.

### **§ 8.23 Waiver of Notice**

- (a) A director may waive any notice required by this Act, the articles of incorporation or the bylaws before or after the date and time stated in the notice. Except as provided by subsection § 8.23(b), the waiver must be in writing, signed by the director entitled to the notice and delivered to the corporation for filing by the corporation 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 after objecting 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.

Notices and other communications, see § 1.41.

Notice of meeting, see § 8.22.

### **OFFICIAL COMMENT**

If a director actually attends the meeting, section 8.23(b) generally provides the director may not subsequently raise an objection based on lack of notice. If a director does wish to object, he or she must call attention to the lack of notice at the outset of the meeting or promptly upon arriving and not vote for any action taken at the meeting. That director may then attack the validity of any action taken at the meeting on the grounds of lack of notice, as may any other director who was not given notice and was not present at the meeting.

### **§ 8.24 Quorum and Voting**

- (a) Unless the articles of incorporation or bylaws provide for a greater or lesser number or unless otherwise expressly provided in this Act, a quorum of a board of directors consists of a majority of the number of directors specified in or fixed in accordance with the articles of incorporation or bylaws.
- (b) The quorum of the board of directors specified in or fixed in accordance with the articles of incorporation or bylaws may not consist of less than one-third of the specified or fixed number of directors.
- (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 or unless otherwise expressly provided in this Act.



- (d) A director who is present at a meeting of the board of directors or a committee when corporate action is taken is deemed to have assented to the action taken unless: (i) the director objects at the beginning of the meeting (or promptly upon arrival) to holding it or transacting business at the meeting; (ii) the dissent or abstention from the action taken is entered in the minutes of the meeting; or (iii) 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.

Committees of board of directors, see § 8.25.

Meetings of board of directors, see § 8.20.

Notices and other communications, see § 1.41.

Number of directors, see § 8.03.

Quorum for determination of advance for expenses, see § 8.53.

Quorum for determination and authorization of indemnification, see § 8.55.

## **OFFICIAL COMMENT**

In the absence of a provision in the articles of incorporation or bylaws, a quorum is a majority of the total number of directors specified (*e.g.*, “the number of directors shall be X”) in or fixed (*e.g.*, “the number of directors shall be not less than Y or more than Z as determined by the board of directors”) in accordance with the articles of incorporation or the bylaws.

Section 8.24(a) 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 allows the articles of incorporation or bylaws to decrease the required quorum (but not below one-third) or to increase the quorum or the vote necessary to take action up to and including unanimity. 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 options to increase the quorum and vote requirements might be used, for example, 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.

If a director who is present at a meeting wishes to object or abstain with respect to action taken by the board of directors or a committee, that director must make his or her position clear in one of the ways described in section 8.24(d). If objection is made in the form of a written dissent under clause (iii) of section 8.24(d), it may be transmitted by any form of delivery authorized by the definition of that term in section 1.40, including electronic transmission, if authorized by section 1.41. Section 8.24(d) serves the important purpose of bringing the position of the dissenting director clearly to the attention of the other directors. The provision that a director who is present is deemed to have assented unless an objection is noted also prevents a

director from later seeking to avoid responsibility because of unexpressed doubts about the wisdom 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 of the Board**

- (a) Unless this Act, the articles of incorporation or the bylaws provide otherwise, a board of directors may establish one or more board committees composed exclusively of one or more directors to perform functions of the board of directors.
- (b) The establishment of a board committee and appointment of members to it shall be approved by the greater of (i) a majority of all the directors in office when the action is taken or (ii) the number of directors required by the articles of incorporation or bylaws to take action under section 8.24, unless, in either case, this Act or the articles of incorporation provide otherwise.
- (c) Sections 8.20 through 8.24 apply to board committees and their members.
- (d) A board committee may exercise the powers of the board of directors under section 8.01, to the extent specified by the board of directors or in the articles of incorporation or bylaws, except that a board committee may not:
  - (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 § 8.25(e), on any board committees; or
  - (4) adopt, amend, or repeal bylaws.
- (e) The board of directors may appoint one or more directors as alternate members of any board committee to replace any absent or disqualified member during the member's absence or disqualification. If the articles of incorporation, the bylaws, or the resolution creating the board committee so provide, the member or members present at any board committee meeting and not disqualified from voting may, by unanimous action, appoint another director to act in place of an absent or disqualified member during that member's absence or disqualification.

### **CROSS-REFERENCES**

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

Amendment of bylaws, see ch. 10B.

Conversions, see ch. 9C.

Derivative proceedings, see §§ 7.40 through 7.47.

Director standards of conduct, see § 8.30.

Disposition of assets, see ch. 12.

Dissolution, see ch. 14.

“Distribution” defined, see § 1.40.

Distributions to shareholders, see § 6.40.

Domestications, see ch. 9B.

Functions of board of directors, see § 8.01.

Indemnification determination and authorization, see § 8.55.

Issuance of shares, see §§ 6.01 and 6.02.

Mergers and share exchanges, see ch. 11.

Quorum and voting, see § 8.24.

Reacquisition of shares, see §§ 6.03 and 6.31.

Vacancies on board of directors, see § 8.10.

## **OFFICIAL COMMENT**

Section 8.25 deals only with board committees authorized to perform functions of the board of directors. The board of directors or management, independently of section 8.25, may establish non-board committees composed in whole or in part of directors, employees, or others to address matters in ways that do not constitute performing functions required to be performed by the board of directors under section 8.01, including acting in an advisory capacity.

Under section 8.25(a), except as otherwise provided by the Act, the articles of incorporation or the bylaws, a board committee may 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 board committee or where only one board member is disinterested or independent with respect to a matter. Various other sections of the 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)(2)), a determination that indemnification is permissible (section 8.55(b)(1)), an approval of a director’s conflicting interest transaction (section 8.62(a)), and disclaimer of the corporation’s interest in a business opportunity (section 8.70(a)).

The requirement of section 8.25(b) that, unless the Act or the articles of incorporation otherwise provide, a board committee 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 bylaws, reflects the importance of the decision to invest board committees with power to act under section 8.25. Sections 7.44(b), 8.55(b), 8.62(a) and 8.70 contain exceptions to this rule.

The limitations in section 8.25(d)(1) through (4) are based on the principle that the listed actions so substantially affect the rights of shareholders or are so fundamental to the governance of the corporation that they should be determined by the full board and not delegated to a committee. On the other hand, section 8.25(d) allows board committees to take many actions that may be material, such as the authorization of long-term debt and capital investment or the issuance of shares.

Although section 8.25(d)(1) generally makes nondelegable the decision whether to authorize or approve distributions, including dividends, it does permit the delegation to a board 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 of directors could set a dollar range and timeframe

for a prospective dividend and delegate to a board committee the authority to determine the exact amount and record and payment dates of the dividend. The board of directors also could establish certain conditions to the payment of a distribution and delegate to a board committee the power to determine whether the conditions have been satisfied.

Section 8.25(e) is a rule of convenience that permits the board of directors or the other board committee members to replace an absent or disqualified member during the time that the member is absent or disqualified. Unless otherwise provided or unless a quorum is no longer present, replacement of an absent or disqualified member of a committee is not necessary to permit the other committee members to continue to perform their duties.

### **§ 8.26 Submission of Matters for Shareholder Vote**

A corporation may agree to submit a matter to a vote of its shareholders even if, after approving the matter, the board of directors determines it no longer recommends the matter.

### **CROSS-REFERENCES**

Action on a plan of:

conversion, see § 9.32.

domestication, see § 9.21.

merger or share exchange, see § 11.04.

Amendment of articles, see § 10.03.

Disposition of assets, see § 12.02.

Dissolution, see § 14.02.

### **OFFICIAL COMMENT**

Section 8.26 authorizes a corporation to enter into an agreement, such as a merger agreement, containing a provision that requires a shareholder vote on the matter despite a subsequent change in the recommendation of the board of directors. Otherwise, a board is not required to submit a matter to the shareholders, even if it has been approved by the board. Section 8.26 also applies to the provisions of the Act that require the board of directors to approve a matter before recommending that the shareholders vote to approve it. Section 8.26 does not change the standards of conduct or liability applicable when considering whether to authorize such agreement by the corporation.

## **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:
  - (i) in good faith, and
  - (ii) 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 board committee, 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 board 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 board 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 board 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 board committee 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.
- Derivative proceedings, see §§ 7.40 through 7.47.
- Director's conflicting interest transactions, see ch. 8F.
- Functions of board of directors, see § 8.01.
- Indemnification, see § 8.50 through § 8.59.
- Meetings of board of directors, see §§ 8.20 and 8.21.
- Quorum of directors, see § 8.24.
- Removal of directors, see §§ 8.08 and 8.09.
- Standards of conduct for officers, see § 8.42.
- Standards of liability for directors, see § 8.31.
- Unlawful distributions, see § 8.32.

## **OFFICIAL COMMENT**

Section 8.30 sets standards of conduct for directors that focus on the manner in which directors make their decisions, not the correctness of the decisions made. Section 8.30 should be

read in light of the basic role of directors set forth in section 8.01(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 of directors,” as supplemented by various provisions of the Act assigning specific powers or responsibilities to the board. The standards of conduct for directors established by section 8.30 are analogous to those generally articulated by courts in evaluating director conduct, often referred to as the duties of care and loyalty.

Section 8.30 addresses standards of conduct—the level of performance expected of directors undertaking the role and responsibilities of the office of director. The section does not address the liability of a director, although exposure to liability may result from a failure to honor the standards of conduct required to be observed. The issue of director liability is addressed in sections 8.31 and 8.32. 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 also serves as a frame of reference for determining, under section 8.32(a), liability for an unlawful distribution. Finally, section 8.30 compliance may influence a court’s analysis where injunctive relief against a transaction is being sought. Directors act both individually and collectively as a board in performing their functions and discharging their duties. Section 8.30 addresses actions in both capacities.

Under the standards of section 8.30, the board may delegate or assign to appropriate officers or employees of the corporation the authority or duty to exercise powers that the law does not require the board to retain. Because the directors are entitled to rely on these persons absent knowledge making reliance unwarranted, the directors will not be in breach of the standards under section 8.30 as a result of their delegates’ 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 addition, subsections (d), (e) and (f) permit a director to rely on enumerated third parties for specified purposes, although reliance is prohibited when a director has knowledge that makes reliance unwarranted. Section 8.30(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 and its mandate governs all aspects of directors’ conduct, including the requirements in other subsections. It includes concepts courts have used in defining the duty of loyalty. Two of the phrases used in section 8.30(a) deserve further comment:

- 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.” Although a director has wide discretion in gathering information 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, taking into account that director’s knowledge and experience, have arrived at that belief) ultimately involves an overview that is objective in character.

- The phrase “best interests of the corporation” is key to an understanding 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 of shareholders or other corporate constituencies may differ.

Section 8.30 operates as a “baseline” principle governing director conduct in circumstances uncomplicated by self-interest. The Act recognizes, however, that directors’ personal interests may not always align with the corporation’s best interests and provides procedures by which situations and transactions involving conflicts of interest can be processed. See subchapter D (derivative proceedings) of chapter 7 and subchapters E (indemnification and advance for expenses), F (directors’ conflicting interest transactions), and G (business opportunities) of this chapter 8. Those procedures generally contemplate that the interested director will provide appropriate disclosure and will not be involved in taking action on the matter giving rise to the conflict of interest.

## 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. Although certain aspects will involve individual conduct (*e.g.*, preparation for meetings), these functions are generally performed by the board of directors through collective action, as recognized by the reference in subsection § 8.30(b) to board and committee “members” and “their duties.” In contrast with section 8.30(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 used collectively by the directors when performing those functions. 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 section 8.30(b) involves an objective standard.

The process by which a director becomes informed, in carrying out the decision-making and oversight functions, will vary. The directors’ decision-making function is reflected in various sections of the Act, including: the issuance of shares (section 6.21); distributions (section 6.40); dismissal of derivative proceedings (section 7.44); indemnification (section 8.55); conflict of interest transaction authorization (section 8.62); articles of incorporation amendments (sections 10.02 and 10.03); bylaw amendments (section 10.20); mergers and share exchanges (section 11.04); asset dispositions (section 12.02); and dissolution (section 14.02). The directors’ oversight function is established under section 8.01. In discharging the section 8.01 duties associated with the board’s oversight function, the standard of care entails primarily a requirement 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 attention of the directors 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:

- 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 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 or participation in the deliberations leading up to a vote. In addition to considering information and data on which a director is expressly entitled to rely under section 8.30(e), “becoming informed” can also involve consideration of information and data generated by other persons, for example, review of industry studies or research articles prepared by third parties. 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.

- The phrase “devoting attention,” in the context of the oversight function, refers to considering such matters as the corporation’s information and reporting systems generally and not to an independent investigation into particular system inadequacies or noncompliance. Although directors typically give attention to future plans and trends as well as current activities, they should not be expected to anticipate any particular 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 appropriate systems have been established, such as those concerned with legal compliance, risk assessment or internal controls. Such assurances also should cover establishment of ongoing monitoring of the systems in place, with appropriate follow-up responses when alerted to the issues requiring attention.
- The reference to “person,” without embellishment, is intended to avoid implying any qualifications, such as specialized expertise or experience requirements, beyond the basic attributes of common sense, practical wisdom, and informed judgment (however, see the last bullet below).
- The phrase “reasonably believe appropriate” refers to the array of possible options that a person possessing the basic 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 section 8.30(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 is an abuse of discretion, will not satisfy the standard.
- 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.
- The combined phrase “in a like position ... under similar circumstances” is intended to recognize that (i) 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, (ii) decisions must be made on the basis of the information known to the directors without the benefit of hindsight, and (iii) the special background, qualifications, and oversight responsibilities of a particular director may be relevant in evaluating that director's compliance with the standard of care.

### 3. *Section 8.30(c)*

A requirement to disclose to other directors information that a director knows to be material to the decision-making or oversight functions of the board of directors or a board committee is implicit in the standards of conduct set forth in sections 8.30(a) and (b), but section 8.30(c) makes this explicit. Thus, for example, when a member of the board of directors knows information that the director recognizes is material to a decision by the board but is not known to the other directors, the director is obligated to disclose that information to the other members of the board. Such disclosure 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 information.

Section 8.30(c) recognizes that a duty of confidentiality to a third party can override a director's obligation to share with other directors information pertaining to a current corporate matter. In some circumstances, a duty of confidentiality to a third party 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 to a third party 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 withholding of material information may, depending on the nature of the material information and of the matter before the board of directors or a board committee, require that a director abstain or recuse himself or herself from all or a portion of the other directors' deliberation or vote on the matter to which the undisclosed information is material, or even resign as a director. See Official Comment to section 8.62.

In connection with a director's conflicting interest transaction, the required disclosure (as defined in section 8.60) that must be made under section 8.62(a) 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 conflicting 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)(1) for deliberation and a 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 decisions. Although they may be different from the generally applicable provisions of section 8.30(c), the specific provisions of subchapter 8F control and are exclusive with respect to director conflicting interest transactions.

The requirement that a director disclose information to other directors as set forth in section 8.30(c) is different from any common law duty the board may have to cause the corporation to make disclosures to shareholders under certain circumstances. The Act does not seek to codify such a duty of disclosure, 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 described in section 8.30(d) may take a variety of forms, including (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). Under section 8.30(d), a director may properly rely on those to whom authority has been delegated pursuant to section 8.30(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 controls, 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 persons 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 section 8.25 and its Official Comment for discussion of delegation to committees of the authority of the board under section 8.01. By employing the concept of delegation, the Act 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).

Although the board of directors may delegate the authority or duty to perform one or more of its functions, delegation and reliance under section 8.30(d) may not alone constitute compliance with sections 8.30(a) and (b) and the action taken by the delegatee may not alone satisfy the directors or a noncommittee board member's section 8.01 responsibilities. On the other hand, failure of the board committee or the corporate officer or employee performing the function delegated to meet section 8.30(b)'s standard of care will not automatically result in violation by the board of section 8.01. Factors to be considered in determining whether a violation of section 8.01 has occurred 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 reasonably 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 satisfied, 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 who is accountable for the acts of delegates will fulfill the director's duties if the standards contained in section 8.30 are met.

5. *Section 8.30(e)*

Reliance under section 8.30(e) on a report, statement, opinion, or other information is permitted only if the director has read or heard orally presented the information, opinion, report or statement in question, 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. *Section 8.30(f)*

In determining whether a corporate officer or employee is “reliable,” for purposes of section 8.30(f)(1), 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 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 reliance on shared experience and wisdom of other board members is an implicit underpinning of collective board 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.

Advisers on whom a director may rely under section 8.30(f)(2) include not only licensed professionals, 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 appraisers. The adviser could be an individual or an organization, such as a law or investment banking 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 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 engage a private investigator to inquire into a particular matter (*e.g.*, follow up on rumors about a senior executive’s alleged misconduct) and properly rely on the private investigator’s report.

Section 8.30(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. There also might be reliance upon an investigation undertaken by a board committee and reported to the full board, which forms the basis for a decision by the board of directors not to take dispositive action. Another example is reliance on a board committee, such as an 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. In parallel with section 8.30(f)(2)(ii), the concept of "confidence" is used instead of "competence" 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." Depending on the circumstances, the reliance contemplated by section 8.30(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. Ordinarily, after making an initial judgment that a committee (of which a director is not a member) merits confidence, a director may continue to rely on that committee so long as the director has no reason to believe that confidence is no longer warranted.

#### 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 principles set forth in 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 by section 2.02(b)(6), (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 for such inquiry; 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 (i) 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, (ii) 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 8.32 or a transactional interest under section 8.61, or (iii) 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**

Business opportunities, see ch. 8G.

Derivative proceedings, see §§ 7.40 through 7.47.

Director's conflicting interest transactions, see ch. 8F.

Expanding indemnification by provision in articles of incorporation, see § 2.02.

Functions of board of directors, see § 8.01.

Indemnification and advance for expenses, see §§ 8.50 through 8.59.

Limiting director liability by provision in articles of incorporation, see § 2.02.

Removal of directors by judicial proceeding, see § 8.09.

Standards of conduct for directors, see § 8.30.

Unlawful distributions, see § 8.32.

## **OFFICIAL COMMENT**

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 have been unwise or the result of a mistake of judgment, it is not reasonable to impose liability for an

informed decision made in good faith which with the benefit of hindsight turns out to be wrong or unwise. Therefore, as a general rule, a director is not exposed to personal liability for injury or damage caused by an unwise decision and conduct conforming with the standards of section 8.30 will almost always be protected regardless of the end result. Moreover, the fact that a director's performance fails to meet the standards of section 8.30 does not in itself establish personal liability for damages that the corporation or its shareholders may have suffered as a consequence. Nevertheless, a director can be held liable for misfeasance or nonfeasance in performing his or her duties. Section 8.31 sets forth the standards of liability of directors as distinct from the standards of conduct set forth in section 8.30.

Courts have developed the broad common law concept of the business judgment rule. Although formulations vary, in basic principle, a board of directors generally 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 the board's decisions can be attributed to any rational business purpose. It is also 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. The elements of the business judgment rule and the circumstances for its application continue to be developed and refined by courts. Accordingly, it would not be desirable to freeze the concept in a statute. Thus, section 8.31 does not codify the business judgment rule as a whole, although certain of its principal elements, relating to personal liability issues, are reflected in section § 8.31(a)(2).

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#### *Note on Directors' Liability*

A director's exposure to financial liability (*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:

- *Articles of incorporation limitations.* 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 exceptions prescribed in that section that preclude the elimination of liability. If the matter involves a director's taking of a business opportunity and an articles of incorporation provision has been adopted under section 2.02(b)(6) eliminating directors' duties with respect to those opportunities, there also will be no liability. See section 2.02 and its Official Comment.
- *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) 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 8F.
- *Business opportunities safe harbors.* Similarly, if the matter involves a director's pursuit or taking of a business opportunity, there is no liability for that director if (i) an applicable limitation or elimination of any duty to offer that business opportunity has been adopted pursuant to section 2.02(b)(6), or (ii) a safe harbor procedure under section 8.70 has been properly implemented, even if the articles of incorporation contain no provision under section 2.02(b)(6). See subchapter 8G.

- *Business judgment rule.* If a provision in the articles of incorporation adopted pursuant to section 2.02(b)(4) or (6) or a safe harbor procedure under section 8.61 or § 8.70 does not shield the director's conduct from liability, the presumptions, standards of judicial review and procedural matters related to the business judgment rule may insulate the director from liability for conduct in connection with a corporate decision.
- *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.
- *Other liability for money payment.* Aside from a claim for damages, the director may have monetary liability for other reasons, for example, if corporate resources have been used without proper authorization, or a claim for disgorgement of short-swing trading profits under section 16(b) of the Securities Exchange Act of 1934.
- *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.
- *Corporate indemnification.* If the director is monetarily liable, the director may be indemnified by the corporation for any payments made and expenses incurred, depending upon the circumstances. See subchapter 8E.
- *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 and grounds for liability come within the coverage under directors' and officers' liability insurance that has been purchased by the corporation as authorized under section 8.57.

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### 1. Section 8.31(a)

#### A. SECTION 8.31(A)(1)—AFFIRMATIVE DEFENSES

Under section 8.31(a)(1), if a provision in the articles of incorporation (i) (adopted pursuant to section 2.02(a)(4)) shelters the director from liability for money damages, or (ii) (adopted pursuant to section 2.02(b)(6) limits or eliminates any duty to offer the particular business opportunity to the corporation, or if a safe harbor procedure under sections 8.61(b)(1) or § 8.61(b)(2) or section 8.70(a)(1) shelters the director's conduct in connection with a conflicting interest transaction or the pursuit or 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, dismissal or summary judgment would presumably be granted with respect to those claims. Termination of the proceeding or dismissal of claims on the basis of a provision in the articles of incorporation or a safe harbor procedure 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 sections 8.61

and 8.70, the directors approving the conflicting interest transaction or approving a director's taking of the business opportunity will presumably be protected as well, because compliance with the relevant standards of conduct under section 8.30 is important for their action to be effective and because, 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 section 8.31(a)(a)(1), section 8.31(a)(2) provides the basis for evaluating whether the conduct in question can be challenged. One of the elements in section 8.31(a)(2) must be established for a director to have liability under section 8.31.

#### B. SECTION 8.31(A)(2)(I)—GOOD FAITH

It is a basic standard under section 8.31(a)(a)(2)(i) that a director's conduct in performing his or her duties be in good faith. If a director's conduct can be successfully challenged pursuant to other clauses of section 8.31(a)(2), there is a substantial likelihood that the conduct in question will also present an issue of good faith implicating section 8.31(a)(a)(2)(i). Similarly, if section 8.31(a)(2) included only subsection § 8.31(a)(2)(i), much of the conduct with which the other clauses are concerned could still be considered under that subsection, on the basis that such conduct evidenced the director's lack of good faith. Where conduct has not been found deficient on other grounds, decision-making outside the bounds of reasonable judgment can give rise to an inference of bad faith. That form of conduct, sometimes characterized as "reckless indifference" or "deliberate disregard," giving rise to an inference of bad faith can also raise a question whether the director could have reasonably believed that the best interests of the corporation would be served. These issues could arise, for example, in approval of conflicting interest transactions. See the Official Comment to section 8.61.

#### C. SECTION 8.31(A)(2)(II)—REASONABLE BELIEF

Liability under section 8.31(a)(2)(ii) turns on a director's reasonable belief with respect to the nature of his or her decision and the degree to which he or she has become informed. In each case, the director must have an actual subjective belief and, so long as it is his or her honest and good faith belief, a director has wide discretion. There is also an objective element to be met, in that the director's belief must also be reasonable. The inquiry is similar to that in section 8.30(a)—could a reasonable person in a like position and acting in similar circumstances have arrived at that belief? 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.*, if the director has undertaken no preparation and is completely uninformed), the director's judgment will not be sustained.

#### D. SECTION 8.31(A)(2)(III)—LACK OF OBJECTIVITY OR INDEPENDENCE

If the matter at issue involves a director's transactional interest, such as a "director's conflicting interest transaction" in which a "related person" is involved (see section 8.60), it will be governed by section 8.61; otherwise, a lack of objectivity due to a relationship's influence on the director's judgment will be evaluated, in the context of the pending challenge of director conduct, 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. For example, the closeness or nature of the relationship with the person allegedly exerting influence on the director could be a factor. If the director is required under section 8.31(a)(a)(2)(iii)(B) to establish that the action taken by him or her was reasonably believed to be in the best interests of the corporation, the inquiry will involve the elements of actual subjective belief and objective reasonableness similar to those found in section 8.31(a)(2)(ii) and section 8.30(a).

To call into question the director's objectivity or independence on the basis of a person's relationship with, or exertion of dominance over, the director, the person must have a material interest in the challenged conduct. 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 of directors or a board committee will cross the materiality threshold, but not always—and would then consider the materiality of that person's interest in the matter. The possibility that a director's judgment would be adversely affected by another's interest in a transaction or conduct that is not material, or another's immaterial interest in a transaction or conduct, is sufficiently remote that it should not be made subject to judicial review.

In situations where there may be a lack of objectivity, domination, a conflict of interest or divided loyalty, or even where there may be grounds for the issue to be raised, the better course to follow where board or committee action is required is usually for the director to disclose the facts and circumstances posing the possible issue, 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 may then take appropriate action as contemplated by section 8.30 (or section 8.61 if applicable). If this course is followed, the director's conduct respecting the matter in question should be beyond challenge.

#### E. SECTION 8.31(A)(2)(IV)—FAILURE TO DEVOTE ATTENTION

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. Although 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 by a director to devote attention, not a brief distraction or temporary interruption. Also embedded in the oversight function is the need to inquire when suspicions are aroused. This need to inquire is not a component of ongoing oversight, and does not entail proactive vigilance, but arises under section 8.31(a)(2)(iv) 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) surface.

#### F. SECTION 8.31(A)(2)(V)—IMPROPER FINANCIAL BENEFIT AND OTHER BREACHES OF DUTIES

Subchapter 8F deals in detail with directors' transactional interests. Its coverage of those interests is exclusive and its safe harbor procedures for director's 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.

There is no materiality threshold that applies to a financial benefit to which a director is not properly entitled. The Act observes this principle in several places, for example, the exception to liability elimination prescribed in section 2.02(a)(4)(i) and the indemnification restriction in section 8.51(d)(2), as well as the liability standard in section 8.31(a)(2)(v).

The second clause of section 8.31(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 principles that can give rise to liability for directors. As developed in the case law, these actionable breaches may include unauthorized use of corporate property or information (which as noted above, might also be characterized as receipt of an improper financial benefit), unfair competition with the corporation or the taking of a corporate opportunity. In the case of corporate opportunity, if the director is alleged to have wrongfully diverted a business opportunity as to which the corporation had a prior right, the Act provides two possible safe harbors. First, any duty to offer the business opportunity to the corporation may have been limited or eliminated pursuant to a provision in the articles of incorporation authorized by section . Second, section 8.70(a)(1) provides a safe harbor procedure for a director who wishes to pursue or 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 procedure of section 8.70(a)(1) does not create an implication 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.

## 2. *Section 8.31(b)*

Whether a corporation or its shareholders have suffered harm and whether a particular director’s conduct was the proximate cause of that harm may be affected by the collective nature of board action. 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 section 8.31(a)(2)(ii)(B) by reason of having been uninformed about the decision or not reading the materials distributed before the meeting, or arriving late at the board meeting just in time for the vote but, nonetheless, voting in favor solely because the others were in favor—the favorable action by a quorum of properly informed directors would ordinarily protect the director against liability, either because there was no harm or the offending director’s actions were not the proximate cause of the harm. Although the concept of “proximate cause” is a term of art that is basic to tort law, for purposes of section 8.31(b)(1), a useful approach for the concept’s application would be that the challenged conduct must have been a “substantial factor in producing the harm.”

## 3. *Section 8.31(c)*

Section 8.31(c) expressly disclaims any shift of the burden of proof otherwise applicable where the question of the fairness of a transaction or other challenged conduct is at issue. This is the case

whether the question of fairness arises under another section of the Act, such as section 8.61, under existing case law, under a judicial requirement in a particular instance or otherwise. Similarly, section 8.31 does not affect liability under other sections of the Act. It also does not foreclose any rights of the corporation or its shareholders under other laws, for example, rights of shareholders or the corporation under applicable federal securities laws. In addition, directors can have liability to persons other than the corporation and its shareholders, such as liability to employee benefit plan participants and beneficiaries (who may or may not be shareholders), if the directors are determined to be fiduciaries under other applicable laws, to government agencies for regulatory violations or to individuals claiming damages for injury governed by tort-law concepts (*e.g.*, libel or slander). Section 8.31 is not intended to change the standards applicable under these other laws or legal principles.

### **§ 8.32 Directors' Liability for Unlawful Distributions**

- (a) A director who votes for or assents to a distribution in excess of what may be 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 § 8.32(a) for an unlawful distribution is entitled to:
  - (1) contribution from every other director who could be held liable under subsection § 8.32(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 § 8.32(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 § 8.32(b) is barred unless it is commenced within one year after the liability of the claimant has been finally adjudicated under subsection § 8.32(a).

### **CROSS-REFERENCES**

Director duties in dissolution, see § 14.09.

Director standards of conduct, see § 8.30.

“Distribution” defined, see § 1.40.

Distributions to shareholders, see § 6.40.

Indemnification, see §§ 2.02 and 8.50 through 8.59.

Limiting director liability by provision in articles of incorporation, see § 2.02.

### **OFFICIAL COMMENT**

A director whose conduct, in voting for or assenting to a distribution, is challenged under section 8.32 will have no liability unless the complaining party establishes a breach of the relevant standards of section 8.30, for example a failure to act with the care required by section § 8.308.30(b) or reliance on persons or information unwarranted under section 8.30(d) or 8.30(e). A shareholder (other than a director) who receives a payment not knowing of its invalidity is not subject to recoupment under subsection § 8.32(b)(2). Although no attempt has been made in the Act to work out in detail the relationship between the right of recoupment from shareholders under subsection § 8.32(b)(2) and the right of contribution from directors under subsection § 8.32(b)(1), a court may equitably apportion the obligations and benefits arising from the application of the principles set forth in section 8.32.

Section 8.32(c) limits the time within which a proceeding may be commenced against a director for an unlawful distribution and the time within which a proceeding for contribution or recoupment may be made. The one-year period specified in subsection § 8.32(c)(2) may end within or extend beyond the two-year period specified in subsection § 8.32(c)(2).

## **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 an officer responsibility for maintaining and authenticating the records of the corporation required to be kept under section 16.01(a).
- (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 and 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.  
Resignation and 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 officers it will have. No particular officers are required.

The board of directors, as well as duly authorized officers, employees or agents, may also appoint other agents for the corporation. In addition, a board of directors has the intrinsic power to organize its own internal affairs, including designating officers of the board.

The officer who has the responsibility to maintain the minutes and authenticate the corporate records referred to in section 16.01(a) is referred to as the “secretary” of the corporation throughout the Act. See section 1.40. The person so designated 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**

Bylaws, see § 2.06 and ch. 10B.

Officer as employee, see § 1.40.

Standards of conduct:

directors, see § 8.30.

officers, see § 8.42.

### **OFFICIAL COMMENT**

The methods of investing officers with formal authority in section 8.40 do not exhaust the sources of an officer’s actual or apparent authority. Specific officers, particularly the chief executive officer, may have implied authority to take certain actions on behalf of a corporation merely by virtue of their positions. Officers may also be vested with apparent authority by reason of corporate conduct on which third persons reasonably rely.

In addition to express, implied, or apparent authority, a corporation is bound by unauthorized acts of officers if they are ratified by the board of directors. Generally, ratification may extend 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 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 board committee 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 board committee, 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 through 8.59.  
Resignation and removal of officers, see § 8.43.  
Standards of conduct for directors, see § 8.30.  
Standards of liability for directors, see § 8.31.

## **OFFICIAL COMMENT**

Under section 8.42(a), an officer, when performing in such officer's official capacity, has to meet standards of conduct generally specified for directors under section 8.30. 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.

Common law has generally recognized a duty on the part of officers and key employees to disclose to their superiors material information relevant to the affairs of the corporation. This duty is implicit in, and embraced under, the broader standard of section 8.42(a), but section 8.42(b) sets forth this disclosure obligation explicitly. Section 8.42(b)(1) specifies that business information shall be transmitted through the officer's regular reporting channels. Section 8.42(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 § 8.42(b)(2) accommodates any normative standard that the corporation may have prescribed 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, as well as 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).

Section 8.42(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 § 8.42(b) may not be negated by agreement; however, their scope under section 8.42(b)(1) may be shaped by prescribing the scope of an officer's functional responsibilities.

With respect to the duties under section 8.42(b)(2), codes of conduct or codes of ethics 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 section 8.42(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 ordinarily not be material to the financial position or results of operations of the corporation.

The duty under section 8.42(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 § 8.42(b)(2), however, does not excuse officers from their obligations under subsection § 8.42(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 such 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 includes an officer; accordingly, section 8.42 contemplates the delegation of responsibilities to other officers as well as to non-officer employees.

Although under section 8.42(d), performance meeting that section's standards of conduct will eliminate an officer's exposure to any liability to the corporation or its shareholders, failure by an officer to meet that section's standards will not automatically result in 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 8.43.

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, section 8.42(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 officer 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 a written notice to the board of directors, or its chair, or to the appointing officer or the secretary. A resignation is effective as provided in section 1.41(i) unless the notice provides for a delayed effectiveness, including effectiveness determined upon a future event or events. If effectiveness of a resignation is stated to be delayed and the board of directors or the appointing officer accepts the delay, the board of directors or the appointing officer may fill the pending vacancy before the delayed effectiveness but the new officer may not take office until the vacancy occurs.
- (b) An officer may be removed at any time with or without cause by (i) the board of directors; (ii) the appointing 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" defined, see § 1.40.

Notices and other communications, see § 1.41.

"Secretary" defined, see § 1.40.

### **OFFICIAL COMMENT**

In part because of the unlimited power of removal under section 8.43(b), a corporation may enter into an employment agreement with the holder of an office that gives the officer rights in the event of removal or failure to be reelected or reappointed to office. 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. Such an employment agreement does not override the removal power set forth in section 8.43(b) and may give the officer the right to damages, but not specific performance, if employment is terminated before the end of the contract term.

Section 8.43(b) 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.

#### **§ 8.44 CONTRACT RIGHTS OF OFFICERS**

- (a) The election or 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, see § 8.40.

Resignation and removal of officers, see § 8.43.

#### **OFFICIAL COMMENT**

The removal of an officer with contract rights is without prejudice to the officer’s rights in a proceeding seeking 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 election or 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**

#### *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.

The concept of indemnification recognizes that there will be situations in which even though 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, the corporation should nevertheless be

permitted (or required) to absorb the economic costs incurred by the director in any ensuing litigation.

Subchapter 8E is an integrated treatment of indemnification and advance for expenses and strikes a balance among important public policies. 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. If permitted too broadly, however, indemnification may violate equally basic tenets of public policy. 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. A similar policy issue is raised in connection with indemnification against liabilities or sanctions imposed under state or federal civil or criminal statutes. 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.

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. 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 subchapter E does not limit a corporation's power to indemnify or advance expenses to employees and agents in accordance with applicable law.

## *2. Relationship of Indemnification to Other Policies Established in the Act*

Indemnification is closely related to the standards of conduct for directors and officers established elsewhere in chapter 8. The structure of the 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). The converse, however, is not necessarily true. The basic standards for indemnification set forth in section 8.51 for a civil action, in the absence of an indemnification provision in the articles of incorporation (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. 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, subchapter E 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 if the court determines that it would be fair and reasonable to do so.

### **§ 8.50 Subchapter Definitions**

In this subchapter:

“Corporation” includes any domestic or foreign predecessor entity of a corporation in a

merger.

“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.

“Liability” means the obligation to pay a judgment, settlement, penalty, fine (including an excise tax assessed with respect to an employee benefit plan), or expenses incurred with respect to a proceeding.

“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 joint venture, trust, employee benefit plan, or other entity.

“Party” means an individual who was, is, or is threatened to be made, a defendant or respondent in a proceeding.

“Proceeding” means any threatened, pending, or completed action, suit, or proceeding, whether civil, criminal, administrative, arbitral, or investigative and whether formal or informal.

## **CROSS-REFERENCES**

Effect of merger or share exchange, see § 11.07.

“Entity” defined, see § 1.40.

“Expenses” defined, see § 1.40.

Officers, see § 8.40.

## **OFFICIAL COMMENT**

The definitions set forth in section 8.50 apply only to subchapter E and have no application elsewhere in the Act, except for the use of “liability” in section 2.02(b)(5). The term “qualified director,” which is used in sections 8.53 and 8.55, is defined in section 1.43.

### *1. Corporation*

Subchapter E’s definition of “corporation” includes predecessor entities that have been absorbed in mergers to negate any argument that a different result might be reached under section 11.07(a), 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. The definition of “corporation” in section 8.50 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.

Even without such a formal action, the second sentence of the definition of “director” or “officer” in section 8.50 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 ERISA’s 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, for example, (i) eligibility for benefits, (ii) investment decisions, or (iii) interpretation of plan provisions respecting (a) qualifying service, (b) years of service, or (c) retroactivity, are all subject to the protections of this subchapter. See also the definition of “official capacity” in section 8.50.

In the last sentence of the definition of “director” or “officer” in section 8.50, the phrase “unless the context requires otherwise” is intended to clarify that the estate or personal representative does not have the right to participate in decisions by directors authorized in this subchapter.

## 3. *Liability*

“Liability” is defined for convenience 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 of “expenses.” The definition of “expenses” in section 1.40 limits expenses to those that are reasonable. The result is that any portion of expenses which is not reasonable should not be advanced or indemnified. In contrast, 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 limitation of “reasonableness” for settlements is inappropriate.

The definition of “liability” is intended to cover every type of monetary obligation that may be imposed upon a director, including civil penalties, restitution, and the levy of excise taxes under the Internal Revenue Code pursuant to ERISA.

#### 4. *Official Capacity*

The term “official capacity” is used in determining 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 8.51(a).

#### 5. *Party*

The definition of “party” 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, but as specifically provided in section 8.58(e) payment or reimbursement of witness 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, 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) the director 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 his or her 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 § 8.51(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, regardless of whether it involved action in the director's official capacity.

## CROSS-REFERENCES

Advance for expenses, see § 8.53.

“Corporation” defined, see § 8.50.

Court-ordered indemnification and advance for expenses, see § 8.54.

Derivative proceedings, see §§ 7.40 through 7.47.

Determination and authorization of indemnification, see § 8.55.

“Director” defined, see § 8.50.

Director's conflicting interest transaction, see ch. 8F.

Exclusivity of subchapter, see § 8.59.

“Expenses” defined, see § 1.40.

“Liability” defined, see § 8.50.

Limiting director liability by provision in articles of incorporation, see § 2.02.

Limits on indemnification, see § 8.58.

Mandatory indemnification, see § 8.52.

Obligatory indemnification, see §§ 2.02 and 8.58.

“Officer” defined, see § 8.50.

Officer indemnification, see § 8.56.

“Official capacity” defined, see § 8.50.

“Party” defined, see § 8.50.

“Proceeding” defined, see § 8.50.

Standards of conduct for directors, see § 8.30.

Standards of liability for directors, see § 8.31.

## OFFICIAL COMMENT

### *1. Section 8.51(a)*

The standards for indemnification of directors contained in section 8.51(a) define the limits of the conduct for which discretionary indemnification is permitted under the Act, except to the extent that court-ordered indemnification is available under section 8.54(a)(3). Conduct that falls within these 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). Absent such an obligatory provision, section 8.52 defines much narrower circumstances in which directors are entitled as a matter of right to indemnification.

The standards of conduct in section 8.51(a) are not dependent on the type of proceeding in which the claim arises. These standards are closely related, but not identical, to the standards of conduct imposed by section 8.30 on 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). As in the case of section 8.30, where the concept of good faith is also used, section 8.51 provides no definition for that term. The concept involves a subjective test, which would permit indemnification for an unwise decision or “a mistake of judgment,” even though made 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.

In section 8.51(a)(1)(ii)(B), the words “at least” qualify “not opposed to” and make clear that this standard is for conduct other than in an official capacity. Although this provision deals with indemnification by the corporation, a director serving another entity at the request of the corporation remains subject to the provisions of the law governing service to that other entity, including provisions dealing with conflicts of interest. Compare sections 8.60 through 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 a duty owed to that other 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.

If the relevant standards are met, 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 antitrust, environmental or securities laws.

In addition to indemnification under section 8.51(a)(1)(ii)(B), section 8.51(a)(2) permits indemnification under the standard of conduct set forth in a provision of the articles of incorporation adopted pursuant to section 2.02(b)(5). Based on such a 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 provision of the articles of incorporation 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 § 8.51(d)(1) against indemnification of settlements and judgments in derivative suits, except as ordered by a court under section 8.54(a)(3). It is also subject to the prohibition of subsection § 8.51(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)(i).

## 2. *Section 8.51(b)*

As discussed in the Official Comment to the definition of “director” or “officer” in section 8.50, 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. The standard in section 8.51(b) for indemnification of a director who is serving as a trustee or fiduciary for an employee benefit plan under ERISA 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)*

Section 8.51(c) rejects the argument that indemnification is automatically improper whenever a proceeding has been concluded on a basis that does not exonerate the director claiming indemnification. However, any judicial determination of substantive liability should be taken into account in determining whether the standards of section 8.51(a) were met. By the same token, it is clear that the termination of a proceeding by settlement or plea of no contest should not of itself create a presumption either that conduct met or did not meet the relevant standard of subsection § 8.51(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 entitles the director to indemnification of expenses under section 8.52.

## 4. *Section 8.51(d)*

Section 8.51(d) does not permit indemnification of settlements and judgments in derivative proceedings which 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. Further, in many cases a director may be protected by a provision in the articles of incorporation under section 2.02(a)(4) limiting liability or because a proceeding was dismissed under section 7.44. The prohibition on indemnification of a settlement or a judgment in a derivative proceeding, however, does not extend to the related 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 and advance of expenses may be ordered by a court under section 8.54(a)(3) even if the relevant standard was not met.

Indemnification under section 8.51 is also prohibited if there has been an adjudication that a director received a financial 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)(ii) establishing the 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 section 8.51(a)(2). Although it is unlikely that a director found to have received an improper financial benefit could meet the standard in section 8.51(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 section 8.51(d)(2) to petition a court for a judicial determination of entitlement to indemnification for expenses. The language of section 8.51(d)(2) parallels sections 2.02(b)(4)(i) and § 2.02(b)(5)(i), and thus, the same standards should be used in interpreting the application of all three 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.

Court-ordered indemnification, see § 8.54.

“Director” defined, see § 8.50.

“Expenses” defined, see § 1.40.

Limits on indemnification, see § 8.58.

“Party” defined, see § 8.50.

Permissible indemnification, see § 8.51.

“Proceeding” defined, see § 8.50.

### **OFFICIAL COMMENT**

Section 8.52 creates a right of indemnification in favor of the director who meets its requirements. Enforcement of this right by judicial proceeding is specifically contemplated by section 8.54(a)(1). Section 8.54(b) gives the director a right to recover expenses incurred in enforcing the director’s 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. 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 .

Although the standard “on the merits or otherwise” 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 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 director if the director delivers to the corporation a signed written undertaking of the director to repay any funds advanced if (i) the director is not entitled to mandatory indemnification under section 8.52 and (ii) it is ultimately determined under section 8.54 or section 8.55 that the director is not entitled to indemnification.
- (b) The undertaking required by subsection § 8.53(a) 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 consisting solely 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 of directors 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 board of directors, see § 8.25.
- “Corporation” defined, see § 8.50.
- Court-ordered advance for expenses, see § 8.54.
- Determination and authorization of indemnification, see § 8.55.
- “Director” defined, see § 8.50.
- “Expenses” defined, see § 1.40.
- Limits on indemnification and advance for expenses, see § 8.58.
- Obligatory advance for expenses, see § 8.50.
- “Party” defined, see § 8.50.
- “Proceeding” defined, see § 8.50.
- “Qualified director” defined, see § 1.43.
- Quorum of directors, see § 8.24.
- Standard for indemnification, see § 8.51.

### **OFFICIAL COMMENT**

Section 8.53 authorizes, but does not require, a corporation to advance or reimburse a director’s reasonable expenses, subject to the delivery of the repayment undertaking required by subsection § 8.53(a) and any limitations set forth in the articles of incorporation pursuant to

section 8.58(d). The repayment undertaking required by section 8.53 is also required in connection with obligatory advancement pursuant to section § 8.588.58(a).

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. Indemnification may include reimbursement for non-advanced expenses. Advance for expenses is necessarily prospective and, in situations where advancement is not obligatory, the individuals making the decision whether to authorize expense advancement generally have fewer known facts on which to base their decision.

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 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 of actions taken in that capacity. 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 will advance these expenses. Accordingly, many corporations enter into contractual obligations (*e.g.*, by a provision in the articles of incorporation or bylaws or by individual agreements) to advance expenses for directors. See section 8.58(a).

A single written undertaking by the director pursuant to section 8.53(a) may cover all funds advanced from time to time in connection with a proceeding. The theory underlying section 8.53(b) 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.

If advancement is not obligatory, the standards of section 8.30 should, in general, govern the decision of directors acting on a request for advancement. In making such a decision, the directors may consider any matters they deem appropriate and may condition the advance of expenses on compliance with any requirements they believe are appropriate, including, for example, an affirmation of a requesting director's good faith belief that he or she is entitled to indemnification under section 8.51.

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 the articles of incorporation or bylaws, by a resolution of its board of directors or shareholders, or by an agreement. Unless provided otherwise, section 8.58(a) deems a general obligatory provision requiring indemnification to the fullest extent permitted by law to include advance for expenses to the fullest extent permitted by law, even if not specifically mentioned, subject to providing the required repayment undertaking. No other procedures are required or contemplated although obligatory arrangements may include notice and any other requirements that the directors believe are appropriate.

If advancement is not obligatory, 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 section 8.53(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 section 8.53(c)(2), the applicable procedure specified in subsection § 8.53(c)(1) must be used.

Under subsection § 8.53(c)(1)(ii), which is available only if subsection § 8.53(c)(1)(i) is not available, the action of the board of directors 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 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 non-qualified directors) than to leave it with one qualified director.

**Illustration 1:** The board consists of 15 directors, four of whom are non-qualified 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 § 8.53(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 a majority of the committee.

**Illustration 2:** The board consists of 15 directors, only one of whom is a qualified director. Subsection § 8.53(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 § 8.53(c)(2)).

With respect to shareholder authorizations under section § 8.53(c)(2), the prohibition on voting shares owned by or voted under the control of directors who at the time are not qualified directors does not affect general rules as to the required presence of a quorum at the meeting.

The fact that there has been an advance for expenses does not determine whether a director is entitled to indemnification. A proceeding will often terminate without a judicial or other determination as to whether the director's conduct met the applicable standard of conduct in section 8.51. 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, in the case of (i) or (ii), 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 section § 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 § 8.54(a)(1) or to indemnification or advance for expenses under subsection § 8.54(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 § 8.54(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.

“Director” defined, see § 8.50.

“Expenses” defined, see § 1.40.

Limits on indemnification and advance for expenses, see § 8.58.

Mandatory indemnification, see § 8.52.

Obligatory indemnification, see § 8.58.

“Party” defined, see § 8.50.

Permissible indemnification, see § 8.51.

“Proceeding” defined, see § 8.50.

### **OFFICIAL COMMENT**

In determining whether indemnification or expense advance would be “fair and reasonable” under , a court should give appropriate deference to an informed decision of a board of directors 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. A director seeking court-ordered indemnification or expense advance under 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 intra-corporate declination or any otherwise applicable statutory prohibition against indemnification, *e.g.*, sections 8.51(a) or (d).

Apart from the provisions of , there are no statutory outer limits on the court’s power to order indemnification under that subsection. 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 provision

in the articles of incorporation. It would be unusual for a court to provide indemnification going beyond the limits of section 2.02(b)(4), but the court is permitted to do so.

Among the factors a court may want to consider under 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. For example, 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. Also, 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? Additionally, 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 the 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 corporate decision to participate?

Under section 8.54(b), if a director successfully sues to enforce the right to indemnification under subsection § 8.54(a)(1) or to indemnification or advance for expenses under subsection § 8.54(a)(2), the court is required to order the corporation to pay the director's expenses in the enforcement proceeding. However, if a director successfully sues for indemnification or expense advancement under subsection § 8.54(a)(3), the court may (but is not required to) order the corporation to pay those expenses. 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 a request for indemnification is governed by the general standards of conduct of section 8.30. Even if the corporation does not oppose the request, the court must satisfy itself that the person seeking indemnification is entitled to or otherwise deserving of receiving it under section 8.54.

As provided in section 8.58(d), a corporation may limit the rights of a director under section 8.54 by a provision in the 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 subsection § 8.55(b)(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 § 8.55(b)(2)(i).

### **CROSS-REFERENCES**

Advance for expenses, see § 8.53.

Committees of board of directors, see § 8.25.

“Corporation” defined, see § 8.50.

“Director” defined, see § 8.50.

“Party” defined, see § 8.50.

“Proceeding” defined, see § 8.50.

“Qualified director” defined, see § 1.43.

Quorum of directors, see § 8.24.

Standard for indemnification, see § 8.51.

### **OFFICIAL COMMENT**

Section 8.55 distinguishes between a “determination” that indemnification is permissible and an “authorization” of indemnification. A “determination” involves a decision by individuals or groups described in section 8.55(b) 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. 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. Although 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. The committee of qualified directors referred to in subsection § 8.55(b)(1) may include a committee 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 § 8.55(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 § 8.55(b)(1). 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 non-qualified directors in the authorization decision is justified by the principle of necessity.

Under section § 8.55(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.

The phrase “special legal counsel” is not defined in the Act, and it is important that the process be sufficiently flexible to permit selection of counsel in light of the particular circumstances. In many instances, however, it may be important that “special legal counsel” be counsel having no prior professional relationship with those seeking indemnification, be retained for the specific purpose, and not be or have been either inside counsel or regular outside counsel to the corporation. Among other factors that may be considered are whether special legal counsel has 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.

In determinations of eligibility for indemnification by shareholders under section § 8.55(b)(3), 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. 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. Although such an arrangement may effectively provide an authorization of indemnification, the determination requirements of sections 8.55(a) and (b) must still be satisfied.

## **§ 8.56 Indemnification of Officers**

- (a) A corporation may indemnify and advance expenses under this subchapter to an officer who is a party to a proceeding because he or she is an officer
  - (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 or the bylaws, or by a resolution adopted or a contract approved by the board of directors or shareholders, except for
    - (i) 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
    - (ii) liability arising out of conduct that constitutes
      - (A) receipt by the officer of a financial benefit to which he or she is not entitled,
      - (B) an intentional infliction of harm on the corporation or the shareholders, or
      - (C) an intentional violation of criminal law.
- (b) Subsection (a)(2) shall apply to an officer who is also a director if he or she is made a party to the proceeding based on an act or omission solely as an officer.
- (c) An officer 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 sections.



## CROSS-REFERENCES

Advance for expenses, see § 8.53.

“Corporation” defined, see § 8.50.

“Director” defined, see § 8.50.

“Expenses” defined, see § 1.40.

Indemnification of employees and agents, see § 8.58.

“Liability” defined, see § 8.50.

Limits on rights to indemnification and advance for expenses, see § 8.58.

Obligatory indemnification, see §§ 2.02 and § 8.58.

“Officer” defined, see § 8.50.

Officer standards of conduct, see § 8.42.

“Party” defined, see § 8.50.

“Proceeding” defined, see § 8.50.

## 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.

- 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, subject to the limits set forth in section § 8.56(a)(2).
- An officer who is *also* a director is entitled to the indemnification rights of a director, and if the conduct that is the subject of the proceeding was solely in his or her capacity as an officer, also to any of the rights of an officer who is not a director. See preceding bullet.
- An officer 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.

Although subchapter E is silent with respect to such employees and agents, they may be indemnified using broad grants of powers to corporations under section 3.02, 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 use these powers to provide for employees and agents 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*

Although section 8.56 does not prescribe the standards governing the rights of officers to indemnification, subsection § 8.56(a) does set outer limits beyond which the corporation may not indemnify. These limits for officers are substantially the same as the outer limits on the corporation's power to indemnify directors. 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 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 § 8.51(a)(2), only with a provision included in the articles of incorporation pursuant to section 2.02(b)(5). This procedural difference reflects the reduced risk of self-dealing as to officers.

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*

Section 8.56(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 or herself of the provisions of subsection § 8.56(a) unless the act or omission that is the subject of the proceeding was committed solely in the capacity as an 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 limits of section § 8.56(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 non-director capacities for which indemnification may be appropriate.

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 of incorporation 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 the articles of incorporation, subject to the limitations 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 bylaw or a resolution of the board of directors authorizing such indemnification is required, rather than a provision in the articles of incorporation. If such a bylaw or resolution is adopted, the standards for indemnification are those specified in section § 8.56(a)(2). However, when a director-officer seeks indemnification or expense advance under sections 8.56(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 section 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 or a joint venture, trust, employee benefit plan, or other entity, against liability asserted against or incurred by the individual in that capacity or arising from the individual's status as a director or officer, regardless of whether 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.

“Director” defined, see § 8.50.

Employees and agents, see § 8.58.

“Expenses” defined, see § 1.40.

“Liability” defined, see § 8.50.

“Officer” defined, see § 8.50.

“Official capacity” defined, see § 8.50.

Standard for indemnification, see § 8.51.

#### **OFFICIAL COMMENT**

In authorizing a corporation to purchase and maintain insurance on behalf of directors and officers, section 8.57 sets no limits on the type of insurance which a corporation may maintain or the type of persons who are covered. Insurance is not limited to claims against which a corporation is entitled to indemnify under this subchapter. Such insurance can provide protection to directors and officers in addition to the rights of indemnification created by or pursuant to subchapter E (as well as typically protecting the individual insureds against the corporation's failure to pay indemnification required or permitted by this subchapter) and can also provide a source of reimbursement for a corporation that indemnifies its 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 laws, or other willful misconduct.

Although section 8.57 does not include employees and agents for the reasons stated in the Official Comment to section 8.58, 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(f).

### **§ 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 the 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 expressly provides otherwise.
- (b) A right of indemnification or to advances for expenses created by this subchapter or under subsection § 8.58(a) and in effect at the time of an act or omission shall not be eliminated or impaired with respect to such act or omission by an amendment of the articles of incorporation or bylaws or a resolution of the board of directors or shareholders, adopted after the occurrence of such act or omission, unless, in the case of a right created under subsection § 8.58(a), the provision creating such right and in effect at the time of such act or omission explicitly authorizes such elimination or impairment after such act or omission has occurred.
- (c) Any provision pursuant to subsection § 8.58(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 expressly provided. Any provision for indemnification or advance for expenses in the articles of incorporation or 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).
- (d) Subject to subsection § 8.58(b), 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.
- (e) 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.
- (f) 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.

“Corporation” defined, see § 8.50.

“Director” defined, see § 8.50.

Effect of amendments to articles of incorporation, see § 10.09.

“Expenses” defined, see § 1.40.

Indemnification, see §§ 8.51 through 8.56.

Insurance, power to provide, see § 8.57.

“Officer” defined, see § 8.50.

“Party” defined, see § 8.50.

Predecessor, see § 8.50.

“Proceeding” defined, see § 8.50.

### **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 indemnification or advance for expenses. An obligatory provision satisfies the requirements for authorization in sections 8.53(c) and § 8.55(c), but the requirements for determination of eligibility for indemnification in subsections § 8.58(a) and (b) of those sections must still be met.

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 view 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 sections 8.53(a) and (b), 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.

Although section 8.58(d) 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.

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(f) makes clear that, although indemnification, advance for expenses, and insurance for employees and agents are beyond the scope of subchapter E, 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.

“Director” defined, see § 8.50.

“Expenses” defined, see § 1.40.

“Officer” defined, see § 8.50.

Standards for indemnification, see §§ 8.51 through 8.56.

## **OFFICIAL COMMENT**

Subchapter E 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 the articles of incorporation, the bylaws, resolutions, or contracts designed to provide procedural machinery in addition to (but not inconsistent with) that provided by subchapter E. 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. DIRECTOR'S CONFLICTING INTEREST TRANSACTIONS**

### **INTRODUCTORY COMMENT**

#### *1. Overview.*

There are four basic elements in subchapter F.

First, subchapter F defines, with bright-line rules, the transactions that are to be treated as director's conflicting interest transactions.

Second, subchapter F provides that a director's transaction that is not within the statutory definition of a director's conflicting interest transaction is 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 may afford the basis for a legal attack on the transaction on some other ground), even if the transaction involves some sort of conflict lying outside the statutory definition, such as a remote familial relationship.

Third, subchapter F provides that if a director's conflicting interest transaction is properly approved by disinterested (or "qualified") directors or shareholders, the transaction is 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 provides that if a director's conflicting interest transaction is properly approved by disinterested (or "qualified") directors or shareholders, the conflicted director may not be subject to an award of damages or other sanctions (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 reflects the judgment that in corporate matters, where planning is critical, the clear and important efficiency gains that result from certainty through defining director's conflicting interest transactions exceed any potential and uncertain efficiency losses that might follow from excluding other director's transactions from judicial review for fairness on conflict-of-interest grounds.

#### *2. Scope of Subchapter F*

Subchapter F addresses legal challenges based on director conflicts of interest 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. So, although 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 address 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.”

Subchapter F applies 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 a unilateral action by the corporation or a director. Whether safe harbor procedures of some kind might be available to the director and the corporation with respect to non-transactional matters is discussed in numbered part 3 of this Introductory Comment.

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 the defenses set forth in this subchapter.

The voting procedures and conduct standards prescribed in subchapter F deal solely with the complicating element presented by the director’s conflicting interest in a transaction. 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 than 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 Act, a corporation may set higher voting requirements and different quorum requirements in the articles of incorporation. See sections § 2.02(b)(2) and § 7.27). In addition, subchapter F does not shield misbehavior by a director or other person that is actionable under other provisions of the 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.

Finally, certain 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 Act. See sections 8.51 and § 8.52 dealing with indemnification arrangements, and section 7.44 dealing with termination of derivative proceedings by board action. Any corporate transactions or arrangements affecting directors that are governed by such regulatory sections of the Act are not governed by subchapter F.

### *3. Nontransactional Situations Involving Interest Conflicts*

#### **A. CORPORATE OR BUSINESS OPPORTUNITY**

Subchapter F does not apply by its terms to corporate or business opportunities because no transaction between the corporation and the director is involved in the taking of an opportunity. However, subchapter 8G 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 corporate opportunity doctrine. Also, section 2.02(b)(6) permits a corporation to include in its articles of incorporation a provision that limits or eliminates the duty to present a business opportunity to the corporation.

#### **B. OTHER SITUATIONS**

Many other kinds of situations can give rise to divergent economic interests between a director and the corporation. For example, a director's personal financial interests can be affected by a nontransactional policy decision of the board of directors, 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 the 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 of directors 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. Although these nontransactional situations are not covered 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.

\* \* \* \* \*

#### *Note on Terms in Official Comments*

In the Official Comments to subchapter F, 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:

"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.

"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;
- (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.

"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.

“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.

“Related person” means:

- (iv) the individual’s spouse;
- (v) a child, stepchild, grandchild, parent, step parent, grandparent, sibling, step sibling, half sibling, aunt, uncle, niece or nephew (or spouse of any such person) of the individual or of the individual’s spouse;
- (vi) a natural person living in the same home as the individual;
- (vii) an entity (other than the corporation or an entity controlled by the corporation) controlled by the individual or any person specified above in this definition;
- (viii) a domestic or foreign (A) business or nonprofit corporation (other than the corporation or an entity controlled by the corporation) of which the individual is a director, (B) unincorporated entity of which the individual is a general partner or a member of the governing body, or (C) individual, trust or estate for whom or of which the individual is a trustee, guardian, personal representative or like fiduciary; or
- (ix) a person that is, or an entity that is controlled by, an employer of the individual.

“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 (or a 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.

“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 and 8.21.

“Entity” defined, see § 1.40.

Indemnification and advance for expenses, see §§ 8.50 through 8.59.

“Proceeding” defined, see § 1.40.

Quorum and voting:

by directors, see § 8.24.

by shareholders, see §§ 7.25 through 7.27.

Shareholder action, see §§ 7.01 through 7.04.

Standards of conduct:

directors, see § 8.30.

officers, see § 8.42.

“Unincorporated entity” defined, see § 1.40.

Vote needed to approve transactions by shareholders:

amendment to articles of incorporation, see § 10.03.

conversions, see § 9.21.

disposition of assets, see § 10.02.

domestications, see § 9.32.

generally, see §§ 7.25 and 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 and section 2.02(b)(6) and, where relevant to subchapter G. They have no application elsewhere in the Act. (For the meaning and use of certain terms used below, such as “D,” “X Co.” and “Y Co.,” see the Note on Terms 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 section 8.60 is the core concept underlying subchapter F. 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 on the ground that the director has a conflict of interest if it falls outside the statutory definition of “director’s conflicting interest transaction.”

#### **A. TRANSACTION**

For purposes of subchapter F, “transaction” 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 no such entity is a party. For example, 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.

#### **B. PARTY TO THE TRANSACTION—THE CORPORATION OR A CONTROLLED ENTITY**

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**

D can have a conflicting interest in only two ways.

**First**, a conflicting interest can arise under either clause (i) or (ii) of the definition of “director’s conflicting interest transaction.” 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 clause (ii) of the definition.

**Second**, a conflicting interest for D can arise under clause (iii) of the definition 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 section 8.60.

Circumstances may arise where a director could have a conflicting interest under more than one clause of the definition. 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 fall under clause (iii), but D also may have a conflicting interest under clause (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 connections to persons and institutions that are not specified in clause (iii) of the definition. Such relationships and connections fall outside subchapter F because the categories of persons described in clause (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 the definition; and therefore, the conflict of interest claim must be rejected by reason of section 8.61(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 clause (ii) of the definition or, if it placed D in control of Y Co., it would fall under clause (iii) (because Y Co. is a related person of D under clause (iv) of the definition). 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, could consider recusal from the other directors’ deliberations and voting on the transaction between X Co. and Y Co.

Any director’s interest in a transaction that meets the criteria of the definition renders the transaction 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.

Routine business transactions frequently occur between companies with overlapping directors. If X Co. and Y Co. have routine, frequent business dealings with terms 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 products or services 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,” although 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.

## 2. *Control*

The definition of “control” in section 8.60 contains two independent clauses. The first clause addresses the ability 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 economic interest in the entity and may include, among other circumstances, financial structures that do not have voting interests or a governing body in the traditional sense, such as special purpose entities.

## 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 at the “relevant time” as defined in section 8.60. 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 not meet the “knowledge” requirement of clauses (ii) or (iii) of the definition of director’s conflicting interest transaction.

## 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 the director 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 clause (ii) of the definition of “director’s conflicting interest transaction,” 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 fall within clause (ii), notwithstanding the portfolio investment’s significance. 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 clause (iii) of that definition, 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” as defined in section 8.60. If there is such knowledge and “interest” (*i.e.*, the financial interest could reasonably be expected to influence the director’s judgment), then the matter involves a director’s conflicting interest transaction.

## 5. *Related Person*

Six categories of “related person” of the director are set out in the definition of that term. 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). These 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 clause (vi) is not separately defined but should be interpreted in light of the purpose of subchapter F. 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.

References in the foregoing to “director” or “D” include the term “officer” where relevant in section 2.02(b)(6) and section 8.70.

## 6. *Fair to the Corporation*

The term “fair” to the corporation in subchapter F has a special meaning. The transaction, viewed as a whole, must have been beneficial to the corporation.

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 of directors 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 at a market price 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 fact 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. See section § 8.61(b)(3). 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.” Generally 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” at the “relevant time” (both as defined) 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*

An important element of subchapter F's safe harbor procedures is that those acting for the corporation be able to make an informed judgment. As an example of “required disclosure” (as defined), 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 the “buyer beware” doctrine. 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, although 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 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.

“Fair to the corporation” defined, see § 8.60.

“Related person” defined, see § 8.60.

“Relevant time” defined, see § 8.60.

“Required disclosure” defined, see § 8.60.

Shareholders' action, see § 8.63.

Standards of conduct for directors, see § 8.30§ 8.30.

## OFFICIAL COMMENT

Section 8.61 is the operational section of subchapter F, as it prescribes the judicial consequences of the other sections. In general terms:

- If the section 8.62 or § 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 by a shareholder or the corporation on the ground of an interest of the director. However, if the transaction is vulnerable to attack on some other ground, observance of subchapter F’s procedures does not make it less so.
- If a transaction is *not* a director’s conflicting interest transaction as defined in section 8.60, 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, regardless of whether it went through the procedures of subchapter F. In that sense, subchapter F is specifically intended to be both comprehensive and exclusive.
- 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 § 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)

Section 8.61(a) makes clear that the bright-line definition of “director’s conflicting interest transaction” is exclusive with respect to a court’s review of a director’s interest in a transaction. 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 the definition of “related person,” 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, or a nonfinancial interest. If, however, there is reason to believe that the fairness of a transaction involving D could be questioned, D should subject the transaction to the safe harbor procedures of subchapter F. The procedures of section 8.62 (and, to a lesser extent, section 8.63) may be used for many transactions that lie outside the definitions of section 8.60.

## 2. *Section 8.61(b)*

Section 8.61(b)(1) provides a defense in a proceeding challenging a director’s conflicting interest transaction if the procedures of section 8.62 have been properly followed.

The plaintiff may challenge the availability of that defense 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 section § 8.61(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 section § 8.61(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. A challenge to the effectiveness of board action for purposes of section § 8.61(b)(1) might also assert that, although 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 section 8.61(b)(3)—will depend heavily on the facts of the individual case.

Section § 8.61(b)(2) regarding shareholders’ approval of the transaction is the matching piece to section § 8.61(b)(1) regarding directors’ approval.

The language “at any time” in these provisions permits the directors or the shareholders to ratify a director’s conflicting interest transaction after the fact for purposes of subchapter F.

Section § 8.61(b)(3) permits a showing that a director’s conflicting interest transaction was fair to the corporation even if there was no compliance with section 8.62 or § 8.63. Under section § 8.61(b)(3) the interested director has the burden of establishing that the transaction was fair.

\* \* \* \* \*

### *Note on Directors’ Compensation*

Although directors’ fees and other forms of director compensation are typically set by the board of directors and are specifically authorized by section 8.11 of the Act, they do involve a director’s conflicting interest transaction in which most if not all of the directors may not be qualified directors. Therefore, 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)(1) 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 board 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 of directors.
- (b) Notwithstanding subsection (a), when a transaction is a director's conflicting interest transaction only because a related person described in clause (v) or (vi) of the definition of "related person" in section 8.60 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 board 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 or bylaws or a provision of law, independent action to satisfy those authorization requirements shall be taken by the board of directors or a board committee, in which action directors who are not qualified directors may participate.

### **CROSS-REFERENCES**

"Director's conflicting interest transaction" defined, see § 8.60.

Judicial action, see § 8.61.

"Qualified director" defined, see § 1.43.

"Related person" defined, see § 8.60.

"Relevant time" defined, see § 8.60.

"Required disclosure" defined, see § 8.60.

Shareholders' action, see § 8.63.

Standards of conduct for directors, see § 8.30.

## 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 have in mind the requirements that directors act in good faith and on reasonable inquiry. See section 8.30. 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 § 8.61(b).

### 1. Section 8.62(a)

The definition of "qualified director" in section 1.43(a)(4) excludes not only a director who is conflicted directly or because of a person specified in the categories of the "related person" definition in section 8.60, but also any director with a familial, financial, employment, professional or other relationship with *another director for whom the transaction is a director's conflicting interest transaction* that would be likely to impair the objectivity of the first director's judgment when participating in a vote on the transaction.

Action under section 8.62 may take the form of committee action meeting the requirements of subsection (a)(2). The requirements for effective committee action are intended to preclude the appointment as committee members of a favorably inclined minority from among all the qualified directors. With respect to required disclosure under subsection (a), if there is more than one conflicted director interested in the transaction, the need for required disclosure would apply to each.

### 2. Section 8.62(b)

Section 8.62(b) accommodates situations where a director who has a conflicting interest is not able to comply fully with the disclosure requirement of subsection § 8.62(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 ethics rule (*e.g.*, attorney-client confidentiality). The most frequent use of subsection (b), however, will likely involve directors who have conflicting fiduciary obligations. If D is also a director of Y Co., D may have acquired confidential information from one or both directorships relevant to a transaction between X Co. and Y Co., that 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 § 8.62(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 section 8.62(b), D must meet all three requirements set forth in clauses (1), (2) and (3). 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. 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 subsection (b), another director who has no financial interest in the transaction might conclude that under applicable law he or she is bound to silence (because of attorney-client confidentiality, for example) and would under general principles of sound director conduct withdraw from participation in the board's deliberations and action. Of course, if D invokes subsection (b) and does not make disclosures that would otherwise be required under subsection § 8.62(a) 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 § 8.62(b) would be irrelevant. Having disclosed the existence and nature of the conflicting interest, D would thereby comply with the "required disclosure" as defined under section 8.60.

Although section 8.62(b) will apply to the 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.

Section 8.62(b) is available to D if a transaction is a director's conflicting interest transaction only because a related person described in clauses (v) or (vi) of the definition of that term in section 8.60 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 clauses (v) or (vi) of the definition of 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, but for the narrow exception set forth in subsection (b), 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.

### 3. *Section 8.62(d)*

Subsection § 8.62(d) underscores the fact that the directors' voting procedures and requirements set forth in subsections (a) through (c) address only the director's conflicting interest. Thus, in any case where the quorum or voting requirements for substantive approval of a transaction differ from the quorum 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 (i) notice to shareholders describing the action to be taken respecting the transaction, (ii) provision to the corporation of the information referred to in subsection (b), and (iii) 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. In the case of shareholders' action at a meeting, the shareholders entitled to vote shall be determined as of the record date for notice of the meeting.

- (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: (i) "holder" means and "held by" refers to shares held by a record shareholder, a beneficial shareholder, and an unrestricted voting trust beneficial owner; and (ii) "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 the definition of "related person" in section 8.60).
- (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 § 8.63(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 or the bylaws or a provision of law, independent action to satisfy those authorization requirements shall be taken by the shareholders, in which action shares that are not qualified shares may participate.

## **CROSS-REFERENCES**

"Beneficial shareholder," "record shareholder" and "unrestricted voting trust beneficial owner" defined, see § 1.40.

Directors' action, see § 8.62.

"Director's conflicting interest transaction" defined, see § 8.60.

Judicial action, see § 8.61.

"Related person" defined, see § 8.60.

"Required disclosure" defined, see § 8.60.

"Secretary" defined, see § 1.40.

## 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)*

Section 8.63(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: (i) shareholders must be given timely and adequate notice describing the transaction; (ii) D must disclose the information called for in subsection (b); and (iii) required disclosure (as defined in section 8.60) must be made to the shareholders entitled to vote. Shareholder action that complies with subsection § 8.63(a) may be taken at any time, before or after 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

### 2. *Section 8.63(b)*

In many circumstances, the secretary or other person charged with counting votes on behalf of X Co. will have no way to know which of X Co.'s outstanding shares should be excluded from the vote. Section 8.63(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 provide information known to the director with respect to the shares that are not qualified.

If the person counting the 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). Subsection (e) permits the court to take the appropriate action in cases where the notification under subsection (b) is defective but not determinative of the outcome of the vote.

### 3. *Section 8.63(c)*

The definition of "qualified shares" in section 8.63(c) does not exclude shares held by entities or persons described in clause (vi) of the definition of "related person" in section 8.60, *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 section 8.63(b), on its face the shareholders' action is not in compliance with subsection § 8.63(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. If, however, D's omission was not motivated by D's effort to influence the integrity of the voting process (for example, it was the result of D's negligence), and the voting of the unreported shares was not determinative of the outcome of the vote, 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.

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)*

Section 8.63(f) 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 or voting requirements for substantive approval of a transaction differ from the quorum 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) If a director or officer pursues or takes advantage of a business opportunity directly, or indirectly through or on behalf of another person, that action may not be the subject of equitable relief, or give rise to an award of damages or other sanctions against the director, officer or other person, in a proceeding by or in the right of the corporation on the ground that the opportunity should have first been offered to the corporation, if
- (1) before the director, officer or other person becomes legally obligated respecting the opportunity the director or officer brings it to the attention of the corporation and either:
    - (i) action by qualified directors disclaiming the corporation's interest in the opportunity is taken in compliance with the same procedures as are set forth in section 8.62, or
    - (ii) shareholders' action disclaiming the corporation's interest in the opportunity is taken in compliance with the procedures set forth in section 8.63, in either case 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, the

director or officer shall have made prior disclosure to those acting on behalf of the corporation of all material facts concerning the business opportunity known to the director or officer; or

- (2) the duty to offer the corporation the business opportunity has been limited or eliminated pursuant to a provision of the articles of incorporation adopted (and where required, made effective by action of qualified directors) in accordance with section 2.02(b)(6).
- (b) In any proceeding seeking equitable relief or other remedies based upon an alleged improper pursuit or taking advantage of a business opportunity by a director or officer, directly, or indirectly through or on behalf of another person, the fact that the director or officer did not employ the procedure described in subsection (a)(1)(i) or (ii) before pursuing or taking advantage of the opportunity shall not create an implication that the opportunity should have been first presented to the corporation or alter the burden of proof otherwise applicable to establish that the director or officer breached a duty to the corporation in the circumstances.

### **CROSS-REFERENCES**

Directors' action, see § 8.62.

“Qualified director” defined, see § 1.43.

Shareholders' action, see § 8.63.

Standards of conduct for director, see § 8.30.

Standards of conduct for officers, see § 8.42.

Standards of liability for directors, see § 8.31.

### **OFFICIAL COMMENT**

Section § 8.70(a)(1) provides a safe harbor for a director or officer weighing possible involvement with a prospective business opportunity that might constitute a “corporate opportunity.” The phrase “directly, or indirectly through or on behalf of another person” recognizes the need to cover transactions pursued or effected either directly by the director or officer or indirectly through or on behalf of another person, which might be a related person as defined in section 8.60 or a person which is not a related person. By action of the board of directors or shareholders of the corporation under section § 8.70(a)(1), the director or officer can obtain a disclaimer of the corporation’s interest in the matter before proceeding with such involvement. In the alternative, the corporation may, among other things, (i) decline to disclaim its interest, (ii) delay a decision respecting granting a disclaimer pending receipt from the director or officer of additional information (or for any other reason), or (iii) attach conditions to the disclaimer it grants under section § 8.70(a)(1).

The safe harbor provided under section § 8.70(a)(1) may be utilized only for a specific business opportunity. A broader advance safe harbor for any, or one or more classes or categories of, business opportunities must meet the requirements of section 2.02(b)(6). Section § 8.70(a)(2) confirms that if the duty of an officer or director to present an opportunity has been limited or eliminated by a provision in the articles of incorporation under section 2.02(b)(6) (and, in the case of officers, appropriate action by qualified directors as required by that section), a safe harbor exists in connection with the pursuit or taking of the opportunity. The common law doctrine of “corporate opportunity” has long been recognized as a part of the director’s duty of loyalty and, under court decisions, extends to officers. See section 8.30(a) and its Official Comment.

The doctrine recognizes that the corporation has a right prior to that of its directors or officers to act on certain business opportunities that come to the attention of the directors or officers. In such situations, a director or officer who acts on the opportunity for the benefit of the director or officer or another person without having first presented it to the corporation can be held to have “usurped” or “intercepted” a right of the corporation. A defendant director or officer who is found by a court to have violated the duty of loyalty in this regard, as well as related or other persons involved in the transaction, may be subject to damages or possible equitable remedies, including injunction, disgorgement or the imposition of a constructive trust in favor of the corporation. Although 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.

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 or taken by the presenting director or officer without breach of the 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, subchapter G provides a safe-harbor mechanism enabling a director or officer to pursue an opportunity directly, or indirectly through or on behalf of another person, free of possible challenge claiming conflict with the director’s or officer’s duty 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 matters addressed.

#### *1. Section 8.70(a)(1)*

Section § 8.70(a)(1) describes the safe harbor available to a director or officer 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 in that section. The safe harbor provided is as broad as that provided for a director’s conflicting interest transaction in section 8.61. If the director or officer makes the prescribed disclosure of the facts specified and the corporation’s interest in the opportunity is disclaimed by director action under subsection (a)(1)(i) or shareholder action under subsection (a)(1)(ii), the director or officer 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 or officer thereafter pursues or takes the opportunity for his or her own account or through or for the benefit of another person. As a general proposition, disclaimer by director action under subsection (a)(1)(i) 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)(1)(ii) must likewise meet all of the requirements for shareholder action under section 8.63. Note, however, several important differences.

First, 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)(1) requires that the director or officer present the opportunity and secure director or shareholder action disclaiming it *before* the director or officer or other person involved through or on behalf of the director or officer becomes legally obligated respecting 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 disclaim the corporation's interest in it. If the director or officer could seek ratification after the legal obligation respecting the opportunity arises, the option of taking over the opportunity would, in most cases, be foreclosed to the corporation. The safe harbor's benefit is available only when the corporation can entertain the opportunity in a fully objective way.

The second difference relates to the necessary disclosure. Instead of employing section § 8.60's definition of "required disclosure" which is incorporated in sections 8.62 and § 8.63 and includes "the existence and nature of the director's conflicting interest," the disclosure obligation of section § 8.70(a)(1) requires only that the director or officer reveal all material facts concerning the business opportunity known to the director or officer. The safe harbor procedure shields the director or officer even if a material fact regarding the business opportunity is not disclosed, so long as the proffering director or officer had no knowledge of that fact.

## 2. *Section 8.70(b)*

Section 8.70(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 reflects the fact-intensive nature of the corporate opportunity doctrine, with the result that a director or officer may be inclined to seek safe harbor protection under section 8.70 before pursuing an opportunity that may or may not be a "corporate opportunity." Likewise, a director or officer may 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 subsection § 8.70(a)(1). Accordingly, subsection § 8.70(b) provides that a decision not to seek the safe harbor offered by subsection § 8.70(a)(1) neither creates a negative implication 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."

## CHAPTER 9

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# Domestication and Conversion

### **Subchapter A.**

#### **PRELIMINARY PROVISIONS**

- § 9.01. Definitions
- § 9.02. Excluded Transactions [Optional]
- § 9.03. Required Approvals [Optional]
- § 9.04. Relationship of Chapter to Other Laws [Optional]

### **Subchapter B.**

#### **DOMESTICATION**

- § 9.20. Domestication
- § 9.21. Action on A Plan of Domestication
- § 9.22. Articles of Domestication; Effectiveness
- § 9.23. Amendment of Plan of Domestication; Abandonment
- § 9.24. Effect of Domestication

### **Subchapter C.**

#### **CONVERSION**

- § 9.30. Conversion
- § 9.31. Plan of Conversion
- § 9.32. Action on a Plan of Conversion
- § 9.33. Articles of Conversion; Effectiveness
- § 9.34. Amendment of Plan of Conversion; Abandonment
- § 9.35. Effect of Conversion

### **INTRODUCTORY COMMENT**

This chapter provides procedures by which a domestic corporation may become a foreign corporation or a different form of domestic or foreign entity and, conversely, a foreign corporation or an eligible entity may become a domestic corporation. These procedures are:

- **Domestication.** The procedures in subchapter 9B permit a corporation to change its state of incorporation, thus allowing a domestic corporation to become a foreign corporation or a foreign corporation to become a domestic corporation.
- **Conversion.** The procedures in subchapter 9C permit a domestic corporation to become a domestic or foreign eligible entity and also permit a domestic or foreign eligible entity to

become a domestic corporation.

The provisions of this chapter apply only if a domestic corporation is present either immediately before or immediately after a domestication or conversion.

***Note on Adoption:** 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, a state may wish to permit a domestic limited partnership to become a domestic limited liability company. The Model Entity Transactions Act prepared by the Uniform Law Commission is such a generalized statute. Some states have elected to include transactions that are described in chapter 9 as domestications in their definition of conversions and not to refer to domestication separately.*

## **Subchapter A.**

### **PRELIMINARY PROVISIONS**

#### **§ 9.01 Definitions**

As used in this chapter:

“Conversion” means a transaction pursuant to subchapter C.

“Converted entity” means the converting entity as it continues in existence after a conversion.

“Converting entity” means the domestic corporation or eligible entity that approves a plan of conversion pursuant to section 9.32 or the foreign eligible entity that approves a conversion pursuant to the organic law of the eligible entity.

“Domesticated corporation” means the domesticating corporation as it continues in existence after a domestication.

“Domesticating corporation” means the domestic corporation that approves a plan of domestication pursuant to section 9.21 or the foreign corporation that approves a domestication pursuant to the organic law of the foreign corporation.

“Domestication” means a transaction pursuant to subchapter B.

“Protected agreement” means:

- (i) a document evidencing indebtedness of a domestic corporation or eligible entity and any related agreement in effect immediately before the enactment date;
- (ii) an agreement that is binding on a domestic corporation or eligible entity immediately before the enactment date;
- (iii) the articles of incorporation or bylaws of a domestic corporation or the organic rules of a domestic eligible entity, in each case in effect immediately before the enactment date; or
- (iv) an agreement that is binding on any of the shareholders, members, interest holders, directors or other governors of a domestic corporation or eligible entity, in their capacities as such, immediately before the enactment date.

For purposes of this definition and sections 9.20 and § 9.30, “enactment date” means the first

date on which the law of this state authorized a transaction having the effect of a domestication or a conversion, as applicable.

***Note on adoption:** When adopting the definition of “protected agreement,” a state could consider setting out in the last sentence of the definition the actual dates when domestication and conversion statutes were first enacted in the state so those dates would be apparent on the face of the statute.*

## **CROSS-REFERENCES**

Articles of incorporation, see § 2.02.

“Corporation,” “domestic” and “foreign” defined, see § 1.40.

“Document” defined, see § 1.40.

“Eligible entity” defined, see § 1.40.

“Entity” defined, see § 1.40.

“Governor” defined, see § 1.40.

“Interest holder” defined, see § 1.40.

“Membership” defined, see § 1.40.

“Organic law” and “organic rules” defined, see § 1.40.

## **OFFICIAL COMMENT**

Section 9.01 sets out definitions used in the Act’s provisions on domestication and conversion. It defines “protected agreement” as those specified documents and agreements which were in effect before the laws of the state first provided for domestication or conversion transactions. A person contracting with a corporation or loaning it money, or which drafted and negotiated special rights relating to mergers or similar transactions, before the enactment of this chapter (or any similar predecessor law) should not be charged with the consequences of not having dealt with domestications and conversions. Sections 9.20(f) and § 9.30(d) provide special rules dealing with protected agreements.

### **§ 9.02 Excluded Transactions [Optional]**

This chapter may not be used to effect a transaction that:

- (a) [converts a company organized on the mutual principle to one organized on the basis of share ownership]; or
- (b) [other examples]

***Note on adoption:** A state should use this section to list those situations in which the state has enacted specific legislation governing the domestication or conversion of domestic corporations that engage in particular types of activities or that do business in a regulated industry. Mutual to share conversions (for instance, of an insurance company, bank, savings institution or credit union) are examples of such transactions.*

## **OFFICIAL COMMENT**

The purpose of this section is to prohibit certain transactions that are subject to a separate statutory or legal framework from being effected under this chapter.

### **§ 9.03 Required Approvals [Optional]**

If a domestic or foreign 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], and the applicable statutes or regulations do not specifically deal with transactions under this chapter but do require such approval for mergers, a corporation or eligible entity shall not be a party to a transaction under this chapter without the prior approval of that agency or official.

*Note on adoption:* § 9.03 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. If this section is used, the list of officials and agencies should be conformed to the laws of the enacting state.

#### **OFFICIAL COMMENT**

The purpose of section 9.03 is to ensure that transactions under chapter 9 will be effected only if required state governmental approvals have been obtained. If other state laws require such approvals in the case of mergers, but do not address approvals in the case of domestications and conversions, then section 9.03 requires that transactions under chapter 9 obtain the same regulatory approvals as mergers.

### **§ 9.04 Relationship of Chapter to Other Laws [Optional]**

A transaction effected under this chapter may not create or impair a right, duty or obligation of a person under the statutory law of this state other than this chapter relating to a change in control, business combination, control-share acquisition, or similar transaction involving a domesticating or converting domestic corporation, unless the approval of the plan of domestication or conversion is by a vote of the shareholders or the board of directors which would be sufficient to create or impair the right, duty or obligation directly under that law.

#### **OFFICIAL COMMENT**

This section protects the application of change of control statutes from being affected by a transaction under this chapter by requiring that the transaction be approved in a manner that would be sufficient to approve changing the application of the change of control statute. If a domestication or conversion is approved in that manner, there is no policy reason to prohibit the application of the change of control statute from being varied for the transaction. If the application of a change of control statute cannot be varied by action of an entity subject to it, then a transaction under this chapter will be permissible only if the change of control provision continues to apply after the transaction or the transaction itself is permissible under the change of control statute.

## **Subchapter B.**

### **DOMESTICATION**

#### **§ 9.20 Domestication**

- (a) By complying with the provisions of this subchapter applicable to foreign corporations, a foreign corporation may become a domestic corporation if the domestication is permitted by the organic law of the foreign corporation.
- (b) By complying with the provisions of this subchapter, a domestic corporation may become a foreign corporation pursuant to a plan of domestication if the domestication is permitted by the organic law of the foreign corporation.
- (c) The plan of domestication must include:
  - (1) the name of the domesticating corporation;
  - (2) the name and jurisdiction of formation of the domesticated corporation;
  - (3) the manner and basis of reclassifying the shares of the domesticating corporation into shares or other securities, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing;
  - (4) the proposed articles of incorporation and bylaws of the domesticated corporation; and
  - (5) the other terms and conditions of the domestication.
- (d) In addition to the requirements of subsection § 9.20(c), a plan of domestication may contain any other provision not prohibited by law.
- (e) The 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 a protected agreement of a domestic domesticating corporation in effect immediately before the domestication becomes effective contains a provision applying to a merger of the corporation and the agreement does not refer to a domestication of the corporation, the provision applies to a domestication of the corporation as if the domestication were a merger until such time as the provision is first amended after the enactment date.

#### **CROSS-REFERENCES**

Abandonment of domestication, see § 9.23.

Approval of plan, see § 9.21.

Articles of domestication, see § 9.22.

Articles of incorporation following domestication, see § 9.22.

“Domestic corporation” defined, see § 1.40.

Effect of domestication, see § 9.24.

“Enactment date” defined in definition of protected agreement, see § 9.01.

Excluded transactions, see § 9.02.

“Interest holder liability” defined, see § 1.40.

“Foreign corporation” defined, see § 1.40.

“Organic law” defined, see § 1.40.

“Protected agreement” defined, see § 9.01.

[Required approvals, see § 9.03]

“Voting group” defined, see § 1.40.

## **OFFICIAL COMMENT**

### *1. Applicability*

This subchapter authorizes a foreign corporation to become a domestic corporation and a domestic corporation to become a foreign corporation. In each case, the domestication is authorized only if the laws of the foreign jurisdiction permit it. Whether and on what terms a foreign corporation is authorized to domesticate in this state are issues governed by the organic law of the foreign corporation, not by this subchapter. A foreign corporation is not required to have a valid registration to do business in this state under chapter 15 to domesticate in this state.

### *2. Terms and Conditions of Domestication*

This subchapter imposes no restrictions or limitations on the terms and conditions of a domestication, except for those set forth in section 9.23(a) with respect to certain amendments to the plan of domestication. The list in section 9.20(c) of required provisions in a plan of domestication is not exhaustive. Unlike a domestic corporation, a foreign corporation is not required to have a plan of domestication, although it must comply with the provisions of this subchapter applicable to foreign corporations.

### *3. Articles of Incorporation*

Under section § 9.20(c)(4), a domestic corporation’s plan of domestication must include that corporation’s proposed articles of incorporation and bylaws, which should comply with the organic law of the foreign jurisdiction into which it is domesticating. In the case of a domestic corporation domesticating into a foreign jurisdiction, the Act places no separate limitations on the provisions that the proposed articles of incorporation and bylaws may contain, and they may be substantially identical to or completely different from those of the domesticating corporation. However, the content of the proposed articles may affect the approvals required for the plan of domestication. See the approval requirements in section 9.21(f) with respect to certain changes in the articles of incorporation, and section 9.21(g) with respect to interest holder liability with respect to the domesticated corporation.

### *4. Appraisal Rights*

This subchapter does not require that a shareholder in the domesticating corporation receive the same type or amount, or even any, shares of the domesticated corporation. However, a shareholder of a domestic corporation that domesticates into a foreign jurisdiction has appraisal rights if the shareholder does not receive shares in the domesticated corporation having terms as favorable to the shareholder in all material respects, and representing at least the same percentage interest of the total voting rights of the outstanding shares of the domesticated corporation, as the shares held by the shareholder before the domestication. See section 13.02(a)(6).

### *5. Protected Agreements*

Section 9.20(f) provides special rules for “protected agreements”—certain documents and agreements in effect before the date (defined as the “enactment date”) of this chapter (or any similar predecessor statute).

### **§ 9.21 Action on A Plan of Domestication**

In the case of a domestication of a domestic corporation into a foreign jurisdiction, the plan of domestication shall be adopted in the following manner:

- (a) The plan of domestication shall first be adopted by the board of directors.
- (b) The plan of domestication shall then be approved by the shareholders. In submitting the plan of domestication to the shareholders for approval, the board of directors shall recommend that the shareholders approve the plan, unless (i) the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation or (ii) section 8.26 applies. If either (i) or (ii) applies, the board shall inform the shareholders of the basis for its so proceeding.
- (c) The board of directors may set conditions for approval of the plan of domestication by the shareholders or the effectiveness of the plan of domestication.
- (d) If the approval of the shareholders is to be given at a meeting, the corporation shall notify each shareholder, regardless of whether 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 of domestication and must contain or be accompanied by a copy or summary of the plan. The notice must include or be accompanied by a copy of the articles of incorporation and the bylaws as they will be in effect immediately after the domestication.
- (e) Unless the articles of incorporation, or the board of directors acting pursuant to subsection § 9.21(c), require a greater vote or a greater quorum, approval of the plan of domestication requires (i) the approval of the shareholders at a meeting at which a quorum exists consisting of a majority of the votes entitled to be cast on the plan, and, (ii) except as provided in subsection § 9.21(f), the approval of each class or series of shares voting as a separate voting group at a meeting at which a quorum of the voting group exists consisting of a majority of the votes entitled to be cast on the plan by that voting group.
- (f) The articles of incorporation may expressly limit or eliminate the separate voting rights provided in subsection § 9.21(e) as to any class or series of shares, except when the articles of incorporation of the foreign corporation resulting from the domestication include what would be in effect an amendment that would entitle the class or series to vote as a separate group under section 10.04 if it were a proposed amendment of the articles of incorporation of the domestic domesticating corporation.
- (g) If as a result of a domestication one or more shareholders of a domestic domesticating corporation would become subject to interest holder liability, approval of the plan of domestication shall require the signing in connection with the domestication, by each such shareholder, of a separate written consent to become subject to such interest holder liability, unless in the case of a shareholder that already has interest holder liability with respect to the domesticating corporation, the terms and conditions of the interest holder liability with respect to the domesticated corporation are substantially identical to those of the existing interest holder liability (other than for changes that eliminate or reduce such interest holder liability).

### **CROSS-REFERENCES**

Abandonment of domestication, see § 9.23.

Contents of plan of domestication, see § 9.20.



“Domestic corporation” defined, see § 1.40

“Interest holder liability” defined, see § 1.40.

“Organic law” defined, see § 1.40.

Submission of matters for shareholder vote, see § 8.26.

“Voting group” defined, see § 1.40.

## OFFICIAL COMMENT

### 1. *In General*

Section 9.21 sets forth the rules for adoption and approval of a plan of domestication of a domestic corporation into a foreign jurisdiction. The manner in which the domestication of a foreign corporation into this state must be adopted and approved will be controlled by the organic law of the foreign corporation.

When submitting a plan of domestication to shareholders, the board of directors must recommend the transaction, subject to two exceptions in section 9.21(b). The board might exercise the exception under clause (i) where the number of directors having a conflicting interest makes it inadvisable for the board to recommend the domestication or where the board is evenly divided as to the merits of the domestication but is able to agree that shareholders should be permitted to consider it. Alternatively, the board of directors might exercise the exception under clause (ii), which recognizes that, under section 8.26, a board of directors may agree to submit a plan to a vote of shareholders even if, after approving the plan, the board of directors determines that it no longer recommends the plan.

Section 9.21(c) permits the board of directors to condition its submission of a plan of domestication to the shareholders or the effectiveness of the plan of domestication. Among the conditions that a board of directors 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.

Section 9.21(d) provides a notice requirement if a plan of domestication is to be considered by the shareholders at a meeting. Requirements concerning the timing and content of a notice of meeting are in section 7.05. Section 9.21(d) does not address the notice to be given to nonvoting or nonconsenting shareholders where the plan is approved without a meeting by written consent. However, that requirement is imposed by section 7.04.

### 2. *Quorum; Voting by Separate Groups*

Section 9.21(e) sets forth quorum and voting requirements applicable to a shareholder vote to approve a plan of domestication. Section 9.21(e) also provides that each class or series has a right to vote on a plan of domestication as a separate voting group. See sections 7.25(f) and § 10.04(c) for rules governing when separate classes or series vote together as a single voting group. Section 9.21(f) permits the articles of incorporation to expressly limit or eliminate separate voting as a voting group for any class or series of shares on a plan of domestication unless the articles of incorporation of the foreign domesticated corporation into which the corporation would be domesticated include what would be an amendment requiring separate group voting under

section 10.04 if it had been done as an amendment of that domestic corporation's articles of incorporation. The requirement that such a limitation or elimination be "express" is meant to avoid any ambiguity that might arise from a provision in the articles of incorporation that denies voting rights to the class or series. In lieu of approval at a meeting, shareholder approval may be by written consent under the procedures set forth in section 7.04.

### *3. Personal Liability of Shareholders*

Section 9.21(g) applies only in situations where a shareholder of a domestic corporation is becoming subject to "interest holder liability," as defined in section 1.40, with respect to the domesticated corporation. Approval of a domestication that would have such a result generally requires the written consent of each such shareholder who becomes subject to such interest holder liability. The exception is the limited case where the shareholder has interest holder liability with respect to the domesticating corporation, and the terms and conditions of the shareholder's interest holder liability with respect to the domesticated corporation are substantially identical to those existing prior to the domestication. If, for example, a shareholder before the domestication has interest holder liability for certain borrowings and after the domestication would have interest holder liability for unpaid wages, the terms and conditions of the interest holder liability are not substantially identical, and the shareholder's written consent to become subject to that liability would be required for the domestication to be approved.

## **§ 9.22 Articles of Domestication; Effectiveness**

- (a) After (i) a plan of domestication of a domestic corporation has been adopted and approved as required by this Act, or (ii) a foreign corporation that is the domesticating corporation has approved a domestication as required under its organic law, articles of domestication shall be signed by the domesticating corporation. The articles must set forth:
  - (1) the name of the domesticating corporation and its jurisdiction of formation;
  - (2) the name and jurisdiction of formation of the domesticated corporation; and
  - (3) if the domesticating corporation is a domestic corporation, a statement that the plan of domestication was approved in accordance with this chapter or, if the domesticating corporation is a foreign corporation, a statement that the domestication was approved in accordance with its organic law.
- (b) If the domesticated corporation is a domestic corporation, the articles of domestication must attach articles of incorporation of the domesticated corporation that satisfy the requirements of section 2.02. Provisions that would not be required to be included in restated articles of incorporation may be omitted from the articles of incorporation attached to the articles of domestication.
- (c) The articles of domestication shall be delivered to the secretary of state for filing, and shall take effect at the effective date determined in accordance with section 1.23.
- (d) If the domesticated corporation is a domestic corporation, the domestication becomes effective when the articles of domestication are effective. If the domesticated corporation is a foreign corporation, the domestication becomes effective on the later of (i) the date and time provided by the organic law of the domesticated corporation, and (ii) when the articles of domestication are effective.
- (e) If the domesticating corporation is a foreign corporation that is registered to do business in this state under chapter 15, its registration statement shall be cancelled automatically when

the domestication becomes effective.

## **CROSS-REFERENCES**

“Domestic corporation” defined, see § 1.40.

“Domesticated corporation” defined, see § 9.01.

“Domesticating corporation” defined, see § 9.01.

Effect of domestication, see §§ 9.24.

Filing requirements, see § 1.20.

“Organic law” defined, see § 1.40.

[Required approvals, see § 9.03.]

## **OFFICIAL COMMENT**

The filing of articles of domestication makes the domestication a matter of public record. Where the domesticated corporation is a domestic corporation, it also makes its articles of incorporation a matter of public record.

The requirements for filing are set forth in section 1.20. Under section 1.23, the articles of domestication are effective on the date and at the time of filing unless a later effective date is specified in the articles within the limits provided in section 1.23. Under section 1.23, a delayed effective date may not be later than the 90th day after the date the document is filed. Section § 9.22(d) provides when the domestication becomes effective.

### **§ 9.23 Amendment of Plan of Domestication; Abandonment**

- (a) A plan of domestication of a domestic corporation may be amended:
  - (1) in the same manner as the plan was approved, if the plan does not provide for the manner in which it may be amended; or
  - (2) in the manner provided in the plan, except that a shareholder that was entitled to vote on or consent to approval of the plan is entitled to vote on or consent to any amendment of the plan that will change:
    - (i) the amount or kind of shares or other securities, obligations, rights to acquire shares or other securities, cash, other property, or any combination of the foregoing, to be received by any of the shareholders of the domesticating corporation under the plan;
    - (ii) the articles of incorporation or bylaws of the domesticated corporation that will be in effect immediately after the domestication becomes effective, except for changes that do not require approval of the shareholders of the domesticated corporation under its organic law or its proposed articles of incorporation or bylaws as set forth in the plan; or
    - (iii) any of the other terms or conditions of the plan, if the change would adversely affect the shareholder in any material respect.
- (b) After a plan of domestication has been adopted and approved by a domestic corporation as required by this subchapter, and before the articles of domestication have become effective, the plan may be abandoned by the corporation without action by its shareholders in

accordance with any procedures set forth in the plan or, if no such procedures are set forth in the plan, in the manner determined by the board of directors.

- (c) If a domestication is abandoned after the articles of domestication have been delivered to the secretary of state for filing but before the articles of domestication have become effective, articles of abandonment, signed by the domesticating corporation, must be delivered to the secretary of state for filing before the articles of domestication become effective. The articles of abandonment take effect upon filing, and the domestication shall be deemed abandoned and shall not become effective. The articles of abandonment must contain:
- (1) the name of the domesticating corporation;
  - (2) the date on which the articles of domestication were filed by the secretary of state; and
  - (3) a statement that the domestication has been abandoned in accordance with this section.

### **CROSS-REFERENCES**

“Domestic corporation” defined, see § 1.40.

“Domesticated corporation” defined, see § 9.01.

“Domesticating corporation” defined, see § 9.01.

“Organic law” defined, see § 1.40.

### **OFFICIAL COMMENT**

Section § 9.23(a)(2) permits the plan of domestication to be amended in the manner provided in the plan, subject to certain cases requiring a shareholder vote on the amendment. If the plan has no provisions with respect to its amendment, it may be amended under section § 9.23(a)(1) in the same manner as it was approved.

Under section 9.23(b), unless otherwise provided in the plan of domestication, a domestic corporation may abandon a domestication without shareholder approval, even though the transaction has been previously approved by the shareholders. The power of a foreign corporation to abandon a domestication will be determined by its organic law.

### **§ 9.24 Effect of Domestication**

- (a) When a domestication becomes effective:
- (1) all property owned by, and every contract right possessed by, the domesticating corporation are the property and contract rights of the domesticated corporation without transfer, reversion or impairment;
  - (2) all debts, obligations and other liabilities of the domesticating corporation are the debts, obligations and other liabilities of the domesticated corporation;
  - (3) the name of the domesticated corporation may but need not be substituted for the name of the domesticating corporation in any pending proceeding;
  - (4) the articles of incorporation and bylaws of the domesticated corporation become effective;
  - (5) the shares of the domesticating corporation are reclassified into shares or other securities, obligations, rights to acquire shares or other securities, cash or other property in accordance with the terms of the domestication, and the shareholders of the domesticating corporation are entitled only to the rights provided to them by those

- terms and to any appraisal rights they may have under the organic law of the domesticating corporation; and
- (6) the domesticated corporation is:
    - (i) incorporated under and subject to the organic law of the domesticated corporation;
    - (ii) the same corporation without interruption as the domesticating corporation; and
    - (iii) deemed to have been incorporated on the date the domesticating corporation was originally incorporated.
  - (b) When a domestication of a domestic corporation into a foreign jurisdiction becomes effective, the domesticated 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) Except as otherwise provided in the organic law or organic rules of a domesticating foreign corporation, the interest holder liability of a shareholder in a foreign corporation that is domesticated into this state who had interest holder liability in respect of such domesticating corporation before the domestication becomes effective shall be as follows:
    - (1) The domestication does not discharge that prior interest holder liability with respect to any interest holder liabilities that arose before the domestication becomes effective.
    - (2) The provisions of the organic law of the domesticating corporation shall continue to apply to the collection or discharge of any interest holder liabilities preserved by subsection § 9.24(c)(1), as if the domestication had not occurred.
    - (3) The shareholder shall have such rights of contribution from other persons as are provided by the organic law of the domesticating corporation with respect to any interest holder liabilities preserved by subsection § 9.24(c)(1), as if the domestication had not occurred.
    - (4) The shareholder shall not, by reason of such prior interest holder liability, have interest holder liability with respect to any interest holder liabilities that are incurred after the domestication becomes effective.
  - (d) A shareholder who becomes subject to interest holder liability in respect of the domesticated corporation as a result of the domestication shall have such interest holder liability only in respect of interest holder liabilities that arise after the domestication becomes effective.
  - (e) A domestication does not constitute or cause the dissolution of the domesticating corporation.
  - (f) Property held for charitable purposes under the laws of this state by a domestic or foreign corporation immediately before a domestication shall not, as a result of the transaction, be diverted from the objects for which it was donated, granted, devised, or otherwise transferred except and to the extent permitted by or pursuant to the laws of this state addressing cy près or dealing with nondiversion of charitable assets.
  - (g) A bequest, devise, gift, grant, or promise contained in a will or other instrument of donation, subscription, or conveyance which is made to the domesticating corporation and which takes effect or remains payable after the domestication inures to the domesticated corporation.
  - (h) A trust obligation that would govern property if transferred to the domesticating corporation applies to property that is transferred to the domesticated corporation after the domestication takes effect.

## **CROSS-REFERENCES**

Appraisal rights, see ch. 13.

“Domesticated corporation” defined, see § 9.01.

“Domesticating corporation” defined, see § 9.01.

“Interest holder liability” defined, see § 1.40.

“Organic law” and “organic rules” defined, see § 1.40.

## **OFFICIAL COMMENT**

The domesticated corporation is the same entity as the domesticating corporation, and it continues without interruption. It becomes a business corporation in the resulting jurisdiction with the same status as if it had been originally incorporated there. The domesticated corporation will have all of the powers, privileges and rights granted to corporations originally incorporated in that jurisdiction and will be subject to all of the duties, liabilities and limitations imposed on business corporations in that jurisdiction. Thus, 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. See, however, section 9.20(f) and its Official Comment with respect to special rules regarding protected agreements. All pending proceedings involving the domesticating corporation are continued.

A domestic corporation domesticating into a foreign jurisdiction remains obligated to its shareholders who exercise appraisal rights to pay them the amount, if any, to which they are entitled under chapter 13. For this purpose, under section 9.24(b) the domesticated corporation is deemed to appoint the secretary of state as its agent for service of process in proceedings to enforce those rights.

Section 9.24(c) preserves the interest holder liability of shareholders of the domesticating foreign corporation only for interest holder liabilities to the extent they arise before the domestication becomes effective. Interest holder liability is not preserved for subsequent changes in an underlying liability, regardless of whether a change is voluntary or involuntary. Section 9.24(d) similarly provides that interest holder liability with respect to the domesticated corporation only relates to interest holder liabilities that arise after the domestication.

## **Subchapter C. CONVERSION**

### **§ 9.30 Conversion**

- (a) By complying with this chapter, a domestic corporation may become (i) a domestic eligible entity or (ii) a foreign eligible entity if the conversion is permitted by the organic law of the foreign entity.
- (b) By complying with this subchapter and applicable provisions of its organic law, a domestic eligible entity may become a domestic corporation. If procedures for the approval of a conversion are not provided by the organic law or organic rules of a domestic eligible entity, the conversion shall be adopted and approved in the same manner as a merger of that

eligible entity. If the organic law or organic rules of a domestic eligible entity do not provide procedures for the approval of either a conversion or a merger, a plan of conversion may nonetheless be adopted and approved by the unanimous consent of all the interest holders of such eligible entity. In either such case, the conversion thereafter may be effected as provided in the other provisions of this subchapter; and for purposes of applying this chapter in such a case:

- (1) the eligible entity, its members or interest holders, eligible interests and organic rules 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 person or persons that are not identical to the members or interest holders, that person or persons shall be deemed to be the board of directors.
- (c) By complying with the provisions of this subchapter applicable to foreign entities, a foreign eligible entity may become a domestic corporation if the organic law of the foreign eligible entity permits it to become a business corporation in another jurisdiction.
- (d) If a protected agreement of a domestic converting corporation in effect immediately before the conversion becomes effective contains a provision applying to a merger of the corporation that is a converting entity and the agreement does not refer to a conversion of the corporation, the provision applies to a conversion of the corporation as if the conversion were a merger, until such time as the provision is first amended after the enactment date.

## **CROSS-REFERENCES**

“Converted entity” defined, see § 9.01.

“Converting entity” defined, see § 9.01.

“Corporation,” “business corporation,” “domestic corporation” and “domestic business corporation” defined, see § 1.40.

“Domestic” and “eligible entity” defined, see § 1.40.

“Eligible interest” defined, see § 1.40.

“Enactment date” defined in definition of protected agreement, see § 9.01.

[Excluded transactions, see § 9.02]

“Foreign” and “eligible entity” defined, see § 1.40.

“Interest holder” defined, see § 1.40.

“Membership” defined, see § 1.40.

“Organic law” and “organic rules” defined, see § 1.40.

“Protected agreement” defined, see § 9.01.

[Required approvals, see § 9.03.]

## **OFFICIAL COMMENT**

### *1. Applicability*

This subchapter authorizes a domestic corporation to become a domestic eligible entity. It also authorizes a domestic corporation to become a foreign eligible entity, but only if the conversion is permitted by the laws under which the foreign eligible entity will be organized.

Further, this subchapter authorizes a domestic or foreign eligible entity to become a domestic corporation. Whether and on what terms a foreign eligible entity is authorized to convert is governed by its organic law. If a foreign eligible entity is so authorized, it must comply with the provisions of this subchapter applicable to foreign entities. For example, it must file articles of conversion under section 9.33(a), and section 9.33(b) requires its articles of incorporation to meet the requirements of section 2.02.

With respect to a domestic eligible entity, if the law under which it is organized does not expressly authorize it to convert to a domestic corporation, section 9.30(b) provides procedures for such an entity to adopt and effect a plan of conversion.

## 2. *Protected Agreements*

section 9.30(d) provides special rules about “protected agreements”—certain documents and agreements in effect before the date (defined as the “enactment date”) of this chapter (or any similar predecessor statute).

### **§ 9.31 Plan of Conversion**

- (a) A domestic corporation may convert to a domestic or foreign eligible entity under this subchapter by approving a plan of conversion. The plan of conversion must include:
  - (1) the name of the converting corporation;
  - (2) the name, jurisdiction of formation and type of entity of the converted entity;
  - (3) the manner and basis of converting the shares of the domestic corporation into eligible interests or other securities, obligations, rights to acquire eligible interests or other securities, cash, other property, or any combination of the foregoing;
  - (4) the other terms and conditions of the conversion; and
  - (5) the full text, as it will be in effect immediately after the conversion becomes effective, of the organic rules of the converted entity which are to be in writing.
- (b) In addition to the requirements of subsection § 9.31(a), a plan of conversion may contain any other provision not prohibited by law.
- (c) The terms of a plan of conversion may be made dependent upon facts objectively ascertainable outside the plan in accordance with section 1.20(k).

### **CROSS-REFERENCES**

Amendment or abandonment of plan of conversion, see § 9.34.

Application to domestic eligible entities, see § 9.30.

Approval of plan, see § 9.32.

Effect of conversion, see § 9.35.

“Eligible entity” defined, see § 1.40e § 1.40.

“Eligible interest” defined, see § 1.40.

“Organic rules” defined, see § 1.40.

### **OFFICIAL COMMENT**



This subchapter imposes no restrictions or limitations on the terms and conditions of a conversion, except for those set forth in section 9.34(a) with respect to certain amendments to the plan of conversion. Under section 9.31(a)(5), the plan of conversion must include the written organic rules of the converted entity, which should comply with the organic law governing the converted entity. The list in section 9.31(a) of required provisions in a plan of conversion is not exhaustive.

The conversion of a domestic corporation to a foreign eligible entity must be adopted and approved as provided in section 9.32. Shareholders of a domestic corporation that adopts and approves a plan of conversion have appraisal rights. See chapter 13.

### **§ 9.32 Action on a Plan of Conversion**

In the case of a conversion of a domestic corporation to a domestic or foreign eligible entity, the plan of conversion shall be adopted in the following manner:

- (a) The plan of conversion shall first be adopted by the board of directors.
- (b) The plan of conversion shall then be approved by the shareholders. In submitting the plan of conversion to the shareholders for their approval, the board of directors must recommend that the shareholders approve the plan, unless (i) the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation, or (ii) section 8.26 applies. If either (i) or (ii) applies, the board of directors shall inform the shareholders of the basis for its so proceeding.
- (c) The board of directors may set conditions for approval of the plan of conversion by the shareholders or the effectiveness of the plan of conversion.
- (d) If the approval of the shareholders is to be given at a meeting, the corporation shall notify each shareholder, regardless of whether entitled to vote, of the meeting of shareholders at which the plan of 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 of conversion and must contain or be accompanied by a copy or summary of the plan. The notice must include or be accompanied by a copy of the organic rules of the converted entity which are to be in writing as they will be in effect immediately after the conversion.
- (e) Unless the articles of incorporation, or the board of directors acting pursuant to subsection § 9.32(c), require a greater vote or a greater quorum, approval of the plan of conversion requires (i) the approval of the shareholders at a meeting at which a quorum exists consisting of a majority of the votes entitled to be cast on the plan, and (ii) the approval of each class or series of shares voting as a separate voting group at a meeting at which a quorum of the voting group exists consisting of a majority of the votes entitled to be cast on the plan by that voting group.
- (f) If as a result of the conversion one or more shareholders of the converting domestic corporation would become subject to interest holder liability, approval of the plan of conversion shall require the signing in connection with the transaction, by each such shareholder, of a separate written consent to become subject to such interest holder liability.

### **CROSS-REFERENCES**

Abandonment of conversion, see § 9.34.

Application to domestic eligible entities, see § 9.30.

- Contents of plan of conversion, see §§ 9.31.
- “Eligible entity” defined, see § 1.40.
- “Interest holder liability” defined, see § 1.40.
- “Organic rules” defined, see § 1.40.
- Submission of matters to shareholders, see § 8.26.
- “Voting group” defined, see § 1.40.

## OFFICIAL COMMENT

### 1. *In General*

This section sets forth the rules for adoption and approval of a plan of conversion by a domestic corporation. The manner in which the conversion of a foreign eligible entity to a domestic corporation must be adopted and approved will be controlled by the organic law of the foreign jurisdiction. The manner in which the conversion of a domestic eligible entity to a domestic corporation must be adopted and approved will be controlled by the organic law of the eligible entity, as supplemented by section 9.30(b), if applicable.

When submitting a plan of conversion to shareholders, the board of directors must recommend the transaction, subject to two exceptions in section 9.32(b). The board might exercise the exception under clause (i) where the number of directors having a conflicting interest makes it inadvisable for the board to recommend the conversion or where the board is evenly divided as to the merits of the conversion but is able to agree that shareholders should be permitted to consider it. Alternatively, the board of directors might exercise the exception in clause (ii), which recognizes that, under section 8.26, a board of directors may agree to submit a plan to a vote of shareholders even if, after approving the plan, the board of directors determines that it no longer recommends the plan.

Section 9.32(c) permits the board of directors to condition its submission of a plan of conversion to the shareholders or the effectiveness of the plan of conversion. Among the conditions that a board of directors 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 percentage of the outstanding shares assert appraisal rights.

Section 9.32(d) provides a notice requirement if a plan of conversion is to be considered by the shareholders at a meeting. Requirements concerning the timing and content of a notice of meeting are in section 7.05. Section 9.32(d) does not address the notice to be given to nonvoting or nonconsenting shareholders where the plan is approved without a meeting by written consent. However, that requirement is imposed by section 7.04.

### 2. *Quorum and Voting*

Section 9.32(e) sets forth quorum and voting requirements applicable to a shareholder vote to approve a plan of conversion. It requires both the vote of the shareholders entitled to vote on the plan, and the vote of each class or series of shares voting as a separate voting group. See sections 7.25(f) and § 10.04(c) for rules governing when separate classes or series vote together as a single voting group. In lieu of approval at a meeting, shareholder approval may be by written consent under the procedures set forth in section 7.04.

### 3. *Personal Liability of Shareholders*

Section 9.32(f) applies only in situations where a shareholder of a domestic corporation is becoming subject to “interest holder liability,” as defined in section 1.40, with respect to the converted entity. Approval of a conversion that would have such a result requires the written consent of each such shareholder who becomes subject to such interest holder liability.

#### **§ 9.33 Articles of Conversion; Effectiveness**

- (a) After (i) a plan of conversion of a domestic corporation has been adopted and approved as required by this Act, or (ii) a domestic or foreign eligible entity that is the converting entity has approved a conversion as required under its organic law, articles of conversion shall be signed by the converting entity and must:
  - (1) state the name, jurisdiction of formation, and type of entity of the converting entity;
  - (2) state the name, jurisdiction of formation, and type of entity of the converted entity;
  - (3) if the converting entity is (i) a domestic corporation, state that the plan of conversion was approved in accordance with this subchapter; or (ii) an eligible entity, (A) state that the conversion was approved by the eligible entity in accordance with its organic law or (B) if the converting entity is a domestic eligible entity the organic law of which does not provide for approval of the conversion, state that the conversion was approved by the domestic eligible entity in accordance with this subchapter; and
  - (4) if the converted entity is (i) a domestic business corporation, or a domestic nonprofit corporation or filing entity, have attached the public organic record of the converted entity, except that provisions that would not be required to be included in a restated public organic record may be omitted; or (ii) a domestic limited liability partnership, have attached the filing required to become a limited liability partnership.
- (b) If the converted entity is a domestic corporation, its articles of incorporation must satisfy the requirements of section 2.02, except that provisions that would not be required to be included in restated articles of incorporation may be omitted from the articles of incorporation. If the converted entity is a domestic eligible entity, its public organic record, if any, must satisfy the requirements of the organic law of this state, except that the public organic record does not need to be signed.
- (c) The articles of conversion shall be delivered to the secretary of state for filing, and shall take effect at the effective date determined in accordance with section 1.23.
- (d) If a converted entity is a domestic entity, the conversion becomes effective when the articles of conversion are effective. With respect to a conversion in which the converted entity is a foreign eligible entity, the conversion itself shall become effective at the later of (i) the date and time provided by the organic law of that eligible entity, and (ii) when the articles of conversion become effective.
- (e) Articles of conversion under this section may be combined with any required conversion filing under the organic law of a domestic eligible entity that is the converting entity or converted entity if the combined filing satisfies the requirements of both this section and the other organic law.
- (f) If the converting entity is a foreign eligible entity that is registered to do business in this state under a provision of law similar to chapter 15, its registration statement or other type of foreign qualification shall be cancelled automatically on the effective date of its conversion.

## CROSS-REFERENCES

“Domestic business corporation” and “domestic corporation” defined, see § 1.40.

“Domestic nonprofit corporation” defined, see § 1.40.

Effect of conversion, see § 9.35.

Effective time and date of filing, see § 1.23.

“Eligible entity” defined, see § 1.40.

“Filing entity” defined, see § 1.40.

Filing requirements, see § 1.20.

“Organic law” defined, see § 1.40.

“Public organic record” defined, see § 1.40.

[Required approvals, see §§ 9.03.]

## OFFICIAL COMMENT

The filing of articles of conversion makes the conversion a matter of public record. Where the converted entity is organized under the laws of this state, the filing also makes a public record of its articles of incorporation or public organic record.

The requirements for filing are set forth in section 1.20. Under section 1.23, the articles of conversion are effective on the date and at the time of filing unless a later effective date is specified in the articles within the limits provided in section 1.23. Under that section, a delayed effective date may not be later than the 90th day after the date the document is filed. Section § 9.33(d) provides when the conversion becomes effective.

### § 9.34 Amendment of Plan of Conversion; Abandonment

- (a) A plan of conversion of a converting entity that is a domestic corporation may be amended:
  - (1) in the same manner as the plan was approved, if the plan does not provide for the manner in which it may be amended; or
  - (2) in the manner provided in the plan, except that shareholders that were entitled to vote on or consent to approval of the plan are entitled to vote on or consent to any amendment of the plan that will change:
    - (i) the amount or kind of eligible interests or other securities, obligations, rights to acquire eligible interests or other securities, cash, other property, or any combination of the foregoing, to be received by any of the shareholders of the converting corporation under the plan;
    - (ii) the organic rules of the converted entity that will be in effect immediately after the conversion becomes effective, except for changes that do not require approval of the eligible interest holders of the converted entity under its organic law or organic rules; or
    - (iii) any other terms or conditions of the plan, if the change would adversely affect such shareholders in any material respect.
- (b) After a plan of conversion has been approved by a converting entity that is a domestic corporation in the manner required by this subchapter and before the articles of conversion become effective, the plan may be abandoned by the corporation without action by its shareholders in accordance with any procedures set forth in the plan or, if no such

- procedures are set forth in the plan, in the manner determined by the board of directors.
- (c) If a conversion is abandoned after the articles of conversion have been delivered to the secretary of state for filing and before the articles of conversion become effective, articles of abandonment, signed by the converting entity, must be delivered to the secretary of state for filing before the articles of conversion become effective. The articles of abandonment take effect on filing, and the conversion is abandoned and does not become effective. The articles of abandonment must contain:
- (1) the name of the converting entity;
  - (2) the date on which the articles of conversion were filed by the secretary of state; and
  - (3) a statement that the conversion has been abandoned in accordance with this section.

### **CROSS-REFERENCES**

“Domestic corporation” defined, see § 1.40.

“Eligible interests” defined, see § 1.40.

“Organic law” and “organic rules” defined, see § 1.40.

### **OFFICIAL COMMENT**

Section § 9.34(a)(2) permits the plan of conversion to be amended in the manner provided in the plan, subject to certain cases requiring a shareholder vote on the amendment. If the plan has no provisions with respect to its amendment, it may be amended under section § 9.34(a)(1) in the same manner as it was approved.

Under section 9.34(b), unless otherwise provided in the plan of conversion, a domestic corporation may abandon a conversion without shareholder approval, even though the transaction has been previously approved by the shareholders. The power of a foreign or domestic eligible entity to abandon a conversion will be determined by its organic law.

### **§ 9.35 Effect of Conversion**

- (a) When a conversion becomes effective:
- (1) all property owned by, and every contract right possessed by, the converting entity remain the property and contract rights of the converted entity without transfer, reversion or impairment;
  - (2) all debts, obligations and other liabilities of the converting entity remain the debts, obligations and other liabilities of the converted entity;
  - (3) the name of the converted entity may but need not be substituted for the name of the converting entity in any pending action or proceeding;
  - (4) if the converted entity is a filing entity or a domestic business corporation or a domestic or foreign nonprofit corporation, its public organic record and its private organic rules become effective;
  - (5) if the converted entity is a nonfiling entity, its private organic rules become effective;
  - (6) if the converted entity is a limited liability partnership, the filing required to become a limited liability partnership and its private organic rules become effective;
  - (7) the shares or eligible interests of the converting entity are reclassified into shares, eligible interests or other securities, obligations, rights to acquire shares, eligible interests or other securities, cash, or other property in accordance with the terms of the

- conversion, and the shareholders or interest holders of the converting entity are entitled only to the rights provided to them by those terms and to any appraisal rights they may have under the organic law of the converting entity; and
- (8) the converted entity is:
- (i) incorporated or organized under and subject to the organic law of the converted entity;
  - (ii) the same entity without interruption as the converting entity; and
  - (iii) deemed to 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 corporation to a foreign eligible entity becomes effective, the converted 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) Except as otherwise provided in the articles of incorporation of a domestic corporation or the organic law or organic rules of a foreign corporation or a domestic or foreign eligible entity, a shareholder or eligible interest holder who becomes subject to interest holder liability in respect of a domestic corporation or eligible entity as a result of the conversion shall have such interest holder liability only in respect of interest holder liabilities that arise after the conversion becomes effective.
- (d) Except as otherwise provided in the organic law or the organic rules of the eligible entity, the interest holder liability of an interest holder in a converting eligible entity that converts to a domestic corporation who had interest holder liability in respect of such converting eligible entity before the conversion becomes effective shall be as follows:
- (1) The conversion does not discharge that prior interest holder liability with respect to any interest holder liabilities that arose before the conversion became effective.
  - (2) The provisions of the organic law of the eligible entity shall continue to apply to the collection or discharge of any interest holder liabilities preserved by subsection § 9.35(d)(1), as if the conversion had not occurred.
  - (3) The eligible interest holder shall have such rights of contribution from other persons as are provided by the organic law of the eligible entity with respect to any interest holder liabilities preserved by subsection § 9.35(d)(1), as if the conversion had not occurred.
  - (4) The eligible interest holder shall not, by reason of such prior interest holder liability, have interest holder liability with respect to any interest holder liabilities that arise after the conversion becomes effective.
- (e) A conversion does not require the converting entity to wind up its affairs and does not constitute or cause the dissolution or termination of the entity.
- (f) Property held for charitable purposes under the laws of this state by a corporation or a domestic or foreign eligible entity immediately before a conversion shall not, as a result of the transaction, be diverted from the objects for which it was donated, granted, devised, or otherwise transferred except and to the extent permitted by or pursuant to the laws of this state addressing cy près or dealing with nondiversion of charitable assets.
- (g) A bequest, devise, gift, grant, or promise contained in a will or other instrument of donation, subscription, or conveyance which is made to the converting entity and which takes effect or

remains payable after the conversion inures to the converted entity.

- (h) A trust obligation that would govern property if transferred to the converting entity applies to property that is transferred to the converted entity after the conversion takes effect.

### **CROSS-REFERENCES**

Appraisal rights, see ch. 13.

“Eligible entity” defined, see § 1.40.

“Eligible interest” defined, see § 1.40.

“Filing entity” defined, see § 1.40.

“Interest holder” defined, see § 1.40.

“Interest holder liability” defined, see § 1.40.

“Nonfiling entity” defined, see § 1.40.

“Organic law” and “organic rules” defined, see § 1.40.

“Private organic rules” defined, see § 1.40.

“Public organic record” defined, see § 1.40.

### **OFFICIAL COMMENT**

The converted entity is the same entity as the converting entity, and it continues without interruption. It becomes the new type of entity in the specified jurisdiction of formation with the same status as if it had been originally incorporated or organized there. The converted entity will be subject to the organic law for that entity in that jurisdiction and will be subject to all of the duties, liabilities and limitations imposed on such entities in that jurisdiction. Thus, a 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 nonassignability, unless the contract specifically provides that it does not survive a conversion. See, however, section 9.30(d) and its Official Comment with respect to special rules regarding protected agreements. All pending proceedings involving the converting entity are continued.

A domestic corporation converting to a foreign entity remains obligated to its shareholders who exercise appraisal rights to pay them the amount, if any, to which they are entitled under chapter 13. For this purpose, under section § 9.35(b)(1) that entity is deemed to appoint the secretary of state as its agent for service of process in proceedings to enforce those rights. Where the converted entity is a domestic other entity, it will be similarly liable to the shareholders of a domestic converting corporation pursuant to section § 9.35(a)(2).

Section 9.35(c) provides that interest holder liability with respect to a domestic corporation or eligible entity that is the converted entity only relates to interest holder liabilities that arise after the conversion. Section 9.35(d) similarly preserves the interest holder liability of interest holders in an eligible entity that converts to a domestic corporation only for interest holder liabilities to the extent they arise before the conversion becomes effective. Interest holder liability is not preserved for subsequent changes in an underlying liability, regardless of whether a change is voluntary or involuntary.

## CHAPTER 10

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# Amendment of Articles of Incorporation and Bylaws

### **Subchapter A.**

#### **AMENDMENT OF ARTICLES OF INCORPORATION**

- § 10.01. Authority to Amend
- § 10.02. Amendment Before Issuance of Shares
- § 10.03. Amendment by Board of Directors and Shareholders
- § 10.04. Voting on Amendments by Voting Groups
- § 10.05. Amendment by Board of Directors
- § 10.06. Articles of Amendment
- § 10.07. Restated Articles of Incorporation
- § 10.08. Amendment Pursuant to Reorganization
- § 10.09. Effect of Amendment

### **Subchapter B.**

#### **AMENDMENT OF BYLAWS**

- § 10.20. Authority to Amend
- § 10.21. Bylaw Increasing Quorum or Voting Requirement for Directors
- § 10.22. Bylaw Provisions Relating to the Election of Directors

### **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.

Procedure for amendment, see §§ 10.02 through 10.07.

Restatement of articles, see § § 10.07.

Share transfer restrictions, see § § 6.27.

Voting by voting groups, see §§ 7.25, 7.26, and 10.04.

“Voting group” defined, see § 1.40.

## OFFICIAL COMMENT

Under section 10.01(a), the sole test for the permissibility of an amendment to the corporation’s articles of incorporation is whether the provision could lawfully have been included in (or in the case of a deletion, omitted from) the articles of incorporation on the effective date of the amendment. The articles of incorporation need not make any reference to, or reserve, the express power to amend the articles of incorporation. 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, a written information statement, or other document issued by the corporation that reflects provisions of the articles of incorporation. Certain amendments or liabilities, however, may not be enforceable against all shareholders without their consent. See, *e.g.*, section 6.27(a) with respect to transfer restrictions and section 9.32(e) with respect to interest holder liability after a conversion, section 10.03(f) with respect to new interest holder liability after an amendment of the articles of incorporation, and section 11.04(i) with respect to new interest holder liability after a merger or share exchange.

Section 10.01 does not override contracts by a corporation outside of its articles of incorporation. For example, a corporation might contract with a shareholder or a third party that it would not make particular amendments to its articles. If the corporation made such an amendment, it would be in breach of the contract even if the amendment were otherwise permitted by this section. A shareholder may also obtain protection against amendments by establishing procedures in the articles of incorporation or bylaws that limit the power of amendment without that shareholder’s consent.

Section 10.01(b) expressly rejects the concept that an otherwise lawful amendment to the articles of incorporation might be restricted or invalidated because it modified particular rights conferred on shareholders by the original or prior version of the articles of incorporation. Similarly, under section 1.02, corporations and their shareholders are subject to subsequent amendments of the Act.

## **§ 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.

Restated articles of incorporation, see § 10.07.

### **OFFICIAL COMMENT**

Section 10.02 allows the incorporators or the board to amend the articles of incorporation before any shares are issued.

## **§ 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 shall first be adopted by the board of directors.
- (b) Except as provided in sections 10.05, § 10.07, and § 10.08, the amendment shall then be approved by the shareholders. In submitting the proposed amendment to the shareholders for approval, the board of directors shall recommend that the shareholders approve the amendment, unless (i) the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation, or (ii) section 8.26 applies. If either (i) or (ii) applies, the board must inform the shareholders of the basis for its so proceeding.
- (c) The board of directors may set conditions for the approval of the amendment by the shareholders or the effectiveness of the amendment.
- (d) If the amendment is required to be approved by the shareholders, and the approval is to be given at a meeting, the corporation shall notify each shareholder, regardless of whether 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. The notice 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 § 10.03(c), require a greater vote or a greater quorum, approval of the amendment requires the approval of the shareholders at a meeting at which a quorum consisting of 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 exists consisting of a majority of the votes entitled to be cast on the amendment by that voting group.
- (f) If as a result of an amendment of the articles of incorporation one or more shareholders of a domestic corporation would become subject to new interest holder liability, approval of the amendment requires the signing in connection with the amendment, by each such shareholder, of a separate written consent to become subject to such new interest holder

liability, unless in the case of a shareholder that already has interest holder liability the terms and conditions of the new interest holder liability (i) are substantially identical to those of the existing interest holder liability, or (ii) are substantially identical to those of the existing interest holder liability (other than changes that eliminate or reduce such interest holder liability).

- (g) For purposes of subsection § 10.03(f) and section 10.09, “new interest holder liability” means interest holder liability of a person resulting from an amendment of the articles of incorporation if (i) the person did not have interest holder liability before the amendment becomes effective, or (ii) the person had interest holder liability before the amendment becomes effective, the terms and conditions of which are changed when the amendment becomes effective.

### **CROSS-REFERENCES**

“Interest holder liability” defined, see § 1.40.

Notice of shareholders’ meeting, see § 7.05.

Notices and other communications, see § 1.41.

Quorum and voting requirements for shareholders, see §§ 7.25 and 7.27.

Restatement of articles of incorporation, see § 10.07.

Submission of matters to shareholders, see § 8.26.

Voting by voting group, see §§ 7.25, 7.26 and 10.04.

Voting entitlement of shares, see § 7.21.

“Voting group” defined, see § 1.40.

### **OFFICIAL COMMENT**

Section 10.03 governs amendments to the articles of incorporation after shares have been issued. Most such amendments will require a shareholder vote. When submitting an amendment to the articles of incorporation to shareholders, the board of directors must recommend the amendment, subject to two exceptions in section 10.03(b). The board might exercise the exception under clause (i) where the number of directors having a conflicting interest makes it inadvisable for the board to recommend the amendment or where the board is evenly divided as to the merits of the amendment but is able to agree that shareholders should be permitted to consider it. Alternatively, the board of directors might exercise the exception under clause (ii), which recognizes that, under section 8.26, a board of directors may agree to submit an amendment to a vote of shareholders even if, after approving the amendment, the board of directors determines that it no longer recommends the amendment.

Section 10.03(c) permits the board of directors to set conditions for its submission of an amendment to the shareholders or effectiveness of an amendment. Examples of 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 votes of disinterested shareholders, or (ii) if shareholders holding more than a specified number or percentage of outstanding shares assert appraisal rights.

Section 10.03(e) specifies quorum and voting requirements applicable to a shareholder vote to approve an amendment to the articles of incorporation. If the prescribed 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 amendment, unless the articles of incorporation or the board of directors acting pursuant to section § 10.03(c) require a greater vote. In lieu of approval at a meeting, shareholder approval may be by written consent under the procedures set forth in section 7.04.

If an amendment would affect the voting or quorum 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) 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 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 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 § 10.04(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 shall vote together as a single voting group on the proposed amendment, unless otherwise provided in the articles of incorporation or added as a condition by the board of directors pursuant to section 10.03(c).
- (d) A class or series of shares is entitled to the voting rights granted by this section even if the articles of incorporation provide that the shares are nonvoting shares.

#### **CROSS-REFERENCES**

Authorized shares, see § 6.01.

Classes and series of shares, see §§ 6.01 and 6.02.

Share rights and limitations, see § 6.01.

Voting by voting groups, see §§ 7.25 and 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 or series of shares outstanding. Even if a class or series of shares is described as “nonvoting” or the articles purport to make that class or series nonvoting “for all purposes,” that class or series nonetheless has the voting rights provided by this section. Likewise, shares are entitled to vote as separate voting groups under this section even though the articles of incorporation 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, pursuant to authority granted in the articles of incorporation, of the rights, preferences and limitations of any class before 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 sections 6.02(a) and (b).

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 affect that class or series. This section, however, does not make the right to vote by a separate voting group dependent on an evaluation of whether the amendment is detrimental to that 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.

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 the fractional share is to be issued or otherwise paid in cash under section 6.04. sections 10.04(a)(5) and (6) refer to preferences with respect to distributions, including distributions in liquidation or dissolution. See section 1.40 and the Official Comment to section 1.40 under “Distributions.”

Sections 7.25 and § 7.26 set forth the mechanics of voting by multiple voting groups. Section 10.04(b) extends the privilege of voting as a separate voting group to a series of a class of shares if the series is affected in one or more of the ways described in subsection § 10.04(a). Any distinguishing feature of a series, which an amendment affects or alters, should trigger the right of voting as a separate voting group for that series. However, if a proposed amendment that affects two or more classes or series of shares in the same or a substantially similar way, under subsection § 10.04(c), 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 a condition set by the board of directors pursuant to section § 10.03(c).

The application of sections 10.04(b) and (c) may best be illustrated by the following examples, all of which assume there is no provision in the articles of incorporation providing otherwise and that the board has not set an additional voting condition.

First, assume there is a class of shares 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 unless the Series C shares are voting

shares under the articles of incorporation, in which case the Series C shares would not vote as a separate voting group but would vote in the voting group consisting of all shares in the class, as well as 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.

### **§ 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:

- (a) to extend the duration of the corporation if it was incorporated at a time when limited duration was required by law;
- (b) to delete the names and addresses of the initial directors;
- (c) 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;
- (d) if the corporation has only one class of shares outstanding:
  - (1) to change each issued and unissued authorized share of the class into a greater number of whole shares of that class; or
  - (2) to increase the number of authorized shares of the class to the extent necessary to permit the issuance of shares as a share dividend;
- (e) 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;
- (f) 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;
- (g) 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
- (h) to make any change expressly permitted by section 6.02(a) or (b) to be made without shareholder approval.

### **CROSS-REFERENCES**

Acquisition of shares, see § 6.31.

Classes and series of shares, see §§ 6.01 and 6.02.

Duration of corporate existence, see § 3.02.

Effective date of amendment, see § 1.23.

Name of corporation, see ch. 4.

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 subsections (a) through (h) are so routine and ministerial in nature as not to require approval by shareholders. None affects the substantive rights of shareholders in any meaningful way. Although the board of directors' designation of the preferences, rights and limitations of a new class or series of shares under section 6.02 may have substantive effects, amendments of the articles of incorporation to set forth the terms of a new class or series are already permitted by section 6.02(c). 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**

- (a) 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 must 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:
    - (i) was adopted by the incorporators or board of directors without shareholder approval, a statement that the amendment was duly adopted by the incorporators or by the board of directors, as the case may be, and that shareholder approval was not required;
    - (ii) 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
    - (iii) is being filed pursuant to section 1.20(k)(5), a statement to that effect.
- (b) Articles of amendment shall take effect at the effective date determined in accordance with section 1.23.

## **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.

Effective date of amendment, see § 1.23.

Extrinsic facts, see § 1.20.

Filing requirements, see § 1.20.

Voting by voting groups, see §§ 7.25, 7.26 and 10.04.

“Voting group” defined, see § 1.40.

## **OFFICIAL COMMENT**

Section § 10.06(a)(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 confusion 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. If such transitional provisions are not part of the amendment itself, they are not required to be in a restatement of the articles of incorporation pursuant to section 10.07.

### **§ 10.07 Restated Articles of Incorporation**

- (a) A corporation’s board of directors may restate its articles of incorporation at any time, 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 shall 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:
  - (1) the name of the corporation;
  - (2) the text of the restated articles of incorporation;
  - (3) a statement that the restated articles consolidate all amendments into a single document; and
  - (4) if a new amendment is included in the restated articles, the statements required under section 10.06 with respect to the new amendment.
- (d) Duly adopted restated articles of incorporation supersede the original articles of incorporation and all amendments to the articles of incorporation.
- (e) The secretary of state may certify restated articles of incorporation as the articles of incorporation currently in effect, without including the statements required by subsection (c)(4).

## **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.



Effective date of restatement, see § 1.23.

Filing requirements, see § 1.20.

Notices and other communications, see § 1.40.

Notice of shareholders' meeting, see § 7.05.

## **OFFICIAL COMMENT**

Restated articles of incorporation permit articles of incorporation that have been amended over 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, but only a consolidation of amendments. 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. If it is unclear 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.

### **§ 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**

Effective date of amendment, see § 1.23.

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.

### **§ 10.09 Effect of Amendment**

- (a) 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 the shareholders. An amendment changing a corporation's name does not affect a proceeding brought by or against the corporation in its former name.
- (b) A shareholder who becomes subject to new interest holder liability in respect of the corporation as a result of an amendment to the articles of incorporation shall have that new interest holder liability only in respect of interest holder liabilities that arise after the amendment becomes effective.
- (c) Except as otherwise provided in the articles of incorporation of the corporation, the interest holder liability of a shareholder who had interest holder liability in respect of the corporation before the amendment becomes effective and has new interest holder liability after the amendment becomes effective shall be as follows:
  - (1) The amendment does not discharge that prior interest holder liability with respect to any interest holder liabilities that arose before the amendment becomes effective.
  - (2) The provisions of the articles of incorporation of the corporation relating to interest holder liability as in effect immediately prior to the amendment shall continue to apply to the collection or discharge of any interest holder liabilities preserved by subsection § 10.09(c)(1), as if the amendment had not occurred.
  - (3) The shareholder shall have such rights of contribution from other persons as are provided by the articles of incorporation relating to interest holder liability as in effect immediately prior to the amendment with respect to any interest holder liabilities preserved by subsection § 10.09(c)(1), as if the amendment had not occurred.
  - (4) The shareholder shall not, by reason of such prior interest holder liability, have interest holder liability with respect to any interest holder liabilities that arise after the amendment becomes effective.

### **CROSS-REFERENCES**

Amendment after issuance of shares, see §§ 10.03 through 10.05.

Amendment before issuance of shares, see § 10.02.

Effective time and date of filing, see § 1.23.

“Interest holder liability” defined, see § 1.40.

“New interest holder liability” defined, see § 10.03.

“Proceeding” defined, see § 1.40.

### **OFFICIAL COMMENT**

Under section 10.09, amendments to articles of incorporation do not interrupt the corporate existence. Sections 10.09(b) and (c) govern the effects of amendments to the articles of incorporation that impose or change interest holder liability.

## **Subchapter B.**

### **AMENDMENT OF BYLAWS**

#### **§ 10.20 Authority to Amend**

- (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) except as provided in section 2.06(d), the shareholders in amending, repealing, or adopting a bylaw expressly provide that the board of directors may not amend, repeal, or adopt that bylaw.
- (c) A shareholder of the corporation does not have a vested property right resulting from any provision in the bylaws.

#### **CROSS-REFERENCES**

Action by:

board of directors, see §§ 8.20 through 8.24.

shareholders, see §§ 7.01 through 7.04.

Bylaw provisions relating to the election of directors, see § 10.22.

Increase in quorum and voting 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) permits the reservation of amendment power to the shareholders to be limited to specific articles or sections of the bylaws or to specific subjects or topics addressed in the bylaws.

The authority granted to the shareholders in section § 10.20(b)(2) to prevent the board of directors from further changing a bylaw which the shareholders have amended, repealed, or adopted is expressly subject to section 2.06(d), which limits the authority of shareholders to restrict board action on bylaws with regard to procedures or conditions set forth in certain bylaws regulating the election of directors. See the Official Comment to section 2.06.

See section 10.21 and its Official Comment describing limitations on the power of directors to adopt or amend supermajority provisions in bylaws.

See section 10.22 and its Official Comment describing limitations on the power of directors to repeal a bylaw adopted by shareholders which elects the provisions of that section. Similar to section 10.01(b), section 10.21(c) expressly confirms that an amendment to the bylaws may not be restricted or invalidated because it modifies particular rights conferred on shareholders by the original or a prior version of the bylaws.

#### **§ 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; or
  - (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 § 10.21(a) to amend or repeal a bylaw that changes a quorum or voting requirement for the board of directors shall 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**

Modifying quorum and voting requirements for shareholders, see § 7.23.

Quorum and voting of directors, see § 8.24.

### **OFFICIAL COMMENT**

The bylaws may increase a quorum or voting requirement for the board over the requirement that would otherwise apply under the Act (“supermajority requirements”). See sections 8.24(a) and (c). These requirements may be amended or repealed by the board of directors or shareholders as provided in section 10.21.

### **§ 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 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 shall 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 subsection § 10.22(a)(3), 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**

Cumulative voting, see § 7.28.

Inspectors of election, see § 7.29.

Resignation of directors, see § 8.07.

Vacancy on board of directors, see § 8.11 § 8.10.

Voting for directors, see § 7.28.

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 to be governed by its terms. The provisions of section 10.22 effectively modify the term and holdover provisions of section 8.05 pursuant to a limited exception for section 10.22 that is recognized in section 8.05. 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.

#### *1. Section 10.22(a)*

The rule in subsection § 10.22(a) 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) (*e.g.*, 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 the preferred slate or by voting against a candidate on the disfavored slate, or to abstain. Because it would be in the interests of all contestants to explain in their proxy materials that against votes would not be counted in favor of any candidate in a contested election, the rational voter in a contested election might 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. Although there is no prohibition in the Act against a corporation offering shareholders the opportunity to vote “against” candidates at any time, unless the corporation elects to be governed by section 10.22 or the articles of incorporation are amended to make such a vote meaningful, an “against” vote is given no effect under the Act.

Section § 10.22(a)(2) does not conflict with or alter the plurality voting default standard. However, because section 10.22 shortens the term of a director who is elected but receives more votes against election than in favor of election, a vacancy will exist if no action is taken to fill the vacancy before the expiration of the shortened term. 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 of directors. See section 8.03.

Under section 8.05(d), the director appointed to fill 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.

There is also no limitation in section 10.22 or elsewhere in the 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) than director positions to be filled, the resulting election contest would not be subject to the voting regime under section 10.22(a). Instead, it 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 between competing candidates.

The timing provided in clauses (i) and (ii) of subsection § 10.22(b) for determining when section 10.22(a) does not apply to an election 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 the proxy appointment form will be clear and reflect the applicable voting regime. The determination of how many candidates there are to fill the number of director positions up for election may be made by the board of directors. The board’s determination of whether an individual shall not be considered a candidate for purposes of section 10.22(b) because the candidacy does not create a bona fide election contest must be made before notice of the meeting is given. The board of directors 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.

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. Conversely, unless the bylaws require advance notice of director nomination, an uncontested election could become contested before the vote is taken but after notice of the meeting has been given because there is no limitation on 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 those circumstances.



## CHAPTER 11

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# Mergers and Share Exchanges

§ 11.01. Definitions

§ 11.02. Merger

§ 11.04. Action on a Plan of Merger or Share Exchange

§ 11.05. Merger Between Parent and Subsidiary or Between Subsidiaries

§ 11.06. Articles of Merger or Share Exchange

§ 11.07. Effect of Merger or Share Exchange

§ 11.08. Abandonment of a Merger or Share Exchange

### **INTRODUCTORY COMMENT**

#### *Transactions Permitted*

Chapter 11 deals with mergers and share exchanges. A merger is the traditional form for combining entities by operation of law, and the range of merger transactions chapter 11 permits is broad. In a merger, a domestic business corporation may merge with one or more of the following domestic or foreign entities: (i) business corporations; (ii) unincorporated entities (including limited liability companies, general and limited partnerships and business trusts); and (iii) nonprofit corporations (which are defined together with unincorporated entities as “eligible entities;” neither is included in the defined term “corporation”). These and other relevant terms used in this chapter are defined in sections 1.40 and 11.01.

The entity resulting from the merger may be one of the parties to the merger, or a new corporation or eligible entity created by the merger. Chapter 11 therefore may apply to a merger in which none of the parties is a domestic corporation, as long as the resulting entity (defined in section 11.01 as the “survivor”) is a new domestic corporation. In the case of any merger involving a corporation or eligible entity organized under the laws of a foreign jurisdiction, the Act recognizes that whether and how those foreign entities may merge are matters governed by the law of the foreign jurisdiction.

Chapter 11 also permits share exchanges in which either (i) a domestic corporation acquires all of the shares or eligible interests of one or more classes or series of another domestic or foreign corporation or eligible entity, or (ii) all of the shares of one or more classes or series of a domestic corporation are acquired by another domestic or foreign corporation or eligible entity. As a result, in a share exchange, the existence of the acquired entity (the entity whose shares are acquired) continues. If enough shares or eligible interests are acquired, the acquired entity may become a subsidiary of the acquiring entity. Each of these transactions is a share exchange, even if it involves no shares and only “eligible interests” (which are defined in section 1.40 as specified rights in unincorporated entities and memberships in nonprofit corporations). A foreign



corporation or eligible entity may only be the acquired entity in a share exchange if it is permitted by the law governing the foreign corporation or eligible entity.

Other chapters of the Act permit transactions that once could only be effected by merger. For example, chapter 9 provides for domestications, in which corporations can reincorporate in another jurisdiction, and conversions, in which corporations may convert to eligible entities. The Act's approach is generally to provide similar procedures for effecting any of these types of transactions and certain other fundamental actions, such as amendments to the articles of incorporation under chapter 10 and sales of assets outside the usual and regular course of business under chapter 12.

### *Requirements and Effects*

Section 11.02 generally authorizes mergers and sets out requirements for their approval. For a domestic corporation, the requirements usually include a plan of merger, adopted by the board of directors and recommended by the board of directors to the shareholders, and approved by the shareholders. Section 11.03 has similar provisions for share exchanges and plans of share exchange. These sections permit the holders of shares or eligible interests of a party to a merger or of an acquired class or series in a share exchange to receive a broad range of consideration for their shares or interests. Section 11.04 sets out the approval requirements for domestic corporations that are parties to mergers or acquired entities in share exchanges, although section 11.05 has special rules for certain parent-subsidary transactions. Section 11.06 relates to the preparation and filing of articles of merger and share exchange, and section 11.07 states the effects of those transactions. Finally, section 11.08 provides how mergers and share exchanges may be abandoned after they are adopted and approved. Dissenting shareholders in certain mergers and share exchanges and certain other fundamental actions have appraisal rights under chapter 13.

## **§ 11.01 Definitions**

As used in this chapter:

“Acquired entity” means the domestic or foreign corporation or eligible entity that will have all of one or more classes or series of its shares or eligible interests acquired in a share exchange.

“Acquiring entity” means the domestic or foreign corporation or eligible entity that will acquire all of one or more classes or series of shares or eligible interests of the acquired entity in a share exchange.

“New interest holder liability” means interest holder liability of a person, resulting from a merger or share exchange, that is (i) in respect of an entity which is different from the entity in which the person held shares or eligible interests immediately before the merger or share exchange became effective; or (ii) in respect of the same entity as the one in which the person held shares or eligible interests immediately before the merger or share exchange became effective if (A) the person did not have interest holder liability immediately before the merger or share exchange became effective, or (B) the person had interest holder liability immediately before the merger or share exchange became effective, the terms and conditions of which were changed when the merger or share exchange

became effective.

“Party to a merger” means any domestic or foreign corporation or eligible entity that will merge under a plan of merger but does not include a survivor created by the merger.

“Survivor” in a merger means the domestic or foreign corporation or eligible entity into which one or more other corporations or eligible entities are merged.

## **CROSS-REFERENCES**

“Corporation,” “domestic corporation,” “business corporation” and “domestic business corporation” defined, see § 1.40.

“Eligible entity,” “domestic” and “foreign” defined, see § 1.40.

“Eligible interest” defined, see § 1.40.

“Foreign corporation” and “foreign business corporation” defined, see § 1.40.

“Interest holder liability” defined, see § 1.40.

“Merger” defined, see § 1.40.

“Share exchange” defined, see § 1.40.

## **OFFICIAL COMMENT**

Section 11.01 defines the parties to a merger as the entities that merge. Thus the parties to a merger do not include, for example, a new corporation or entity created by the merger that is the survivor, even though it results from the merger, or a parent corporation or entity that issues its securities as part of the merger consideration but does not itself merge. The definition of “survivor” contemplates the possibility that the survivor may not exist prior to the merger, and not be a party to the merger, but rather be created by the merger of two or more other corporations or entities. In that case, the survivor will need to be specified as a new corporation or entity in the plan of merger.

Share exchange is defined in section 1.40 by reference to section 11.03, and the range of parties and types of consideration permitted in a transaction under that section is broad. It could include, for example, the acquisition by a corporation of eligible interests in a partnership for cash. While that transaction would not involve either the acquisition or issuance of a corporation’s shares, it nevertheless falls within the definition of share exchange.

### **§ 11.02 Merger**

- (a) By complying with this chapter:
  - (1) 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, resulting in a survivor; and
  - (2) two or more foreign business corporations or domestic or foreign eligible entities may merge, resulting in a survivor that is a domestic business corporation created in the merger.
- (b) By complying with the provisions of this chapter applicable to foreign entities, 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 as the survivor in a merger in which a domestic

- business corporation is a party, but only if the merger is permitted by the organic law of the foreign business corporation or eligible entity.
- (c) If the organic law or organic rules of a domestic eligible entity do not provide procedures for the approval of a merger, a plan of merger may nonetheless be adopted and approved by the unanimous consent of all of the interest holders of such eligible entity, and the merger may thereafter be effected as provided in the other provisions of this chapter; and for the purposes of applying this chapter in such a case:
- (1) the eligible entity, its members or interest holders, eligible interests and articles of incorporation or other organic rules 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 person or persons that are not identical to the members or interest holders, that group shall be deemed to be the board of directors.
- (d) The plan of merger must include:
- (1) as to each party to the merger, its name, jurisdiction of formation, and type of entity;
  - (2) the survivor's name, jurisdiction of formation, and type of entity, and, if the survivor is to be created in the merger, a statement to that effect;
  - (3) the terms and conditions of the merger;
  - (4) 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;
  - (5) the articles of incorporation of any domestic or foreign business or nonprofit corporation, or the public organic record 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 other public organic record; and
  - (6) 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 rules of any such party.
- (e) In addition to the requirements of subsection § 11.02(d), a plan of merger may contain any other provision not prohibited by law.
- (f) Terms of a plan of merger may be made dependent on facts objectively ascertainable outside the plan in accordance with section 1.20(k).
- (g) A plan of merger may be amended only with the consent of each party to the merger, except as provided in the plan. A domestic party to a merger may approve an amendment to a plan:
- (1) in the same manner as the plan was approved, if the plan does not provide for the manner in which it may be amended; or
  - (2) in the manner provided in the plan, except that shareholders, members, or interest holders that were entitled to vote on or consent to approval of the plan are entitled to vote on or consent to any amendment of the plan that will change:
    - (i) 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, members, or interest holders of any party to the merger;
- (ii) the articles of incorporation of any domestic or foreign business or nonprofit corporation, or the organic rules of any unincorporated entity, that will be the survivor of the merger, except for changes permitted by section 10.05 or by comparable provisions of the organic law of any such foreign corporation or domestic or foreign nonprofit corporation or unincorporated entity; or
  - (iii) any of the other terms or conditions of the plan if the change would adversely affect such shareholders, members, or interest holders in any material respect.

## **CROSS-REFERENCES**

Abandonment of merger, see § 11.08.

Amendment of articles of incorporation in merger, see § 11.06.

Amendment of articles of incorporation by board of directors, see § 10.05.

Appraisal rights, see ch. 13.

Approval of plan of merger, see § 11.04.

Articles of merger, see § 11.06.

“Corporation “ and “domestic business corporation” defined, see § 1.40.

Effect of merger, see § 11.07.

“Eligible entity” defined, see § 1.40.

Extrinsic facts, see § 1.20.

“Foreign corporation” and “foreign business corporation” defined, see § 1.40.

“Interest holder” defined, see § 1.40.

“Membership” defined, see § 1.40.

Merger between parent and subsidiary or between subsidiaries, see § 11.05.

“Organic law” and “organic rules” defined, see § 1.40.

“Public organic record” defined, see § 1.40.

“Unincorporated entity” defined, see § 1.40.

## **OFFICIAL COMMENT**

### *1. In General*

Section 11.02 authorizes domestic corporations to merge with each other. It also authorizes one or more domestic corporations to merge with one or more foreign corporations or domestic or foreign eligible entities (such as limited liability companies or partnerships). In addition, it provides for the merger of two or more foreign corporations or foreign or domestic eligible entities, even if no domestic business corporation is a party to the merger, but only if the survivor is a domestic business corporation created by the merger.

### *2. Applicability to Foreign Corporations and Eligible Entities and to Domestic Eligible Entities*

A foreign corporation or a foreign eligible entity may be a party to or be the survivor in a merger authorized by chapter 11 only if the merger is permitted by the laws under which the

foreign corporation or eligible entity is organized. Whether and on what terms a foreign corporation or a foreign eligible entity is authorized to merge is governed by those laws. If a foreign corporation or eligible entity is so authorized, it must comply with the applicable provisions of chapter 11 in addition to the requirements of its own governing laws. For example, section § 11.02(d) sets forth certain requirements for the contents of a plan of merger with a domestic corporation, and section § 11.07(d) provides that upon a merger becoming effective, a foreign corporation or foreign eligible entity that is the survivor is deemed to appoint the secretary of state as its agent for service of process in a proceeding to enforce appraisal rights of shareholders of each domestic corporation that is a party to the merger.

With respect to a domestic eligible entity, if the law under which it is organized does not expressly authorize it to be a party to or survive a merger under chapter 11, section 11.02(c) provides procedures for such an entity to adopt and effect a plan of merger.

### *3. Terms and Conditions of Merger*

Chapter 11 imposes no restrictions or limitations on the terms or conditions of a merger, except for those set forth in section 11.02(g). The list in section 11.02(d) of provisions in a plan of merger is not exhaustive.

### *4. Amendments of Articles of Incorporation*

Under section 11.02, a corporation's articles of incorporation may be amended by a merger, and section 11.02(d)(5) provides that a plan of merger must include any such amendments. If the plan of merger is approved and the survivor is a domestic entity, section 11.07 provides that the amendments will become effective with the merger. If the plan includes amendments to the articles of incorporation of a surviving domestic corporation, section § 11.04(f)(1)(ii), by reference to the voting requirements of section 10.04 relating to amendments of the articles of incorporation, may impose voting requirements by separate voting groups that would not otherwise apply.

Although the plan of merger must include any amendments to the articles of incorporation or public organic record of the survivor, the survivor's articles of incorporation or public organic record are not required to be included in the plan unless the survivor is created by the merger. However, if approval of the plan of merger by the shareholders of a domestic corporation is required under section 11.04, section 11.04(d) requires that its shareholders be furnished with a copy or summary of the articles of incorporation or public organic record of the survivor in connection with voting on approval.

## **§ 11.03 Share Exchange**

- (a) By complying with this chapter:
- (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 eligible interests of one or more classes or series of interests of a domestic or foreign eligible entity, in exchange for shares or other securities, eligible interests, obligations, rights to acquire shares or other securities or eligible interests, 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 eligible entity, in exchange for shares or other securities, eligible interests, obligations, rights to acquire

- shares or other securities or eligible interests, 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 the acquired entity in a share exchange only if the share exchange is permitted by the organic law of that corporation or other entity.
  - (c) If the organic law or organic rules of a domestic eligible entity do not provide procedures for the approval of a share exchange, a plan of share exchange may be adopted and approved, and the share exchange effected, in accordance with the procedures, if any, for a merger. If the organic law or organic rules of a domestic eligible entity do not provide procedures for the approval of either a share exchange or a merger, a plan of share exchange may nonetheless be adopted and approved by the unanimous consent of all of the interest holders of such eligible entity whose interests will be exchanged under the plan of share exchange, and the share exchange may thereafter be effected as provided in the other provisions of this chapter; and for purposes of applying this chapter in such a case:
    - (1) the eligible entity, its interest holders, interests and articles of incorporation or other organic rules 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 person or persons that are not identical to the members or interest holders, that person or those persons shall be deemed to be the board of directors.
  - (d) The plan of share exchange must include:
    - (1) the name of each domestic or foreign corporation or other eligible entity the shares or eligible interests of which will be acquired and the name of the domestic or foreign corporation or eligible entity that will acquire those shares or eligible interests;
    - (2) the terms and conditions of the share exchange;
    - (3) the manner and basis of exchanging shares of a domestic or foreign corporation or eligible interests in a domestic or foreign eligible entity the shares or eligible interests of which will be acquired under the share exchange for 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; and
    - (4) any other provisions required by the organic law governing the acquired entity or its articles of incorporation or organic rules.
  - (e) 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).
  - (f) A plan of share exchange may be amended only with the consent of each party to the share exchange, except as provided in the plan. A domestic entity may approve an amendment to a plan:
    - (1) in the same manner as the plan was approved, if the plan does not provide for the manner in which it may be amended; or
    - (2) in the manner provided in the plan, except that shareholders, members, or interest holders that were entitled to vote on or consent to approval of the plan are entitled to vote on or consent to any amendment of the plan that will change:
      - (i) 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, members or interest holders of the acquired entity; or

- (ii) any of the other terms or conditions of the plan if the change would adversely affect such shareholders, members or interest holders in any material respect.

## **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 and series of shares, see §§ 6.01 and 6.02.
- “Corporation” and “domestic corporation” defined, see § 1.40.
- Effect of share exchange, see § 11.07.
- “Eligible entity” defined, see § 1.40.
- Extrinsic facts, see § 1.20.
- “Foreign corporation” defined, see § 1.40.
- “Interest holder” defined, see § 1.40.
- “Membership” defined, see § 1.40.
- “Organic law” and “organic rules” defined, see § 1.40.

## **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.

Section 11.03 authorizes a share exchange—a transaction in which the acquiring entity acquires all of the shares or eligible interests of one or more classes or series of shares or eligible interests of the acquired entity. The shares or eligible interests of one or more other classes or series of the acquired entity may be excluded from the share exchange or may be included on different bases. Shares or eligible interests of the affected class or series of the acquired entity owned at the effective time of the share exchange by the acquiring entity (or any parent of the acquiring entity or by any wholly owned subsidiary of the acquiring entity or of any such parent, each as defined in section § 11.04(k)), may also be excluded from the share exchange.

After the plan of share exchange is adopted and approved as required by section 11.04, it is binding on all holders of the shares or eligible interests of the class or series to be acquired. 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. In contrast to mergers, the articles of incorporation or public organic record of a party to a share exchange may not be amended by a plan of share exchange. Such an amendment to the articles of

incorporation may, however, be effected under chapter 10 as a separate element of a corporate combination that involves a share exchange.

## *2. Applicability to Foreign Corporations and Foreign and Domestic Eligible Entities*

A foreign corporation or a foreign eligible entity may be an acquired entity in a share exchange authorized by chapter 11 only if the share exchange is permitted by the organic law of the foreign corporation or eligible entity. Whether and on what terms a foreign corporation or a foreign eligible entity is authorized to be a party to a share exchange is governed by its organic law. If a foreign corporation or eligible entity is so authorized, it must also comply with the applicable terms of chapter 11 in addition to the requirements of its organic law. For example, section § 11.03(d) sets forth certain requirements for the content of a plan of share exchange.

With respect to a domestic eligible entity, if the law under which it is organized does not expressly authorize it to be a party to a share exchange under chapter 11, section 11.03(a) is intended to provide the necessary authority. In that case, section 11.03(c) provides procedures for adopting, approving and effecting a plan of share exchange.

## *3. Terms and Conditions of Share Exchange*

Chapter 11 imposes no restrictions or limitations on the terms or conditions of a share exchange, except for those contained in section 11.03(f), and the requirement in section 11.03(a) that the acquiring entity must acquire all the shares or eligible interests of the acquired class or series of shares or eligible interests. However, shares or interests of the acquired class or series owned at the effective time of the share exchange by the acquiring entity or any of its parents or their wholly owned subsidiaries may be excluded from the exchange. The list in section 11.03(d) of provisions in a plan of share exchange is not exhaustive.

### **§ 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 the acquired entity in a share exchange, the plan of merger or share exchange shall be adopted in the following manner:

- (a) The plan of merger or share exchange shall first be adopted by the board of directors.
- (b) Except as provided in subsections (h), (j) and (l) and in section 11.05, the plan of merger or share exchange shall then be approved by the shareholders. In submitting the plan of merger or share exchange to the shareholders for approval, the board of directors shall recommend that the shareholders approve the plan or, in the case of an offer referred to in subsection (j)(2), that the shareholders tender their shares to the offeror in response to the offer, unless (i) the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation or (ii) section 8.26 applies. If either (i) or (ii) applies, the board shall inform the shareholders of the basis for its so proceeding.
- (c) The board of directors may set conditions for the approval of the plan of merger or share exchange by the shareholders or the effectiveness of the plan of merger or share exchange.
- (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 shall notify each shareholder, regardless of whether 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 foreign or domestic corporation or eligible entity, the notice must also include or be accompanied by a copy or summary of the articles of incorporation and bylaws or the organic rules of that corporation or eligible entity. If the corporation is to be merged with a domestic or foreign corporation or eligible entity and a new domestic or foreign corporation or eligible entity is to be created pursuant to the merger, the notice must include or be accompanied by a copy or a summary of the articles of incorporation and bylaws or the organic rules of the new corporation or eligible entity.

- (e) Unless the articles of incorporation, or the board of directors acting pursuant to subsection (c), require a greater vote or a greater quorum, approval of the plan of merger or share exchange requires the approval of the shareholders at a meeting at which a quorum exists consisting of a majority of the votes entitled to be cast on the plan, 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 is present consisting of a majority of the votes entitled to be cast on the merger or share exchange by that voting group.
- (f) Subject to subsection (g) 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 shares, other securities, eligible interests, obligations, rights to acquire shares, other securities or eligible interests, cash, other property, or any combination of the foregoing; or
    - (ii) are entitled to vote as a separate group on a provision in the plan that constitutes a proposed amendment to the articles of incorporation of a surviving corporation that requires 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, respectively.
- (g) The articles of incorporation may expressly limit or eliminate the separate voting rights provided in subsections (f)(1)(i) and (f)(2) as to any class or series of shares, except when the plan of merger or share exchange (i) includes what is or would be in effect an amendment subject to subsection § 11.04(f)(1)(i), and § 11.04(f)(1)(ii) will not effect a substantive business combination.
- (h) Unless the articles of incorporation otherwise provide, approval by the corporation's shareholders of a plan of merger is not required if:
  - (1) the corporation will survive the merger;
  - (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, rights and limitations, immediately after the effective date of the merger; and
  - (4) the issuance in the merger of shares or other securities convertible into or rights exercisable for shares does not require a vote under section 6.21(f).
- (i) If as a result of a merger or share exchange one or more shareholders of a domestic

corporation would become subject to new interest holder liability, approval of the plan of merger or share exchange requires the signing in connection with the transaction, by each such shareholder, of a separate written consent to become subject to such new interest holder liability, unless in the case of a shareholder that already has interest holder liability with respect to such domestic corporation, (i) the new interest holder liability is with respect to a domestic or foreign corporation (which may be a different or the same domestic corporation in which the person is a shareholder), and (ii) the terms and conditions of the new interest holder liability are substantially identical to those of the existing interest holder liability (other than for changes that eliminate or reduce such interest holder liability).

- (j) Unless the articles of incorporation otherwise provide, approval by the shareholders of a plan of merger or share exchange is not required if:
- (1) the plan of merger or share exchange expressly (i) permits or requires the merger or share exchange to be effected under this subsection and (ii) provides that, if the merger or share exchange is to be effected under this subsection, the merger or share exchange will be effected as soon as practicable following the satisfaction of the requirement set forth in subsection (j)(6);
  - (2) another party to the merger, the acquiring entity in the share exchange, or a parent of another party to the merger or the acquiring entity in the share exchange, makes an offer to purchase, on the terms provided in the plan of merger or share exchange, any and all of the outstanding shares of the corporation that, absent this subsection, would be entitled to vote on the plan of merger or share exchange, except that the offer may exclude shares of the corporation that are owned at the commencement of the offer by the corporation, the offeror, or any parent of the offeror, or by any wholly owned subsidiary of any of the foregoing;
  - (3) the offer discloses that the plan of merger or share exchange provides that the merger or share exchange will be effected as soon as practicable following the satisfaction of the requirement set forth in subsection (j)(6) and that the shares of the corporation that are not tendered in response to the offer will be treated as set forth in subsection (j)(8);
  - (4) the offer remains open for at least 10 days;
  - (5) the offeror purchases all shares properly tendered in response to the offer and not properly withdrawn;
  - (6) the shares listed below are collectively entitled to cast at least the minimum number of votes on the merger or share exchange that, absent this subsection, would be required by this chapter and by the articles of incorporation for the approval of the merger or share exchange by the shareholders and by any other voting group entitled to vote on the merger or share exchange at a meeting at which all shares entitled to vote on the approval were present and voted:
    - (i) shares purchased by the offeror in accordance with the offer;
    - (ii) shares otherwise owned by the offeror or by any parent of the offeror or any wholly owned subsidiary of any of the foregoing; and
    - (iii) shares subject to an agreement that they are to be transferred, contributed or delivered to the offeror, any parent of the offeror, or any wholly owned subsidiary of any of the foregoing in exchange for shares or eligible interests in such offeror, parent or subsidiary;
  - (7) the offeror or a wholly owned subsidiary of the offeror merges with or into, or effects a share exchange in which it acquires shares of, the corporation; and

- (8) each outstanding share of each class or series of shares of the corporation that the offeror is offering to purchase in accordance with the offer, and that is not purchased in accordance with the offer, is to be converted in the merger into, or into the right to receive, or is to be exchanged in the share exchange for, or for the right to receive, the same amount and kind of securities, eligible interests, obligations, rights, cash, or other property to be paid or exchanged in accordance with the offer for each share of that class or series of shares that is tendered in response to the offer, except that shares of the corporation that are owned by the corporation or that are described in clause (ii) or (iii) of subsection (j)(6) need not be converted into or exchanged for the consideration described in this subsection (j)(8).
- (k) As used in subsection § 11.04(j):
  - (1) “offer” means the offer referred to in subsection (j)(2);
  - (2) “offeror” means the person making the offer;
  - (3) “parent” of an entity means a person that owns, directly or indirectly (through one or more wholly owned subsidiaries), all of the outstanding shares of or eligible interests in that entity;
  - (4) shares tendered in response to the offer shall be deemed to have been “purchased” in accordance with the offer at the earliest time as of which (i) the offeror has irrevocably accepted those shares for payment and (ii) either (A) in the case of shares represented by certificates, the offeror, or the offeror’s designated depository or other agent, has physically received the certificates representing those shares or (B) in the case of shares without certificates, those shares have been transferred into the account of the offeror or its designated depository or other agent, or an agent’s message relating to those shares has been received by the offeror or its designated depository or other agent; and
  - (5) “wholly owned subsidiary” of a person means an entity of or in which that person owns, directly or indirectly (through one or more wholly owned subsidiaries), all of the outstanding shares or eligible interests.
- (l) Unless the articles of incorporation otherwise provide,
  - (1) approval of a plan of share exchange by the shareholders of a domestic corporation is not required if the corporation is the acquiring entity in the share exchange; and
  - (2) shares not to be exchanged under the plan of share exchange are not entitled to vote on the plan.

## **CROSS-REFERENCES**

Abandonment of merger or share exchange, see § 11.08.

Appraisal rights, see ch. 13.

“Corporation” and “domestic corporation” defined, see § 1.40.

“Eligible entity” defined, see § 1.40.

“Foreign corporation” defined, see § 1.40.

“Interest holder liability” defined, see § 1.40.

“New interest holder liability” defined, see § 11.01.

Notices and other communications, see § 1.41.

Notice of shareholders’ meeting, see § 7.05.

“Organic rules” defined, see § 1.40.

Share issuances requiring shareholder approval, see § 6.21.

Submission of matters to shareholders, see § 8.26.

Supermajority quorum and voting requirements for shareholders, see § 7.27.

Voting by voting groups, see §§ 7.25 and 7.26.

Voting by voting group on amendment of articles of incorporation, see § 10.04.

Voting entitlement of shares, see § 7.21.

“Voting group” defined, see § 1.40.

“Voting power” defined, see § 1.40.

Written consent of shareholders, see § 7.04.

## OFFICIAL COMMENT

### 1. *In General*

Subject to the exceptions set forth in section 11.04(b), a plan of merger must always be approved by the shareholders of a corporation that is a party to a merger and a plan of share exchange must always be approved by shareholders of the class or series that is being acquired in a share exchange. Under section 11.04(h) approval of a plan of merger by the shareholders of a surviving corporation is not required if the conditions stated in that section are satisfied. Under section 11.04(j), shareholder action by selling shares in a tender offer or exchange offer is accepted as an alternative to the traditional consent by voting if the conditions specified in section 11.04(j) are met.

Section 11.04(g), together with the appraisal rights provisions of chapter 13, is designed to assure that in transactions or actions that may occur under chapters 9, 10, 11 and 12, a shareholder has either a group voting right or an appraisal right.

Under section 10.04(c), and therefore under section § 11.04(f)(1)(ii), 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, unless otherwise provided in the articles of incorporation or required by the board of directors. If separate voting by voting groups is required for a merger or a share exchange under section 11.04(f), it will not fall within the exception to shareholder approval provided by section 11.04(h). 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 to those sections.

If a merger would amend the articles of incorporation of a survivor that is a domestic corporation 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*

When submitting a plan of merger or share exchange to shareholders, the board of directors must recommend the transaction, subject to two exceptions in section 11.03(b). The board might exercise the exception under clause (i) where the number of directors having a conflicting interest makes it inadvisable for them to recommend the transaction or where the board is evenly divided as to the merits of the transaction but is able to agree that shareholders should be permitted to consider the transaction. Alternatively, the board of directors might exercise the exception in clause (ii), which recognizes that, under section 8.26, a board of directors may include a “force the vote” clause in a plan of merger or share exchange, agreeing to submit the

plan to shareholders even if, after approving the plan, the board of directors determines that it no longer recommends the plan. Section 11.04(c) permits the board of directors to condition its submission of a plan of merger or share exchange to the shareholders or the effectiveness of a plan of merger or share exchange. Among the conditions that a board of directors 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.

Section 11.04(d) sets forth the notice requirements if a plan of merger or share exchange is to be considered by the shareholders at a meeting. Requirements concerning the timing and content of a notice of meeting are set out in section 7.05. Section 11.04(d) does not address the notice to be given to nonvoting or nonconsenting shareholders where the merger or share exchange is approved, without a meeting, by written consent. However, that requirement is imposed by section 7.04.

### *3. Quorum and Voting*

Section 11.04(e) sets forth quorum and voting requirements applicable to a shareholder vote to approve a plan of merger or share exchange. See sections 7.25(f) and § 10.04(c) for rules governing when separate classes or series vote together as a single voting group. If a quorum is present, and subject to any greater vote required by the articles of incorporation or the board of directors pursuant to section 11.04(c), 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 each separate voting group, as the case may be, entitled to vote on the plan. In lieu of action at a meeting, shareholder approval may be by written consent under the procedures set forth in section 7.04.

Section 11.04(g) authorizes limiting or eliminating separate voting as a voting group for a class or series of shares in a merger or share exchange by an express provision in the articles of incorporation. The authorization, however, does not apply to a plan of merger that includes amendments to the articles of incorporation of the survivor for which, under section 11.04(f)(1)(ii), a separate vote under section 10.04 is required. The authorization also would not apply if a plan of merger that is subject to section § 11.04(f)(1)(i) or a share exchange that is subject to section § 11.04(f)(2) has the same effect as an amendment to which section 10.04 would apply and the transaction has no substantive business combination effect, such as a reincorporation or recapitalization where there is no significant change in the enterprise on a consolidated basis. For example, if a corporation with preferred and common shares merges into a wholly-owned subsidiary with all shares being exchanged for common shares of the subsidiary, the authorization to eliminate the separate group vote of the preferred shares would not apply because the transaction would be in effect an amendment of the preferred stock without separate substance as a business combination. On the other hand, if the subsidiary (assuming it was significant) was only 60% owned and the holders of the remaining 40% were being cashed out in the merger, elimination of the separate group vote would be effective because the merger would have substance as a business combination. The requirement that a provision limiting or eliminating group voting rights on a merger or share exchange be “express” is meant to avoid any ambiguity that might arise from a provision that generally denies voting rights.

### *4. Two-Step Transactions*

Section 11.04(j) authorizes a two-step transaction meeting the requirements of that section to proceed without the shareholder vote that would otherwise be required by section 11.04(b). The first step is an offer to the shareholders to tender their shares in response to which enough shareholders tender so that, upon consummation of the offer, the offering party (and any parent or wholly owned subsidiary) owns or has the right to acquire shares with sufficient voting power to satisfy the shareholder approval that would otherwise be required to approve the plan of merger or share exchange pursuant to section 11.04. The second step is a merger or share exchange providing the remaining shareholders the same consideration as was offered to their class or series in the first step offer. The shareholder action in selling in response to the offer provides the necessary consent for the transaction, in lieu of a shareholder vote, if the other conditions set forth in section 11.04(j) are met. The requirements of section 11.04(j), together with sections 11.03(b), 13.03, 13.21 and 13.22, are intended to ensure that shareholders are not disadvantaged by the absence of a vote, and that they receive the same protection in terms of timing, director duties and appraisal rights that they would in a transaction approved by a shareholder vote. For example, section 11.04(b) requires, subject to limited exceptions, that the board of directors make a recommendation with respect to the offer that shareholders tender their shares. This ensures that there is a corporate action implicated by the offer, and that the same director duties will apply to the recommendation to tender into the offer as to conversion or exchange pursuant to a plan of merger or share exchange.

#### *5. Personal Liability of Shareholders*

The approval provisions of section 11.04(i) apply only in situations where a shareholder is becoming subject to “new interest holder liability” as defined in section 11.01, for example, where a corporation is merging into a general partnership or a cap on the shareholder’s interest holder liability is increased. The effect of a merger or share exchange on interest holder liability will be determined as provided in section 11.07(e).

### **§ 11.05 Merger Between Parent and Subsidiary or Between Subsidiaries**

- (a) A domestic or foreign parent entity that owns shares of a domestic corporation which carry at least 90% of the voting power of each class and series of the outstanding shares of the subsidiary that has voting power may (i) merge the subsidiary into itself (if it is a domestic or foreign corporation or eligible entity) or into another domestic or foreign corporation or eligible entity in which the parent entity owns at least 90% of the voting power of each class and series of the outstanding shares or eligible interests which have voting power, or (ii) merge itself (if it is a domestic or foreign corporation or eligible entity) into such subsidiary, in either case without the approval of the board of directors or shareholders of the subsidiary, unless the articles of incorporation or organic rules of the parent entity or the articles of incorporation of the subsidiary corporation otherwise provide. Section 11.04(i) applies to a merger under this section. The articles of merger relating to a merger under this section do not need to be signed by the subsidiary.
- (b) A parent entity shall, within 10 days after the effective date of a merger approved under subsection 11.05(a), notify each of the subsidiary’s shareholders that the merger has become effective.
- (c) Except as provided in subsections 11.05(a) and (b), a merger between a parent entity and a domestic subsidiary corporation 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.

“Corporation” and “domestic corporation” defined, see § 1.40.

“Eligible entity” defined, see § 1.40.

“Foreign corporation” defined, see § 1.40.

“Organic rules” defined, see § 1.40.

“Voting power” defined, see § 1.40.

## **OFFICIAL COMMENT**

If the conditions of section 11.05 are met, no approval is required by the board of directors and the shareholders of a subsidiary that is merged into the parent or another subsidiary. In other respects, mergers between parents and 90%-owned subsidiaries are governed by the other provisions of chapter 11, including section § 11.04(i).

### **§ 11.06 Articles of Merger or Share Exchange**

- (a) After (i) a plan of merger has been adopted and approved as required by this Act, or (ii) if the merger is being effected under section § 11.02(a)(2), the merger has been approved as required by the organic law governing the parties to the merger, then articles of merger shall be signed by each party to the merger except as provided in section 11.05(a). The articles must set forth:
- (1) the name, jurisdiction of formation, and type of entity of each party to the merger;
  - (2) the name, jurisdiction of formation, and type of entity of the survivor;
  - (3) if the survivor of the merger is a domestic corporation and its articles of incorporation are amended, or if a new domestic corporation is created as a result of the merger:
    - (i) the amendments to the survivor’s articles of incorporation; or
    - (ii) the articles of incorporation of the new corporation;
  - (4) if the survivor of the merger is a domestic eligible entity and its public organic record is amended, or if a new domestic eligible entity is created as a result of the merger:
    - (i) the amendments to the public organic record of the survivor; or
    - (ii) the public organic record of the new eligible entity;
  - (5) if the plan of merger required approval by the shareholders of a domestic corporation that is a party to the merger, 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;
  - (6) if the plan of merger or share exchange did not require approval by the shareholders of a domestic corporation that is a party to the merger, a statement to that effect;
  - (7) as to each foreign corporation that is a party to the merger, a statement that the participation of the foreign corporation was duly authorized as required by its organic law;

- (8) as to each domestic or foreign eligible entity that is a party to the merger, a statement that the merger was approved in accordance with its organic law or section 11.02(c); and
  - (9) if the survivor is created by the merger and is a domestic limited liability partnership, the filing required to become a limited liability partnership, as an attachment.
- (b) After a plan of share exchange in which the acquired entity is a domestic corporation or eligible entity has been adopted and approved as required by this Act, articles of share exchange shall be signed by the acquired entity and the acquiring entity. The articles shall set forth:
- (1) the name of the acquired entity;
  - (2) the name, jurisdiction of formation, and type of entity of the domestic or foreign corporation or eligible entity that is the acquiring entity; and
  - (3) a statement that the plan of share exchange was duly approved by the acquired entity by:
    - (i) the required vote or consent of each class or series of shares or eligible interests included in the exchange; and
    - (ii) the required vote or consent of each other class or series of shares or eligible interests entitled to vote on approval of the exchange by the articles of incorporation or organic rules of the acquired entity or section 11.03(c).
- (c) In addition to the requirements of subsection § 11.06(a) or (b), articles of merger or share exchange may contain any other provision not prohibited by law.
- (d) The articles of merger or share exchange shall be delivered to the secretary of state for filing and, subject to subsection § 11.06(e), the merger or share exchange shall take effect at the effective date determined in accordance with section 1.23.
- (e) With respect to a merger in which one or more foreign entities is a party or a foreign entity created by the merger is the survivor, the merger itself shall become effective at the later of:
- (1) when all documents required to be filed in foreign jurisdictions to effect the merger have become effective, or
  - (2) when the articles of merger take effect.
- (f) Articles of merger filed under this section may be combined with any filing required under the organic law governing 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**

“Acquired entity” defined, see § 11.01.

“Acquiring entity” defined, see § 11.01.

Approval of merger or share exchange, see § 11.04.

“Corporation” and “domestic corporation” defined, see § 1.40.

“Eligible entity” defined, see § 1.40.

Filing requirements, see § 1.20.

“Foreign corporation” defined, see § 1.40.

Merger of parent and subsidiary, see § 11.05.

“Organic law” and “organic rules” defined, see § 1.40.

“Public organic record” defined, see § 1.40.



Voting by voting group, see §§ 7.25 and 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. Under section 1.23, the articles are effective on the date and at the time of filing unless a later effective date is specified in the articles within the limits provided in section 1.23 under the authority of section § 11.06(c). Under section 1.23, a delayed effective date may not be later than the 90th day after the date the document is filed.

If a merger involves a domestic eligible entity whose organic law also requires a filing to effect the transaction, section 11.06(f) permits the filings under that organic law and this section to be combined so that only one document need be delivered to the secretary of state for filing.

### **§ 11.07 Effect of Merger or Share Exchange**

- (a) When a merger becomes effective:
- (1) the domestic or foreign 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 domestic or foreign corporation or eligible entity that is a party to the merger, other than the survivor, ceases;
  - (3) all property owned by, and every contract right possessed by, each domestic or foreign corporation or eligible entity that is a party to the merger, other than the survivor, are the property and contract rights of the survivor without transfer, reversion or impairment;
  - (4) all debts, obligations and other liabilities of each domestic or foreign corporation or eligible entity that is a party to the merger, other than the survivor, are debts, obligations or liabilities of 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) if the survivor is a domestic entity, the articles of incorporation and bylaws or the organic rules of the survivor are amended to the extent provided in the plan of merger;
  - (7) the articles of incorporation and bylaws or the organic rules of a survivor that is a domestic entity and is created by the merger become effective;
  - (8) the shares of each domestic or foreign corporation that is a party to the merger, and the eligible interests in an eligible entity that is a party to a merger, that are to be converted in accordance with the terms of the merger 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, are converted, and the former holders of such shares or eligible interests are entitled only to the rights provided to them by those terms or to any rights they may have under chapter 13 or the organic law governing the eligible entity or foreign corporation;
  - (9) except as provided by law or the terms of the merger, all the rights, privileges, franchises, and immunities of each entity that is a party to the merger, other than the survivor, are the rights, privileges, franchises, and immunities of the survivor; and

- (10) if the survivor exists before the merger:
  - (i) all the property and contract rights of the survivor remain its property and contract rights without transfer, reversion, or impairment;
  - (ii) the survivor remains subject to all its debts, obligations, and other liabilities; and
  - (iii) except as provided by law or the plan of merger, the survivor continues to hold all of its rights, privileges, franchises, and immunities.
- (b) When a share exchange becomes effective, the shares or eligible interests in the acquired entity that are to be exchanged for 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, 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 or under the organic law governing the acquired entity.
- (c) Except as otherwise provided in the articles of incorporation of a domestic corporation or the organic law governing or organic rules of a foreign corporation or a domestic or foreign eligible entity, the effect of a merger or share exchange on interest holder liability is as follows:
  - (1) A person who becomes subject to new interest holder liability in respect of an entity as a result of a merger or share exchange shall have that new interest holder liability only in respect of interest holder liabilities that arise after the merger or share exchange becomes effective.
  - (2) If a person had interest holder liability with respect to a party to the merger or the acquired entity before the merger or share exchange becomes effective with respect to shares or eligible interests of such party or acquired entity which were (i) exchanged in the merger or share exchange, (ii) were cancelled in the merger or (iii) the terms and conditions of which relating to interest holder liability were amended pursuant to the merger:
    - (i) The merger or share exchange does not discharge that prior interest holder liability with respect to any interest holder liabilities that arose before the merger or share exchange becomes effective.
    - (ii) The provisions of the organic law governing any entity for which the person had that prior interest holder liability shall continue to apply to the collection or discharge of any interest holder liabilities preserved by subsection § 11.07(c)(2)(i), as if the merger or share exchange had not occurred.
    - (iii) The person shall have such rights of contribution from other persons as are provided by the organic law governing the entity for which the person had that prior interest holder liability with respect to any interest holder liabilities preserved by subsection § 11.07(c)(2)(i), as if the merger or share exchange had not occurred.
    - (iv) The person shall not, by reason of such prior interest holder liability, have interest holder liability with respect to any interest holder liabilities that arise after the merger or share exchange becomes effective.
  - (3) If a person has interest holder liability both before and after a merger becomes effective with unchanged terms and conditions with respect to the entity that is the survivor by reason of owning the same shares or eligible interests before and after the merger becomes effective, the merger has no effect on such interest holder liability.
  - (4) A share exchange has no effect on interest holder liability related to shares or eligible interests of the acquired entity that were not exchanged in the 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) Except as provided in the organic law governing a party to a merger or in its articles of incorporation or organic rules, the merger does not give rise to any rights that an interest holder, governor, or third party would have upon a dissolution, liquidation, or winding up of that party. The merger does not require a party to the merger to wind up its affairs and does not constitute or cause its dissolution or termination.
- (f) Property held for a charitable purpose under the law of this state by a domestic or foreign corporation or eligible entity immediately before a merger becomes effective may not, as a result of the transaction, be diverted from the objects for which it was donated, granted, devised, or otherwise transferred except and to the extent permitted by or pursuant to the laws of this state addressing cy près or dealing with nondiversion of charitable assets.
- (g) A bequest, devise, gift, grant, or promise contained in a will or other instrument of donation, subscription, or conveyance which is made to an entity that is a party to a merger that is not the survivor and which takes effect or remains payable after the merger inures to the survivor.
- (h) A trust obligation that would govern property if transferred to a nonsurviving entity applies to property that is transferred to the survivor after a merger becomes effective.

## **CROSS-REFERENCES**

Appraisal rights, see ch. 13.

“Corporation” and “domestic corporation” defined, see § 1.40.

Effective time and date of merger or share exchange, see §§ 1.23 and 11.06.

“Eligible entity” defined, see § 1.40.

“Foreign corporation” defined, see § 1.40.

“Governor” defined, see § 1.40.

“Organic law” and “organic rules” defined, see § 1.40.

“Interest holder liability” defined, see § 1.40.

“New interest holder liability” defined, see § 11.01.

“Proceeding” defined, see § 1.40.

## **OFFICIAL COMMENT**

Under section 11.07(a), in a merger the parties that merge 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 other party to the merger. 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 addresses that issue. All pending proceedings involving either the survivor or a party whose separate existence ceased as a result of the merger are continued.

In contrast to a merger, a share exchange does not vest in the acquiring entity the assets of the acquired entity, or render the acquiring entity liable for the liabilities of the acquired entity. The statements in sections 11.06(a)(8) and § 11.07(b) regarding the rights of former holders of shares or eligible interests are not intended to preclude an otherwise proper question concerning the validity of the merger or share exchange, or to override or otherwise affect any provisions of chapter 13 concerning the exclusiveness of rights under that chapter.

The deemed appointment and agreement in section 11.07(d) by a foreign survivor is based on the implied consent of such a foreign corporation, or foreign eligible entity, to the terms of chapter 11 by reason of entering into an agreement that is governed by this chapter.

Section 11.07(e) sets forth the impact of mergers and share exchanges on interest holder liability. Section 11.04(i) sets forth when approval of a merger or share exchange requires the consent of shareholders who would otherwise become subject to new interest holder liability.

### **§ 11.08 Abandonment of a Merger or Share Exchange**

- (a) After a plan of merger or share exchange has been adopted and approved as required by this chapter, and before articles of merger or share exchange have become effective, the plan may be abandoned by a domestic business corporation that is a party to the plan 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.
- (b) If a merger or share exchange is abandoned under subsection § 11.08(a) after articles of merger or share exchange have been delivered to the secretary of state for filing but before the merger or share exchange has become effective, a statement of abandonment signed by all the parties that signed the articles of merger or share exchange shall be delivered to the secretary of state for filing before the articles of merger or share exchange become effective. The statement shall take effect on filing and the merger or share exchange shall be deemed abandoned and shall not become effective. The statement of abandonment must contain:
  - (1) the name of each party to the merger or the names of the acquiring and acquired entities in a share exchange;
  - (2) the date on which the articles of merger or share exchange were filed by the secretary of state; and
  - (3) a statement that the merger or share exchange has been abandoned in accordance with this section.

### **CROSS-REFERENCES**

Approval of merger or share exchange, see § 11.04.

“Corporation” and “domestic business corporation” defined, 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 to abandon a transaction 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(c) and § 11.03(c).

## CHAPTER 12

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# Disposition of Assets

§ 12.01. Disposition of Assets Not Requiring Shareholder Approval

§ 12.02. Shareholder Approval of Certain Dispositions

### § 12.01 Disposition of Assets Not Requiring Shareholder Approval

No approval of the shareholders is required, unless the articles of incorporation otherwise provide:

- (a) to sell, lease, exchange, or otherwise dispose of any or all of the corporation's assets in the usual and regular course of business;
- (b) 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, regardless of whether in the usual and regular course of business;
- (c) to transfer any or all of the corporation's assets to one or more domestic or foreign corporations or other entities all of the shares or interests of which are owned by the corporation; or
- (d) to distribute assets pro rata to the holders of one or more classes or series of the corporation's shares.

### CROSS-REFERENCES

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 specifies dispositions for which shareholder approval is not required, and section 12.02 specifies dispositions requiring shareholder approval.

Examples of dispositions in the usual and regular course of business under section 12.01(a) 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, 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 sales of assets by an open- or closed-end investment company the portfolio of which turns over many times in short periods.

No shareholder approval is required for a transaction involving a pro rata distribution because it comes within section 12.01(d). An example is a spin-off in which shares of a subsidiary are

distributed pro rata to the holders of one or more classes or series of shares. On the other hand, a non pro rata distribution—for example, a split-off in which shares of a subsidiary are distributed only to some shareholders in exchange for some or all of their shares—would require shareholder approval under section 12.02(a) if the disposition would leave the corporation without a significant continuing business activity. When the transaction involves a distribution in liquidation—for example, when two or more subsidiaries (whether they have existed previously or are newly formed) representing all of a dissolved corporation’s business activities are distributed to shareholders (sometimes referred to as a split-up)—the transaction will be governed by chapter 14 (dissolution), not by chapter 12.

## **§ 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. A corporation will conclusively be deemed to have retained a significant continuing business activity if it retains a business activity that represented, for the corporation and its subsidiaries on a consolidated basis, at least (i) 25% of total assets at the end of the most recently completed fiscal year, and (ii) either 25% of either income from continuing operations before taxes or 25% of revenues from continuing operations, in each case for the most recently completed fiscal year.
- (b) To obtain the approval of the shareholders under subsection § 12.02(a) the board of directors shall first adopt a resolution authorizing the disposition. The disposition shall then be approved by the shareholders. In submitting the disposition to the shareholders for approval, the board of directors shall recommend that the shareholders approve the disposition, unless (i) the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation, or (ii) section 8.26 applies. If either (i) or (ii) applies, the board shall inform the shareholders of the basis for its so proceeding.
- (c) The board of directors may set conditions for the approval by the shareholders of a disposition or the effectiveness of the disposition.
- (d) If a disposition is required to be approved by the shareholders under subsection § 12.02(a), and if the approval is to be given at a meeting, the corporation shall notify each shareholder, regardless of whether entitled to vote, of the meeting of shareholders at which the disposition 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 disposition and must contain a description of the disposition, including the terms and conditions of the disposition and the consideration to be received by the corporation.
- (e) Unless the articles of incorporation or the board of directors acting pursuant to subsection § 12.02(c) require a greater vote or a greater quorum, the approval of a disposition by the shareholders shall require the approval of the shareholders at a meeting at which a quorum exists consisting of a majority of the votes entitled to be cast on the disposition.
- (f) After a disposition has been approved by the shareholders under this chapter, 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 to be the assets of the parent corporation for the purposes of this section.

## **CROSS-REFERENCES**

Appraisal rights, see ch. 13.

Disposition of assets not requiring shareholder approval, see § 12.01.

Dissolution, see ch. 14.

Modifying quorum or voting requirements, see § 7.27.

Notices and other communications, see § 1.41.

Notice of shareholders' meeting, see § 7.05.

Submission of matters for shareholder vote, see § 8.26.

Voting entitlement of shares, see § 7.21.

## **OFFICIAL COMMENT**

### *1. In General*

Section 12.02(a) requires shareholder approval for a sale, lease, exchange or other disposition of assets by a corporation that would leave the corporation without a significant continuing business activity, other than as provided in section 12.01. Whether a disposition leaves a corporation with a significant continuing business activity, within the meaning of section 12.02(a), depends on whether the corporation's remaining business activity is significant when compared to the corporation's business before the disposition. The 25% safe harbor provides a measure of certainty in making this determination. The safe-harbor test is applied to assets and to revenue or income for the 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 test combines a parent corporation with subsidiaries that are or should be consolidated with it under applicable accounting principles. For example, if a corporation's only significant business is owned by a consolidated subsidiary, a sale of that business requires approval of the parent's shareholders under section 12.02. 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 (for example, the 25% retention tests of section 12.02(a) are met).

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 chapter 12 the corporation should be considered to be in the business of investing in 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% retention tests were met upon the disposition of the other businesses, shareholder approval would not be required.

A board of directors may determine that a retained continuing business falls within the 25% bright-line tests of the safe harbor in section 12.02(a) based 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 in a manner similar to that described in section 6.40(d) and the Official Comment 4 to that section.

The use of the term “significant” and the specific 25% safe harbor test for purposes of this section do not imply a standard for the test of significance or materiality for any other purposes under the Act or otherwise.

## 2. *Submission to Shareholders*

When submitting a proposal to shareholders for a disposition of assets, the board of directors must recommend the disposition, subject to two exceptions in section 12.02(b). The board might exercise the exception under clause (i) where the number of directors having a conflicting interest makes it inadvisable for the board to recommend the disposition or where the board is evenly divided as to the merits of the proposal but is able to agree that shareholders should be permitted to consider it. Alternatively, the board of directors might exercise the exception under clause (ii), which recognizes that, under section 8.26, a board of directors may agree to submit a proposal for a disposition to a vote of shareholders even if, after approving the proposal, the board of directors determines that it no longer recommends the proposal.

Section 12.02(c) permits the board of directors to condition its submission to the shareholders of a proposal for a disposition of assets or the effectiveness of the disposition. Among the conditions that a board of directors might impose are that the proposal 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 exercise appraisal rights.

## 3. *Quorum and Voting*

Requirements concerning the timing and content of a notice of meeting, as required by section 12.02(d), are set out in section 7.05. Section 12.02(d) does not address the notice to be given to nonvoting or nonconsenting shareholders where the proposal is approved without a meeting by written consent. That requirement is imposed by section 7.04.

Section 12.02(e) sets forth quorum and voting requirements applicable to a shareholder vote to approve a disposition. In lieu of approval at a meeting, shareholder approval may be by written consent under the procedures set forth in section 7.04.

The Act does not mandate separate voting by voting groups on dispositions, because after a disposition under this chapter the rights of all classes or series of shares remain the same. Separate voting by voting groups may nevertheless be required if provided for in the articles of

incorporation or by the board of directors, acting pursuant to section 12.02(c). Appraisal may be available to shareholders entitled to vote on the disposition. See chapter 13.

## CHAPTER 13

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# Appraisal Rights

### **Subchapter A.**

#### **RIGHT TO APPRAISAL AND PAYMENT FOR SHARES**

- § 13.01. Definitions
- § 13.02. Right to Appraisal
- § 13.03. Assertion of Rights Bb Nominees and Beneficial Shareholders

### **Subchapter B.**

#### **PROCEDURE FOR EXERCISE OF APPRAISAL RIGHTS**

- § 13.20. Notice of Appraisal Rights
- § 13.21. Notice of Intent to Demand Payment and Consequences of Voting or Consenting
- § 13.22. Appraisal Notice and Form
- § 13.23. Perfection of Rights; Right to Withdraw
- § 13.24. Payment
- § 13.25. After-Acquired Shares
- § 13.26. Procedure if Shareholder Dissatisfied with Payment or Offer

### **Subchapter C.**

#### **JUDICIAL APPRAISAL OF SHARES**

- § 13.30. Court Action
- § 13.31. Court Costs and Expenses

### **Subchapter D.**

#### **OTHER REMEDIES**

- § 13.40. Other Remedies Limited

### **Subchapter A.**

#### **RIGHT TO APPRAISAL AND PAYMENT FOR SHARES**

#### **§ 13.01 Definitions**

In this chapter:

“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 of such person. For purposes of section 13.02(b)(4), a person is deemed to be an affiliate of its senior executives.

“Corporation” means the domestic corporation that is the issuer of the shares held by a shareholder demanding appraisal and, for matters covered in sections 13.22 through § 13.31, includes the survivor of a merger.

“Fair value” means the value of the corporation’s shares determined:

- (i) immediately before the effectiveness 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 of incorporation pursuant to section 13.02(a)(4).

“Interest” means interest from the date the corporate action becomes effective until the date of payment, at the rate of interest on judgments in this state on the effective date of the corporate action.

“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 of the corporation, 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;
    - (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 or governor of the acquiror or any of its affiliates, rights and benefits as a director or governor that are provided on the same basis as those afforded by the acquiror generally to other directors or governors 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 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 shares having voting power 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 before 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.

“Preferred shares” means a class or series of shares whose holders have preference over any other class or series of shares with respect to distributions.

“Senior executive” means the chief executive officer, chief operating officer, chief financial officer, and any individual in charge of a principal business unit or function.

“Shareholder” means a record shareholder, a beneficial shareholder, and a voting trust beneficial owner.

## **CROSS-REFERENCES**

Directors’ action on director’s conflicting interest transaction, see § 8.62.

“Governor” defined, see § 1.40.

“Voting power” defined, see § 1.40.

## **OFFICIAL COMMENT**

### *1. Overview*

Chapter 13 proceeds from the premise that judicial appraisal should be provided by statute only when two conditions co-exist. First, a proposed corporate action as approved by a 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 reduced, however, in the case of publicly traded shares. This explains both the market exception described below and the limits provided to that exception.

When these two conditions exist in connection with domestications and conversions under chapter 9, mergers and share exchanges under chapter 11, and dispositions of assets requiring shareholder approval under chapter 12, chapter 13 provides for appraisal rights. Each of these actions will result in a fundamental change in the shares that a disapproving shareholder may believe was not adequately compensated by the terms approved by the majority. Shareholders are not entitled to appraisal, however, if the change will not alter the terms of the class or series of securities that they hold. For example, statutory appraisal rights are not available for shares of any class or series of the surviving corporation in a merger that are not being changed in the

merger or for shares of any class or series that is not included in a share exchange. Appraisal is also not triggered by a voluntary dissolution under chapter 14 because the dissolution does not affect liquidation rights of the shares of any class or series.

With the exception of reverse stock splits that result in cashing out some of the shares of a class or series, chapter 13 does not grant appraisal rights in connection with amendments to the articles of incorporation. This 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. Chapter 13 delineates in section § 13.02(a)(5) a list of actions for which the corporation may voluntarily choose to provide appraisal. It also allows, under section § 13.02(c), a provision in the articles of incorporation that eliminates, in whole or in part, statutory appraisal rights for preferred shares, subject to certain conditions.

Chapter 13 provides an exception to appraisal rights for publicly traded shares, referred to as the “market exception.” This exception is available in those situations when shareholders are likely to receive fair value if 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 be a liquid market for the shares. The market exception does not apply where the appraisal-triggering action is a conflict transaction.

## 2. *Definitions*

Section 13.01 contains specialized definitions applicable only to chapter 13.

### **A. CORPORATION**

The definition of “corporation” in section 13.01 includes, for purposes of the post-transaction matters covered in sections 13.22 through § 13.31, a successor entity in a merger where the corporation is not the surviving entity. The definition does not include an acquiring entity 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 applicable law of the relevant jurisdiction.

### **B. FAIR VALUE**

Clause (i) of the definition of “fair value” in section 13.01 specifies that fair value is to be determined immediately before the effectiveness of the corporate action, which will be after the shareholder vote. Accordingly, section 13.01 permits consideration of changes in the value of the corporation’s shares after the shareholder vote but before the effectiveness of the transaction, to the extent such changes are relevant. Similarly, in a two-step transaction culminating in a merger, fair value is determined immediately before the second step merger, taking into account any interim changes in value.

Clause (ii) of the definition of “fair value” in section 13.01 adopts the 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, and will normally result in a range of values, not a particular single value. A court determining fair value under chapter 13 should give great deference to the aggregate consideration accepted or approved by a disinterested board of directors for an appraisal-triggering transaction.

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 may give the majority the opportunity to take advantage of minority shareholders who have been forced against their will to accept the appraisal-triggering transaction. Clause (iii) of the definition of “fair value” adopts the 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.

#### **C. INTEREST**

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. Other state law determines whether interest is compound or simple.

#### **D. INTERESTED TRANSACTION**

The term “interested transaction” addresses two groups of conflict transactions: those in subsections (i)(A) and (B) of the definition, which involve large shareholders; and those in subsection (i)(C), which involve senior executives and directors. The phrase “involving an interested person” as applied to subsections (i)(A) and (B) denotes participation beyond merely voting or participating on the same basis as other holders of securities of the same or a similar class or series. When a transaction fits within the definition of an interested transaction there are two consequences: the market exception will not be applicable, and the exclusion of other remedies under section 13.40 will not be applicable unless certain disinterested approvals have been obtained.

The definition of “beneficial owner” in subsection (ii) of the definition of “interested transaction” is used to identify possible conflict situations by deeming each member of a group that agrees to vote in concert to be a beneficial owner of all the voting shares owned by the members of the group. (In contrast, the term “beneficial shareholder,” as defined in section 1.40, is used to identify those persons entitled to appraisal rights.) When an acquisition is effected in two steps (a tender offer followed by a merger) within one year, and the consideration in the merger is of the same kind and of at least the same value as that in the tender offer, the two-step acquisition is properly considered a single transaction for purposes of identifying conflict transactions, regardless of whether the second-step merger is governed by section 11.04 or § 11.05. Therefore the shares acquired in such an offer (defined as “excluded shares” in subsection (iii)) are excluded in subsections (i)(A) and (B) from the determination of whether a person is an “interested person” for purposes of the second-step merger.

A reverse split in which small shareholders are cashed out will constitute an interested transaction if there is an affiliate of the corporation who satisfies the test in subsections (i)(A) or (B). In that case, the corporation itself will be considered an affiliate of the large shareholder and fall within the definition of “interested person,” such that when the corporation acquires and cashes out the shares of the small shareholders the acquisition will be an interested transaction.

Subsection (i)(C) applies to management buyouts because management’s participation in the buyout group is itself “a financial benefit not generally available to other shareholders.” It also applies to transactions involving other types of economic benefits (excluding benefits afforded to shareholders generally) afforded to senior executives (as defined in section 13.01) and directors in specified conflict situations, unless specific objective or procedural standards are met. It

would also 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 specifically defines the term “affiliate” to include an entity of which a person is a senior executive. As a result of this 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 subsection (i)(C), 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.
- 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 to the officer or director than those already in existence or, if they treat the director or officer more favorably, are approved by “qualified” directors (*i.e.*, meeting the standard 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 to, the transaction or arrangements with the acquiring company or one or more of its other subsidiaries.
- If a person who is a director of the corporation and, in connection with the transaction, is to become a director of the acquiror or its parent, or to continue as a director of the corporation when it becomes a subsidiary of the acquiror, 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.

#### **F. SENIOR EXECUTIVE**

The definition of “senior executive” in section 13.01 encompasses the group of individuals in control of corporate information and the corporation’s 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.

#### **F. SHAREHOLDER**

The definition of “shareholder” in section 13.01 encompasses beneficial shareholders and voting trust beneficial owners. This recognizes that these persons have or hold on behalf of others an economic interest in the shares. Use of the term “beneficial shareholder” for this purpose is to be contrasted with the use of the term “beneficial owner” in subsection (ii) of the definition of “interested transaction” to identify possible conflict situations. The distinction between “record shareholder” and “beneficial shareholder” appears 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.

### **§ 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, or would be required but for the provisions of section 11.04(j), 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 the shares of which will be acquired, 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 acquired in the share exchange;
  - (3) consummation of a disposition of assets pursuant to section 12.02 if the shareholder is entitled to vote on the disposition, except that appraisal rights shall not be available to any shareholder of the corporation with respect to shares of any class or series if (i) under the terms of the corporate action approved by the shareholders there is to be distributed to shareholders in cash the corporation's net assets, in excess of a reasonable amount reserved to meet claims of the type described in sections 14.06 and § 14.07, (A) within one year after the shareholders' approval of the action and (B) in accordance with their respective interests determined at the time of distribution, and (ii) the disposition of assets is not an interested transaction;
  - (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 merger, share exchange, disposition of assets or amendment to the articles of incorporation, in each case to the extent provided by the articles of incorporation, bylaws or a resolution of the board of directors;
  - (6) consummation of a domestication pursuant to section 9.20 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 foreign corporation, as the shares held by the shareholder before the domestication;
  - (7) consummation of a conversion of the corporation to a nonprofit corporation pursuant to section 9.30; or
  - (8) consummation of a conversion of the corporation to an unincorporated entity pursuant to section 9.30.
- (b) Notwithstanding subsection § 13.02(a), the availability of appraisal rights under subsections (a)(1), (2) 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;
  - (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 and directors and by any beneficial shareholder and any voting trust beneficial owner 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 which may be redeemed at the option of the holder at net asset value.
- (2) The applicability of subsection § 13.02(b)(1) shall be determined as of:
  - (i) the record date fixed to determine the shareholders entitled to receive notice of the meeting of shareholders to act upon the corporate action requiring appraisal rights or, in the case of an offer made pursuant to section 11.04(j), the date of such offer; or
  - (ii) if there is no meeting of shareholders and no offer made pursuant to section 11.04(j), the day before the consummation of the corporate action or effective date of the amendment of the articles of incorporation, as applicable.
- (3) Subsection § 13.02(b)(1) shall not be applicable and appraisal rights shall be available pursuant to subsection § 13.02(a) for the holders of any class or series of shares (i) 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 § 13.02(b)(1) at the time the corporate action becomes effective, or (ii) in the case of the consummation of a disposition of assets pursuant to section 12.02, unless the cash, shares, or proprietary interests received in the disposition are, under the terms of the corporate action approved by the shareholders, to be distributed to the shareholders, as part of a distribution to shareholders of the net assets of the corporation in excess of a reasonable amount to meet claims of the type described in sections 14.06 and 14.07, (A) within one year after the shareholders' approval of the action, and (B) in accordance with their respective interests determined at the time of the distribution.
- (4) Subsection (b)(1) shall not be applicable and appraisal rights shall be available pursuant to subsection § 13.02(a) for the holders of any class or series of shares where the corporate action is an interested transaction.
- (c) Notwithstanding any other provision of section 13.02, the articles of incorporation as originally filed or any amendment to the articles of incorporation may limit or eliminate appraisal rights for any class or series of preferred shares, except that (i) no such limitation or elimination shall be effective if the class or series does not have the right to vote separately as a voting group (alone or as part of a group) on the action or if the action is a conversion under section 9.30, or a merger having a similar effect as a conversion in which the converted entity is an eligible entity, and (ii) any such limitation or elimination contained in an amendment to the articles of incorporation that limits or eliminates appraisal rights for any of such shares that are outstanding immediately before the effective date of such amendment or that the corporation is or may be required to issue or sell thereafter pursuant to any conversion, exchange or other right existing immediately before the effective date of such amendment shall not apply to any corporate action that becomes

effective within one year after the effective date of such amendment if such action would otherwise afford appraisal rights.

## **CROSS-REFERENCES**

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

Classes and series of shares, see §§ 6.01 and 6.02.

Conversion, see ch. 9C.

Disposition of assets, see ch. 12.

Domestication, see ch. 9B.

Effective time and date of amendment, see § 1.23.

“Eligible entity” defined, see § 1.40.

“Foreign corporation” defined, see § 1.40.

“Interested transaction” defined, see § 13.01.

Merger and share exchange, see ch. 11.

Merger of subsidiary, see § 11.05.

“Nonprofit corporation” defined, see § 1.40.

“Person” defined, see § 1.40.

“Preferred shares” defined, see § 13.01.

Record date, see § 7.07.

Redemption of shares, see §§ 6.01 and 6.31.

Share dividends, see § 6.23.

Share preferences, see §§ 6.01 and 6.02.

“Unincorporated entity” defined, see § 1.40.

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

“Voting power” defined, see § 1.40.

Voting rights, see § 7.21.

## **OFFICIAL COMMENT**

### *1. Transactions Requiring Appraisal Rights*

Section 13.02(a) establishes the scope of appraisal rights by identifying those transactions that afford this right. 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 set forth in section 13.02(a), subject to the exceptions set forth in section 13.02(b). In a two-step transaction authorized by section 11.04(j), shareholders at the time of the second step merger could have appraisal rights even though there is no shareholder vote. Shareholders who tender in response to the offer in the first step of such a transaction would not have appraisal rights; their tendering in response to the offer has the same effect on appraisal rights as if they had voted for the transaction.

Under section 13.02(b)(4), the reasons for granting appraisal rights in a reverse stock split in which shares are cashed out are similar to those for 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 by the amendment. 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.

An express grant of voluntary appraisal rights under section § 13.02(a) (§ 13.02(a)(5)) overrides 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 in connection with a corporate action will automatically make all of the provisions of chapter 13 applicable to the corporation and such holders regarding that corporate action.

## *2. Market Exception to Appraisal Rights*

Chapter 13 provides a limited exception to appraisal rights for those situations where shareholders may either accept the appraisal-triggering corporate action or sell their shares in an organized market described in section § 13.02(b)(1). For purposes of this chapter, the market exception is provided for a class or series of shares if two tests are satisfied: the market in which the shares are traded must be liquid, as described in section § 13.02(b)(1), and the value of the shares established by the appraisal-triggering event must be the result of a process reasonably calculated to arrive at a price reflective of an arm's length transaction.

Because section § 13.02(b)(2)(i) excludes from the market exception 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) specifies the date on which the corporation must satisfy the requirements of section § 13.02(b)(1) for the market exception to be applicable. Section § 13.02(b)(§ 13.02(b)(4)) recognizes that the market price of, or consideration for, shares of a corporation that proposes to engage in an interested transaction of the type listed in section 13.02(a) 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)(§ 13.02(b)(4)) thus provides that the market exception will not apply in those instances where the transaction constitutes an interested transaction (as defined in section 13.01).

## *3. Elimination of Appraisal Rights for Preferred Shares*

Section 13.02(c) permits the corporation to eliminate or limit appraisal rights that would otherwise be available for the holders of one or more series or classes of preferred shares provided that the standards in that section are met. Chapter 13 does not permit the corporation to eliminate or limit the appraisal rights of common shares.

### **§ 13.03 Assertion of Rights Bb Nominees and Beneficial Shareholders**

(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 or a voting trust beneficial owner only if the record shareholder objects with respect to all shares of a class or series owned by the beneficial shareholder or the voting trust beneficial owner and notifies the corporation in writing of the name and address of each beneficial shareholder or voting trust beneficial owner 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 and a voting trust beneficial owner 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 or the voting trust beneficial owner.

### **CROSS-REFERENCES**

“Beneficial shareholder,” “record shareholder” and “voting trust beneficial owner” defined, see §§ 1.40 and 13.01.

Notice to the corporation, see § 1.41.

“Person” defined, see § 1.40.

“Shareholder” defined, see §§ 1.40 and 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 traded 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. The same rule applies to shares held by voting trustees. A shareholder who owns shares in more than one class or series, however, may assert appraisal rights for only some rather than all classes or series that the shareholder owns.

Voting trustees hold shares on behalf of voting trust beneficial owners and may want to or be required to pass the decision on asserting appraisal rights on to the voting trust beneficial owners. To make appraisal rights effective without burdening record shareholders, beneficial shareholders and voting trust beneficial owners are allowed to assert their own claims as provided in section 13.02(b). After the corporation has received the form of consent required by section 13.03(b)(1), the corporation must deal with the beneficial shareholder, or, in the case of a voting trust, the voting trust beneficial owner.

## **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 (or where no approval of such action is required pursuant to section 11.04(j), the offer made pursuant to section 11.04(j)), must state that the corporation has concluded that appraisal rights are, are not or may be available 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 or offer sent to those record shareholders entitled to exercise appraisal rights.
- (b) In a merger pursuant to section 11.05, the parent entity shall notify in writing all record shareholders of the subsidiary who are entitled to assert appraisal rights that the corporate action became effective. Such notice shall 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 shall be sent 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, the notice 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 § 13.20(b) must be accompanied by:
  - (1) financial statements of the corporation that issued the shares that may be subject to appraisal, consisting of a balance sheet as of the end of a fiscal year ending not more than 16 months before the date of the notice, an income statement for that year, and a cash flow statement for that year; provided that, if such financial statements are not reasonably available, the corporation shall provide reasonably equivalent financial information; and
  - (2) the latest interim 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**

Availability of appraisal rights, see §§ 13.02.

“Beneficial shareholder,” “record shareholder” and “voting trust beneficial owner” defined, see §§ 1.40 and § 13.01.

Meeting notice, see § § 7.05.

Merger of subsidiary, see § § 11.05.

Notices and other communications, see § § 1.41.

Shareholder action without a meeting, see § § 7.04.

“Shareholder” defined, see §§ § 1.40 and § 13.01.

Shareholders’ meetings, see §§ § 7.01 through § 7.03.

## **OFFICIAL COMMENT**

The notices required by sections 13.20(a), (b) and (c) are necessary because many shareholders do not know what appraisal rights they may have or how to assert them. 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.

Section 13.20(d) specifies certain disclosure requirements for corporate actions for which appraisal rights are provided. Disclosure of additional information may be necessary under common law disclosure duties.

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 to exercise appraisal rights. 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 sections 13.20 and 13.24.

## **§ 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) shall 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) shall 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 written consent, a shareholder who wishes to assert appraisal rights with respect to any class or series of shares shall not sign a consent in favor of the proposed action with respect to that class or series of shares.
- (c) If a corporate action specified in section 13.02(a) does not require shareholder approval pursuant to section 11.04(j), a shareholder who wishes to assert appraisal rights with respect to any class or series of shares (i) shall deliver to the corporation before the shares are purchased pursuant to the offer written notice of the shareholder’s intent to demand payment if the proposed action is effected; and (ii) shall not tender, or cause or permit to be tendered, any shares of such class or series in response to such offer.
- (d) A shareholder who fails to satisfy the requirements of subsection (a), (b) or (c) is not entitled to payment under this chapter.

## **CROSS-REFERENCES**

“Deliver” defined, see § § 1.40.

Notices and other communications, 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 which shareholders of the subsidiary do not vote on the transaction but are nevertheless entitled to appraisal.

The notice from the shareholder required by section 13.21(a) enables the corporation, among other things, to estimate how much of a cash payment may be required by reference to the maximum number of shares for which appraisal may be sought. It also limits the number of persons to whom the corporation must give further notice during the remainder of the appraisal process.

### **§ 13.22 Appraisal Notice and Form**

- (a) If a corporate action requiring appraisal rights under section 13.02(a) becomes effective, the corporation shall deliver a written appraisal notice and form required by subsection § 13.22(b) to all shareholders who satisfy the requirements of sections 13.21(a), (b) or (c). In the case of a merger under section 11.05, the parent shall deliver an appraisal notice and form to all record shareholders who may be entitled to assert appraisal rights.
- (b) The appraisal notice shall be delivered 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 before 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 as to the class or series of shares for which appraisal is sought;
  - (2) state:
    - (i) where the form shall be sent and where certificates for certificated shares shall be deposited and the date by which those certificates must be deposited, which date may not be earlier than the date by which the corporation must receive the required form under subsection § 13.22(b)(2)(ii);
    - (ii) a date by which the corporation shall receive the form, which date may not be fewer than 40 nor more than 60 days after the date the subsection § 13.22(a) appraisal notice is 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 § 13.22(b)(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 shall be received, which date shall be within 20 days after the date specified in subsection § 13.22(b)(2)(ii); and
- (3) be accompanied by a copy of this chapter.

### **CROSS-REFERENCES**

- After-acquired shares, see § § 13.25.  
“Deliver” defined, see § 1.40.  
Merger of subsidiary, see § § 11.05.  
Notices and other communications, see § § 1.41.

### **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.

Section 13.22(b)(1) requires that the corporation specify the date of the first announcement of the terms of the proposed corporate action. This date determines the rights of shareholder-transferees. Persons who became shareholders before 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 or other person 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.

The information required by sections 13.22(b)(2)(iii) and (iv) is intended to help shareholders assess whether they wish to demand payment or to withdraw their demand for appraisal, although 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.

### **§ 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 shall 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 shall 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)(2)(ii). 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 § 13.23(b).

- (b) A shareholder who has complied with subsection § 13.23(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.

Notice of appraisal rights, see § § 13.22.

Notices and other communications, see § § 1.41.

### **OFFICIAL COMMENT**

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 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, the form required by section 13.23 is the shareholder's first statement of this intention.

Information on the appraisal form regarding whether the beneficial shareholder acquired beneficial ownership of the shares before, on or after the date the transaction was announced 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.

Once a shareholder deposits that shareholder's shares as required by section 13.23(a), that shareholder loses all rights as a shareholder unless the shareholder withdraws from the appraisal process pursuant to section 13.23(b).

Under section 13.23(c), a shareholder who fails to comply with the requirements of 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 13.02(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 § 13.24(a) must be accompanied

by:

- (1) (i) financial statements of the corporation that issued the shares to be appraised, consisting of a balance sheet as of the end of a fiscal year ending not more than 16 months before the date of payment, an income statement for that year, and a cash flow statement for that year; provided that, if such annual financial statements are not reasonably available, the corporation shall provide reasonably equivalent financial information, and (ii) the latest interim financial statements of such corporation, if any;
- (2) a statement of the corporation's estimate of the fair value of the shares, which estimate shall equal or exceed the corporation's estimate given pursuant to section 13.22(b)(2)(iii); and
- (3) a statement that shareholders described in subsection § 13.24(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 in section 13.26(b), such shareholder shall be deemed to have accepted the payment under subsection § 13.24(a) 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 of appraisal rights, see § § 13.22.

Payment demand, see § § 13.23.

Rejection of corporation's offer, see § § 13.26.

### **OFFICIAL COMMENT**

Section 13.24 is applicable to shareholders who have complied with section 13.23(a) and to shareholders 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 treat some shareholders described in section 13.25(a) under section 13.24 but treat others under section 13.25.

The requirement of section 13.24 that the corporation pay its estimate of the fair value of the stock plus interest reflects a judgment that a difference of opinion over the total amount to be paid should not delay payment of the amount that is undisputed. Because a former shareholder must decide whether to accept that payment in full satisfaction, the corporation must include with the payment the information specified in section 13.24(b), which includes a reminder of the former shareholder's further rights.

Even though the information specified in section 13.24(b) 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. That information may need to be updated to satisfy the requirements of section 13.24(b).

### **§ 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 § 13.25(a), it shall, within 30 days after the form required by section 13.22(b)(2)(ii) is due, notify all shareholders who are described in subsection § 13.25(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 shall 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)(4), the corporation shall pay in cash the amount it offered under subsection § 13.25(b)(2) plus interest to each shareholder who agreed to accept the corporation's offer in full satisfaction of the shareholder's demand.
- (d) Within 40 days after delivering the notice described in subsection § 13.25(b), the corporation shall pay in cash the amount it offered to pay under subsection (b)(2) plus interest to each shareholder described in subsection § 13.25(b)(5).

### **CROSS-REFERENCES**

"Fair value" defined, see § § 13.01.

"Interest" defined, see § § 13.01.

Notices and other communications, see § § 1.41.

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 not to make payment under section 13.24(a) to holders of shares acquired on or after the date of that announcement or to holders of shares who are required to but do not certify under section 13.23(a) when they acquired beneficial ownership. Instead, the corporation may give these shareholders an offer of payment which is conditioned on their agreement to accept it in full satisfaction of their claim.

The date used as a cut-off for determining the application of this section is when "the principal terms" of the proposed transaction are first announced to shareholders. See the Official Comment to section 13.22. The cut-off is not 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 discourage use of appraisal rights as a speculative device only after the principal terms of the proposed transaction are announced.

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) A shareholder paid pursuant to section 13.24 who is dissatisfied with the amount of the payment shall notify the corporation in writing of that shareholder's estimate of the fair value of the shares and demand payment of that estimate (less any payment under section 13.24) plus interest. A shareholder offered payment under section 13.25 who is dissatisfied with that offer shall reject the offer and demand payment of the shareholder's stated estimate of the fair value of the shares plus interest.
- (b) 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 § 13.26(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.

"Fair value" defined, see § § 13.01.

"Interest" defined, see § § 13.01.

Judicial appraisal, see § § 13.30.

Notices and other communications, 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 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 [name or describe court].
- (c) The corporation shall make all shareholders (regardless of whether they are residents of this state) whose demands remain unsettled parties to the proceeding as in an action against their shares, and all parties shall 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 § 13.30(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 exceeds the amount paid by the corporation to the shareholder for such shares, plus interest, 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.

“Proceeding” defined, see § § 1.40.

### **OFFICIAL COMMENT**

Section 13.30 provides for judicial appraisal as the ultimate means of determining fair value. All demands for payment made under section 13.26 are to be resolved in a single proceeding brought in the court specified by section 13.30(b). All shareholders making demands under section 13.26 must be made parties, with service by publication authorized if necessary. Because 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 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.

Judicial appraisal, see § § 13.30.

“Proceeding” defined, see § § 1.40.

## **OFFICIAL COMMENT**

The purpose of the grants of discretion to the court under section 13.31 with respect to expenses of appraisal proceedings 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) through (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.

## **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**

Directors' action respecting a director's conflicting interest transaction, see § § 8.62.

"Director's conflicting interest transaction" defined, see § § 8.60.

"Interested transaction" defined, see § § 13.01.

Shareholders' action respecting a director's conflicting interest transaction, see § § 8.63.

### **OFFICIAL COMMENT**

The principle underlying section 13.40 generally is that when the holders of a majority of the shares have approved a corporate change, the corporation should be permitted to proceed even if a minority considers the change unwise or disadvantageous. The existence of an appraisal remedy recognizes that shareholders may disagree about the financial consequences that a corporate action may have and that some may hold such strong views that they will want to vindicate them in a judicial proceeding. Accordingly, if an appraisal 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 exception also 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 the four circumstances described in section 13.40(b)(1). In the case of a corporate action that is an interested transaction, the same reasoning that supports the provision of appraisal rights in situations where the market exception would otherwise apply under section



13.02(b) also supports the approach 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. In those sections, 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, and the extent of the relief that may be available is not addressed by this section.

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 § 13.40(b)(4) applies. See section 8.31 and the related Official Comment and the introductory Official Comment to chapter 8F under the heading “Scope of Subchapter F.”

## CHAPTER 14

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# Dissolution

### **Subchapter A.**

#### **VOLUNTARY DISSOLUTION**

- § 14.01. Dissolution by Incorporators or Initial Directors
- § 14.02. Dissolution by Board of Directors and Shareholders
- § 14.03. Articles of Dissolution
- § 14.04. Revocation of Dissolution
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#### **ADMINISTRATIVE DISSOLUTION**

- § 14.20. Grounds for Administrative Dissolution
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#### **JUDICIAL DISSOLUTION**

- § 14.30. Grounds For Judicial Dissolution
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- § 14.33. Decree of Dissolution
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### **Subchapter D.**

#### **MISCELLANEOUS**

- § 14.40. Deposit with State Treasurer

### **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:

- (a) the name of the corporation;
- (b) the date of its incorporation;
- (c) either (i) that none of the corporation's shares has been issued or (ii) that the corporation has not commenced business;
- (d) that no debt of the corporation remains unpaid;
- (e) that the net assets of the corporation remaining after winding up have been distributed to the shareholders, if shares were issued; and
- (f) that a majority of the incorporators or initial directors authorized the dissolution.

### **CROSS-REFERENCES**

Claims against dissolved corporation, see §§ 14.06 and § 14.07.

Dissolution by board of directors and shareholders, see § 14.02.

Effect of dissolution, see § 14.05.

Effective date of dissolution, see §§ 14.03.

Filing requirements, see § 1.20.

Incorporators, see § 2.01.

Initial directors, see § 2.05.

Revocation of dissolution, see § 14.04.

### **OFFICIAL COMMENT**

Under the Act, a corporation is dissolved on the effective date of its articles of dissolution. The Act uses the term “dissolution” in this specialized sense, and not to describe the final step in the liquidation of the corporate business. Section 14.05 provides that dissolution does not terminate the corporation's existence, but that section does require the corporation to wind up its affairs and liquidate.

Section 14.01 provides a simple method for voluntary dissolution if the corporation has not issued shares (even though it has commenced business) or if it has issued shares but has not commenced business. Section 14.01 takes these situations into account by requiring statements in the articles of dissolution that no debts remain unpaid and that the net assets of the corporation remaining after winding up have been distributed to the shareholders. Dissolution may be accomplished in either situation simply by a majority vote of the incorporators or initial directors.

### **§ 14.02 Dissolution by Board of Directors and Shareholders**

- (a) The board of directors may propose dissolution for submission to the shareholders by first adopting a resolution authorizing the dissolution.
- (b) For a proposal to dissolve to be adopted, it shall then be approved by the shareholders. In submitting the proposal to dissolve to the shareholders for approval, the board of directors shall recommend that the shareholders approve the dissolution, unless (i) the board of directors determines that because of conflict of interest or other special circumstances it

- should make no recommendation or (ii) section 8.26 applies. If either (i) or (ii) applies, the board shall inform the shareholders of the basis for its so proceeding.
- (c) The board of directors may set conditions for the approval of the proposal for dissolution by shareholders or the effectiveness of the dissolution.
  - (d) If the approval of the shareholders is to be given at a meeting, the corporation shall notify each shareholder, regardless of whether entitled to vote, of the meeting of shareholders at which the dissolution is to be submitted for approval. The notice must 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 § 14.02(c) require a greater vote, a greater quorum, 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 exists consisting of a majority of the votes entitled to be cast on the proposal to dissolve.

### **CROSS-REFERENCES**

Effect of dissolution, see § § 14.05.

Modifying quorum or voting requirements, see § § 7.27.

Notice of shareholders' meeting, see § § 7.05.

Notices and other communications, see § § 1.41.

Quorum at shareholders' meeting, see § § 7.25.

Revocation of dissolution, see § § 14.04.

Shareholder action without a meeting, see § § 7.04.

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

Voting entitlement of shares, see § § 7.21.

“Voting group” defined, see § § 1.40.

### **OFFICIAL COMMENT**

When submitting a proposal to dissolve to shareholders, the board of directors must recommend the dissolution, subject to two exceptions in section 14.02(b). The board might exercise the exception under clause (i) where the number of directors having a conflicting interest makes it inadvisable for the board to recommend the proposal or where the board is evenly divided as to the merits of the proposal but is able to agree that shareholders should be permitted to consider it. Alternatively, the board of directors might exercise the exception under clause (ii), which recognizes that, under section 8.26, a board of directors may agree to submit a proposal to dissolve to a vote of shareholders even if, after approving the proposal, the board of directors determines that it no longer recommends the proposal.

Section 14.02(c) permits the board of directors to condition its submission to the shareholders of a proposal for dissolution or the effectiveness of the dissolution. Among the conditions that a board might impose are that the proposal will not be deemed approved 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.

Requirements concerning the timing and content of a notice of meeting, as required by section 14.02(d), are set out in section 7.05. Section 14.02(d) does not address the notice to be

given to nonvoting or nonconsenting shareholders where the proposal is approved, without a meeting, by written consent. However, that requirement is imposed by section 7.04.

Section 14.02(e) sets forth the quorum and voting requirements applicable to a shareholder vote to approve a dissolution. In lieu of approval at a meeting, shareholder approval may be by written consent under the procedures set forth in section 7.04.

The Act does not mandate separate voting by voting groups or appraisal rights in relation to dissolution proposals because upon dissolution, the rights of all classes or series of shares are fixed by the articles of incorporation. Separate voting by voting groups may nevertheless be required if provided for in the articles of incorporation or by the board of directors, acting pursuant to section 14.02(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 that 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) The articles of dissolution shall take effect at the effective date determined in accordance with section 1.23. 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**

Dissolution by:

board of directors and shareholders, see § § 14.02.

incorporators or initial directors, see § § 14.01.

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.

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

“Voting group” defined, see § § 1.40.

### **OFFICIAL COMMENT**

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. Under the 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 as 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 of dissolution is specified, although filing must precede making distributions to shareholders unless there is compliance with section 6.40.

After the effective date of the articles of dissolution, the corporation is referred to as a “dissolved corporation,” although its existence continues under section 14.05 for purposes of winding up. The inclusion of a successor entity within the definition of “dissolved corporation” under section 14.03(c) covers the situation where a liquidating trust or other successor liquidating entity is used to complete the liquidation.

#### **§ 14.04 Revocation of Dissolution**

- (a) A corporation may revoke its dissolution within 120 days after its effective date.
- (b) Revocation of dissolution shall 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 as 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, a statement that the revocation was duly approved by the shareholders in the manner required by this Act and by the articles of incorporation.
- (d) The articles of revocation of dissolution shall take effect at the effective date determined in accordance with section 1.23. 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.

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 requirements, see § § 1.20.

## **OFFICIAL COMMENT**

Section 14.04 provides a procedure to revoke dissolution. Revocation generally requires the same authorization as the dissolution, although section 14.04(b) allows shareholders to authorize the board of directors to act alone in revoking dissolution. This authority could be useful, for example, in proposals to dissolve that are contingent upon the effectiveness of another transaction, such as a sale of corporate assets not in the ordinary course of business.

Articles of revocation of dissolution must be filed before resuming the business of the corporation. The information required in the articles of revocation parallels the information required in the articles of dissolution.

Effectiveness of articles of revocation of dissolution dates back to the effective date of the articles of dissolution and permits the corporation to resume its business without limitation.

### **§ 14.05 Effect of Dissolution**

- (a) A corporation that has dissolved continues its corporate existence but the dissolved corporation 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) making distributions of its remaining assets 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;
  - (3) subject its directors or officers to standards of conduct different from those prescribed in chapter 8;
  - (4) change (i) quorum or voting requirements for its board of directors or shareholders; (ii) provisions for selection, resignation, or removal of its directors or officers or both; or (iii) 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.
- (c) A distribution in liquidation under this section may only be made by a dissolved corporation. For purposes of determining the shareholders entitled to receive a distribution in liquidation, the board of directors may fix a record date for determining shareholders entitled to a distribution in liquidation, which date may not be retroactive. If the board of directors does not fix a record date for determining shareholders entitled to a distribution in

liquidation, the record date is the date the board of directors authorizes the distribution in liquidation.

## **CROSS-REFERENCES**

Administrative dissolution, see §§ § 14.20 through § 14.23.

Claims against dissolved corporation, see §§ § 14.06 and § 14.07.

Deposit with state treasurer, see § § 14.40.

Dissolution by:

board of directors and shareholders, see § § 14.02.

incorporators or initial directors, see § § 14.01.

“Dissolved corporation” defined, see § § 14.03.

“Distribution” defined, see § § 1.40.

Effective date of dissolution, see § § 14.03.

Judicial dissolution, see §§ § 14.30 through § 14.34.

“Proceeding” defined, see § § 1.40.

Quorum requirements:

board of directors, see § § 8.24.

shareholders, see §§ § 7.25 and § 7.26.

Revocation of dissolution, see § § 14.04.

Service on corporation, see § § 5.04.

## **OFFICIAL COMMENT**

Although section 14.05(a) provides that dissolution does not terminate the corporate existence, it does require the corporation to wind up its affairs and liquidate its assets. After dissolution, the corporation may not carry on its business except as may be appropriate for winding up. Because distributions in liquidation that occur after dissolution are distinct from the pre-dissolution distributions governed by section 6.40, section 14.05(c) sets forth a separate provision for establishing a record date for determining shareholders entitled to receive a distribution in liquidation.

### **§ 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 after the written notice is effective, by which the dissolved corporation shall 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 § 14.06(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 after the rejection notice is effective.
- (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” defined, see § § 1.40.

“Dissolved corporation” defined, see § § 14.03.

Effective date of dissolution, see § § 14.03.

Effective date of notice, see § § 1.41.

Notices and other communications, see § § 1.41.

Other claims against dissolved corporation, see § § 14.07.

“Proceeding” defined, see § § 1.40.

### **OFFICIAL COMMENT**

Sections 14.06 and 14.07 provide a simplified system for handling claims against a dissolved corporation. Section 14.06 deals solely with known claims while section 14.07 deals with unknown or subsequently arising claims. Known claims may be unliquidated, but a claim that is contingent or has not yet matured (or in certain cases has matured but has not been asserted) is not a “claim” for purposes of 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 “claim” under section 14.06.

Known claims are handled in section 14.06 through a process of written notice to claimants, which must provide the information described in section 14.06(a). See section 1.41 with respect to notices and communications generally. Section 14.06(c) then provides fixed deadlines by which known claims are barred under various circumstances. Section 14.06(c) however, does not bar a claim if the dissolved corporation does not act on it or fails to notify the claimant of the rejection of the claim. Section 14.07 bars certain claims not covered by section 14.06.

The principles of sections 14.06 and 14.07 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 give notice to the claimant under section 14.06(a) or does not act on a claim—will nevertheless be subject to the general statute of limitations applicable to claims of that type. The Act does not require that a dissolved corporation take the actions set out in sections 14.06 and 14.07, but if it does not do so the protections those sections provide are not available to it.

### **§ 14.07 Other Claims Against Dissolved Corporation**

- (a) A dissolved corporation may 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 (i) 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 or (ii) be posted conspicuously for at least 30 days on the dissolved corporation's website;
  - (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 notice in accordance with subsection § 14.07(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 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 by the corporation;
  - (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(a) 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.

Court proceedings, see § § 14.08.

Decree of judicial dissolution, see § § 14.33.

“Dissolved corporation” defined, see § § 14.03.

“Distribution” defined, see § § 1.40.

Effective date of dissolution, see § § 14.03.

Known claims against dissolved corporation, see § § 14.06.

Notices and other communications, 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 and § 5.01.

## OFFICIAL COMMENT

Section 14.07 addresses the problems created by possible claims that might arise long after the dissolution process is completed and the corporate assets distributed to shareholders. One example would be claims based on personal injuries occurring after dissolution but caused by allegedly defective products sold before dissolution. The problems raised by such claims are difficult. On one hand, the application of a mechanical limitation period to a claim for injury that occurs after the period has expired may involve 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.

The approach 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. The three-year cut-off, although arbitrary, provides a reasonable compromise between the competing interests of potential injured plaintiffs, the ability of dissolved corporations to distribute remaining assets free of all claims, and the interests of shareholders in receiving those assets secure in the knowledge that they may not be reclaimed.

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). Under section 14.07(d)(1), unbarred claimants will continue to have recourse to the remaining assets of the dissolved corporation. Further, where unbarred claims arise after distributions have been made to shareholders in liquidation, section 14.07(d) authorizes recovery against the shareholders receiving those distributions. That section limits recovery, however, to the smaller of the recipient shareholder's pro rata share of the claim or the total amount of assets received as liquidating distributions by the shareholder from the corporation. The provision encourages claimants seeking to recover distributions from shareholders to 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 8.32(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] 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 dissolution, see § § 14.03.

Notices and other communications, see § § 1.41.

“Proceeding” defined, see § § 1.41.

### **OFFICIAL COMMENT**

Section 14.08 allows a dissolved corporation to initiate a court proceeding to establish the provision that should be made for contingent or unknown claims that are not reasonably expected to be barred after the three-year period in section 14.07(c). By following this procedure, a corporation removes the risk of director and shareholder liability for inadequate provision for claims.

Section 14.08 is designed to permit the court to adopt procedures appropriate to the circumstances. Estimates for contingent or unknown 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.

The notice required by section 14.08(b) would include notice to holders of guarantees made by the corporation.

If the dissolved corporation provides for security for claims as set forth in section 14.08(d), that section protects shareholders who receive distributions against those claims, and section 14.09(b) similarly protects directors from liability for those distributions.

### **§ 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 in liquidation of assets to shareholders after payment or provision for claims.
- (b) Directors of a dissolved corporation which has disposed of claims under section 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 section 14.06, § 14.07 or § 14.08.

### **CROSS-REFERENCES**

Claims against dissolved corporation, see § 14.06 and § 14.07.

Directors' liability for unlawful distributions, see § 8.32.

“Dissolved corporation” defined, see § 14.03.

“Distribution” defined, see § 1.40.

Notices and other communications, see § 1.41.

Proceeding to determine security for contingent claims, see § 14.08.

### **OFFICIAL COMMENT**

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. Section 14.09(b) protects directors of a dissolved corporation from liability under section 14.09(a) with respect to claims that are disposed of under section 14.06, § 14.07 or § 14.08. For example, directors need not make provision for claims of known creditors who are barred under section 14.06 by failure to file a claim or commence a proceeding within the specified times, for contingent claimants whose 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 their claims has been approved by a court under section 14.08(d). Section 14.09(b) does not change the provision in section 8.32 that director liability is to 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 dissolve a corporation administratively if:

- (a) the corporation does not pay within 60 days after they are due any fees, taxes, interest or penalties imposed by this Act or other laws of this state;
- (b) the corporation does not deliver its annual report to the secretary of state within 60 days after it is due;
- (c) the corporation is without a registered agent or registered office in this state for 60 days or more;
- (d) the secretary of state has not been notified within 60 days that the corporation's registered agent or registered office has been changed, that its registered agent has resigned, or that its registered office has been discontinued; or
- (e) 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.

Duration of corporation, see § § 3.02.

Judicial dissolution, see §§ § 14.30 through § 14.34.

Registered office and agent, see ch. 5.

Reinstatement following administrative dissolution, see § § 14.22.

### **OFFICIAL COMMENT**

Under the Act, actual or threatened administrative dissolution is an effective enforcement mechanism for a variety of statutory obligations. The advantages of administrative dissolution in the circumstances outlined in this section are compelling: it not only reduces the number of

records maintained by the secretary of state, but also avoids futile attempts to compel compliance by abandoned corporations and returns corporate names promptly to the status of available names. It is also less costly and requires fewer legal resources than judicial dissolution.

### **§ 14.21 Procedure for And Effect of Administrative Dissolution**

- (a) If the secretary of state determines that one or more grounds exist under section 14.09 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 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 against dissolved corporation, see §§ 14.06 and § 14.07.

Deposit with state treasurer, see § 14.40.

Perfection of service, see § 5.04.

Reinstatement following administrative dissolution, see § 14.22.

Service of process, see § 5.04.

Winding up, see § 14.05.

### **OFFICIAL COMMENT**

Some failures to comply with statutory requirements that give rise to administrative dissolution under section 14.09 occur because of oversight or inadvertence by officers of corporations that are carrying on business. Because such failures can usually be corrected promptly when brought to the corporation's attention, § 14.21(a) and (b) provide for notice from the secretary of state and a 60-day grace period before the certificate of administrative dissolution is filed.

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) state 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 § 14.22(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, see ch. 4.

Effective date of administrative dissolution, see § § 14.21.

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 is useful when a corporation through inadvertence or a failure to maintain a registered agent fails to receive or respond to the pre-dissolution notice of default required by section 14.21 and is administratively dissolved. A corporation that is reinstated pursuant to this section resumes carrying on its business as before dissolution.

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 effected. 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**

Grounds for administrative dissolution, see § § 14.20.

Notices and other communications, see § § 1.41.

Reinstatement following administrative dissolution, see § § 14.22.

Service of process, see § § 5.04.

### **OFFICIAL COMMENT**

Section 14.23 provides for an appeal from a decision by the secretary of state denying a petition for reinstatement. Because the Act does not specify who has the burden of proof on appeal and the standard for judicial review, these matters will be governed by general principles of judicial review of agency actions in this state.

## **Subchapter C.**

### **JUDICIAL DISSOLUTION**

#### **§ 14.30 Grounds For Judicial Dissolution**

- (a) The [name or describe court or courts] may dissolve a corporation:
  - (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;
  - (4) in a proceeding by the corporation to have its voluntary dissolution continued under court supervision; or



- (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) Subsection (a)(2) shall not apply in the case of a corporation that, on the date of the filing of the proceeding, has a class or series of shares which is:
  - (1) a covered security under section 18(b)(1)(A) or (B) of the Securities Act of 1933; or
  - (2) not a covered security, but is 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 and voting trust beneficial owners owning more than 10% of such shares).
- (c) In subsection (a), "shareholder" means a record shareholder, a beneficial shareholder, and an unrestricted voting trust beneficial owner, and in subsection (b), "shareholder" means a record shareholder, a beneficial shareholder, and a voting trust beneficial owner.

## **CROSS-REFERENCES**

Administrative dissolution, see §§ § 14.20 through § 14.23.

Appointment of custodian or receiver, see § § 7.48.

"Beneficial owner," "record shareholder" and "unrestricted voting trust beneficial owner" defined, see § § 1.40.

Director action, see §§ § 8.20 through § 8.24.

Election of directors, see § § 8.03.

Lack of power to act, see § § 3.04.

"Proceeding" defined, see § § 1.40.

Purchase of shares in lieu of dissolution, see § § 14.34.

Receiver or custodian, see §§ § 14.31 and § 14.32.

Revocation of incorporation by state, see § § 2.03.

Shareholder voting, see §§ § 7.25 through § 7.27.

Terms of directors, see §§ § 8.05 and § 8.06.

Voluntary dissolution, see §§ § 14.01 through § 14.05.

## **OFFICIAL COMMENT**

Section 14.30 provides grounds for the judicial dissolution of a corporation at the request of the state, a shareholder, a creditor, or when a corporation that has commenced voluntary dissolution seeks judicial oversight. Judicial oversight may be useful to protect the corporation from suits by creditors or shareholders. Under this section, the court has discretion as to whether dissolution is appropriate even though the specified grounds for judicial dissolution exist.

### *1. Involuntary Dissolution by State*

Section § 14.30(a)(1) provides a means by which the state may ensure compliance with the fundamentals of corporate existence and prevent abuse. That section limits the power of the state in this regard to grounds that are reasonably related to this objective.

### *2. Involuntary Dissolution by Shareholders*

Section 14.30(a)(2) provides for involuntary dissolution at the request of a shareholder under circumstances involving deadlock or significant abuse of power by controlling shareholders or directors. Section 14.30(c) extends the ability to seek judicial dissolution under section 14.30(a)(2) to beneficial shareholders and unrestricted voting trust beneficial owners, as these persons have, or hold on behalf of others, an economic interest in the shares. The remedy of judicial dissolution is available only for shareholders of corporations that do not meet the tests in section 14.30(b). Even for those corporations to which section 14.30(a)(2) applies, 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) may often have the ability to sell their shares if they are dissatisfied with current management or may seek other remedies under the Act. See, for example, sections 7.48(a) and 8.09. 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. Although some of the circumstances 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, "oppressive" behavior in section 14.30(a)(2)(ii) generally describes action directed against a particular shareholder. In contrast, the focus of protection in an action to appoint a custodian or receiver under section 7.48(a) is the corporate entity, and the remedy 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 section 14.30(a)(2)(ii) may be severely prejudicial to the interests of an individual shareholder, whereas conduct that is illegal with respect to the entire corporation may be remedied by other causes of action under the Act.

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

### *3. Involuntary 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 laws is an alternative in these situations.

### *4. Judicial Supervision of Dissolution*

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.

## **§ 14.31 Procedure for Judicial Dissolution**

- (a) Venue for a proceeding by the attorney general to dissolve a corporation lies in [name or describe court]. Venue for a proceeding brought by any other party named in section 14.30(a) lies in [name or describe court].
- (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 during the proceeding 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 shall deliver 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**

Receiver or custodian, see § § 14.32.

Judicial dissolution:

grounds, see § § 14.30(a)(2).

purchase of shares in lieu of, see § § 14.34.

Notices and other communications, see § § 1.41.

“Proceeding” defined, see § § 1.40.

### **OFFICIAL COMMENT**

Section 14.31 designates the attorney general as the officer to bring suits for involuntary dissolution by the state. It also sets out procedures for judicial dissolution generally.

### **§ 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 or eligible entity as a receiver or custodian, which, if a foreign corporation or foreign eligible entity, must be registered to do business in this state. 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; and (ii) may sue and defend in the receiver's 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.

The receiver or custodian shall have such other powers and duties as the court may provide in the

appointing order, which may be amended from time to time.

- (d) The court during a receivership may redesignate the receiver a custodian and during a custodianship may redesignate the custodian a receiver.
- (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 custodian or receiver, see § § 7.48.

“Expenses” defined, see § § 1.40.

“Notice” defined, see § § 1.41.

Receiver or custodian during the proceeding, see § § 14.31.

### **OFFICIAL COMMENT**

Although the court always has discretion to appoint a receiver or custodian under section 14.31 (which would be temporary), an appointment under section 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 a later filing, the court may choose to appoint a receiver or custodian under section 14.32.

General statutes or rules of court may 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 for filing.
- (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 and § 14.07.

Deposit with state treasurer, see § § 14.40.

Dissolution does not terminate authority of registered agent, see § § 14.05.

“Proceeding” defined, see § § 1.40.

Receiver or custodian, see §§ § 14.31 and § 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 shall file notice of their intention to join in the purchase no later than 30 days after the effectiveness 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 the 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 proceedings under section 14.30(a)(2) 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 the petitioner's shares among holders of

different classes or series of shares, the court should attempt to preserve the existing distribution of voting rights among holders of different classes or series insofar as practicable and may direct that holders of a specific class or classes or series 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 sections 14.30(a)(2)(ii) or (iv), 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.
- (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**

Acquisition of own shares by corporation as distribution, see § § 1.40.

“Expenses” defined, see § § 1.40.

Judicial dissolution, see § § 14.30.

Notice required, see § § 14.31.

### **OFFICIAL COMMENT**

It is not always necessary to dissolve a corporation and liquidate its assets to provide relief for the situations covered in section 14.30(a)(2). Section 14.34 provides an alternative by means of which a dissolution proceeding under section 14.30(a)(2) can be terminated upon payment of the fair value of the petitioner’s shares, allowing the corporation to continue in existence for the benefit of the remaining shareholders.

#### *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 may only 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 to make an election to purchase.

Sections 14.34(a) and (b) include provisions with respect to the irrevocability of an election and the inability to discontinue a dissolution proceeding or dispose of shares following the filing of an election. These provisions are intended to reduce the risk that either the dissolution

proceeding or the buyout election will be used other than in good faith, because under section 14.34 a petitioner using section 14.30(a)(2) becomes irrevocably committed to sell these shares pursuant to section 14.34 once an election is filed. The petitioning shareholder may not thereafter discontinue the dissolution proceeding or dispose of the petitioner's shares 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.

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. The dissolution proceeding is not affected by the filing of an election; it will be stayed only upon an application to the court to determine the fair value of the petitioner's shares filed 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*

Because any change in the allocation of shareholdings may upset control or other arrangements that have been previously negotiated by the parties, the corporation's election to purchase 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. 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.

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 may raise 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 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.

### *4. Court Order*

If the parties come to terms within the 60-day negotiating period provided for in section 14.34(c), their agreement will be incorporated in an order of the court and will thereafter be enforceable as such. If the parties are unable to reach agreement, any party may apply to the court to determine the fair value of the shares. After the court makes that determination, section 14.34(e) requires it to enter an order directing the sale on such terms as the court finds appropriate. Section 14.34(e) does place some limitations on when the court may provide for

installment payments or award interest or expenses and does state that the court should attempt to preserve the distribution of certain voting rights. Otherwise, the contents of the order under subsection (e) are subject to the court's discretion.

The entry of an order under section 14.34(c) or (e) requires the court to dismiss 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. Under subsection (e), 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 section 14.34(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 section 14.34(e), fall within the definition of "distribution" and are subject to section 6.40.

## **Subchapter D.**

### **MISCELLANEOUS**

#### **§ 14.40 Deposit with State Treasurer**

Assets of a dissolved corporation that should be transferred to a creditor, claimant, or shareholder of the corporation who cannot be found or who is not competent to receive them shall be reduced to cash and deposited with the state treasurer or other appropriate state official for safekeeping. When the creditor, claimant, or shareholder furnishes satisfactory proof of entitlement to the amount deposited, the state treasurer or other appropriate state official shall pay such person or his or her representative that amount.

#### **CROSS-REFERENCES**

Administrative dissolution, see § § 14.20.

Claims against dissolved corporation, see §§ § 14.06 and § 14.07.

Judicial dissolution, see § § 14.30.

#### **OFFICIAL COMMENT**

Section 14.40 is a deposit provision, not an escheat provision. It does not provide for ultimate disposition of unclaimed funds. The handling and ultimate disposition of unclaimed funds by the state treasurer or other appropriate state official is to be determined by state law other than the Act.



## CHAPTER 15

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# Foreign Corporations

- § 15.01. Governing Law
- § 15.02. Registration to do Business in this State
- § 15.03. Foreign Registration Statement
- § 15.04. Amendment of Foreign Registration Statement
- § 15.05. Activities Not Constituting Doing Business
- § 15.06. Noncomplying Name of Foreign Corporation
- § 15.07. Withdrawal of Registration of Registered Foreign Corporation
- § 15.08. Deemed Withdrawal Upon Domestication or Conversion to Certain Domestic Entities
- § 15.09. Withdrawal Upon Dissolution Or Conversion to Certain Nonfiling Entities
- § 15.10. Transfer of Registration
- § 15.11. Administrative Termination of Registration
- § 15.12. Action by [Attorney General]

### § 15.01 Governing Law

- (a) The law of the jurisdiction of formation of a foreign corporation governs:
  - (1) the internal affairs of the foreign corporation; and
  - (2) the interest holder liability of its shareholders.
- (b) A foreign corporation is not precluded from registering to do business in this state because of any difference between the law of the foreign corporation's jurisdiction of formation and the law of this state.
- (c) Registration of a foreign corporation to do business in this state does not permit the foreign corporation to engage in any business or affairs or exercise any power that a domestic corporation may not engage in or exercise in this state.

### CROSS-REFERENCES

Application of Act to existing foreign corporation, see § § 17.02.

Doing business without registration, see § § 15.02.

“Foreign corporation” defined, see § § 1.40.

Foreign registration statement, see § § 15.03.

“Interest holder liability” defined, see § § 1.40.

Powers of domestic corporation, see § § 3.02.

### OFFICIAL COMMENT

Section 15.01 confirms that a foreign corporation is generally governed by the laws of its jurisdiction of formation. A foreign corporation registered in this state, however, may only engage in business or exercise powers in this state to the same extent as a domestic corporation.

### **§ 15.02 Registration to do Business in this State**

- (a) A foreign corporation may not do business in this state until it registers with the secretary of state under this chapter.
- (b) A foreign corporation doing business in this state may not maintain a proceeding in any court of this state until it is registered to do business in this state.
- (c) The failure of a foreign corporation to register to do business in this state does not impair the validity of a contract or act of the foreign corporation or preclude it from defending a proceeding in this state.
- (d) A limitation on the liability of a shareholder or director of a foreign corporation is not waived solely because the foreign corporation does business in this state without registering.
- (e) Section 15.01(a) applies even if a foreign corporation fails to register under this chapter.

### **CROSS-REFERENCES**

Activities not constituting doing business, see § § 15.05.

Foreign registration statement, see § § 15.03.

“Proceeding” defined, see § § 1.40.

### **OFFICIAL COMMENT**

Section 15.02(b) closes the courts of this state to suits brought by foreign corporations that should have registered. Section 15.02(c) makes clear, however, that the failure to register does not impair the validity of a foreign corporation’s acts, and section 15.02(d) preserves the effectiveness of any liability shields applicable under the corporation’s organic law. If a foreign corporation should have registered and failed to do so, it may still enforce its contracts in the courts of this state by registering.

Although section 15.02(b) prevents a foreign corporation that is not registered but should from maintaining a proceeding in this state, section 15.02(c) makes clear that the foreign corporation may still defend a proceeding. The distinction between “maintaining” and “defending” an action or proceeding is determined on the basis of whether affirmative relief is sought. Such a nonregistered foreign corporation may interpose any defense or permissive or mandatory counterclaim to defeat a claimed recovery, but may not obtain a judgment based on the counterclaim until it has registered.

### **§ 15.03 Foreign Registration Statement**

To register to do business in this state, a foreign corporation shall deliver a foreign registration statement to the secretary of state for filing. The registration statement must be signed by the foreign corporation and state:

- (a) the corporate name of the foreign corporation and, if the name does not comply with section 4.01, an alternate name as required by section 15.06;
- (b) the foreign corporation’s jurisdiction of formation;

- (c) the street and mailing addresses of the foreign corporation's principal office and, if the law of the foreign corporation's jurisdiction of formation requires the foreign corporation to maintain an office in that jurisdiction, the street and mailing addresses of that office;
- (d) the street and mailing addresses of the foreign corporation's registered office in this state and the name of its registered agent at that office;
- (e) the names and business addresses of its directors and principal officers; and
- (f) a brief description of the nature of its business to be conducted in this state.

### **CROSS-REFERENCES**

Alternate name, see § § 15.06.

Amendment to foreign registration statement, see § § 15.04.

Annual report, see § § 16.21.

Application of Act to existing qualified foreign corporation, see § § 17.02.

Corporate name, see § § 15.06 and ch. 4.

Filing requirements, see § § 1.20.

“Principal office”:

defined, see § § 1.40.

designated in annual report, see § § 16.21.

Registered office and agent, see ch. 5.

### **OFFICIAL COMMENT**

The foreign registration statement assures that certain basic information about the foreign corporation will be publicly available and that citizens of the state will have access to that information in their dealings with the foreign corporation. The foreign registration statement also provides information that facilitates service of process on the foreign corporation. A registered foreign corporation also must file an annual report as provided in section 16.21.

### **§ 15.04 Amendment of Foreign Registration Statement**

A registered foreign corporation shall sign and deliver to the secretary of state for filing an amendment to its foreign registration statement if there is a change in:

- (a) its name or alternate name;
- (b) its jurisdiction of formation, unless its registration is deemed to have been withdrawn under section 15.08 or transferred under section 15.10; or
- (c) an address required by section 15.03(c).

### **CROSS-REFERENCES**

Change of registered office or agent, see § § 5.02.

Corporate name, see § § 15.06 and ch. 4.

Filing requirements, see § § 1.20.

Foreign registration statement, see § § 15.03.

Resignation of registered agent, see § § 5.03.

## OFFICIAL COMMENT

This section requires that certain information of record in the office of the secretary of state about a registered foreign corporation be kept current. Filings for changes in the foreign corporation's registered office or agent are required by sections 5.02 and 5.03, and need not be duplicated by an amendment to the registration statement.

### § 15.05 Activities Not Constituting Doing Business

- (a) Activities of a foreign corporation that do not constitute doing business in this state for purposes of this chapter include:
- (1) maintaining, defending, mediating, arbitrating, or settling a proceeding;
  - (2) carrying on any activity concerning the internal affairs of the foreign corporation, including holding meetings of its shareholders or board of directors;
  - (3) maintaining accounts in financial institutions;
  - (4) maintaining offices or agencies for the transfer, exchange, and registration of securities of the foreign corporation or maintaining trustees or depositories with respect to those securities;
  - (5) selling through independent contractors;
  - (6) soliciting or obtaining orders by any means if the orders require acceptance outside this state before they become contracts;
  - (7) creating or acquiring indebtedness, mortgages, or security interests in property;
  - (8) securing or collecting debts or enforcing mortgages or security interests in property securing the debts, and holding, protecting, or maintaining property so acquired;
  - (9) conducting an isolated transaction that is not in the course of similar transactions;
  - (10) owning, protecting and maintaining property; and
  - (11) doing business in interstate commerce.
- (b) This section does not apply in determining the contacts or activities that may subject a foreign corporation to service of process, taxation, or regulation under the laws of this state other than this Act.

## CROSS-REFERENCES

Corporate powers, see § 3.02.

Corporate purposes, see § § 3.01.

Governing law, see § § 15.01.

“Proceeding” defined, see § § 1.40.

## OFFICIAL COMMENT

The Act does not attempt to formulate an exclusive definition of what constitutes doing business in this state. Rather, the concept is illustrated in a negative fashion by the non-exclusive list of examples in section 15.05(a) of activities that do not constitute doing business. In general terms, any conduct more regular, systematic, or extensive than that described in subsection § 15.05(a) constitutes doing business and requires the foreign corporation to register to do business. Typical conduct requiring registration 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 purposes. The

passive owning of real estate for investment purposes does not constitute doing business. See sections 15.05(a)(8) and (a)(10).

The description of “doing business” set forth in section 15.05(a) applies only under this chapter, and only to the question whether the foreign corporation’s activities in this state are such that it must register under the Act. It is not applicable to other questions, such as whether the foreign corporation is amenable to service of process under state “long-arm” statutes or liable for state or local taxes. A foreign corporation that has registered (or is required to register) will generally be subject to suit and state taxation in this state, while a foreign corporation that is subject to service of process or state taxation in this state will not necessarily be required to register.

The following provides additional guidance with respect to some of the activities listed in section 15.05(a) that will not, in and of themselves, constitute doing business in this state.

### *1. Engaging in Litigation and Other Proceedings*

Under section 15.05(a)(1), a foreign corporation is not doing business by maintaining, defending, mediating, arbitrating, or settling a proceeding, which as defined in section 1.40 includes civil suits and criminal, administrative, and investigatory actions. Accordingly, a foreign corporation is not doing business solely because it resorts to the courts of this state to, for example, collect 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 register merely because it files a complaint with a governmental agency or participates in an administrative proceeding within this state.

### *2. Internal Affairs*

As provided in section 15.05(a)(2), a foreign corporation does not do business in this state merely because it holds meetings of its shareholders or board of directors within this state. It also may maintain offices or agencies within this state relating solely to the transfer, exchange or registration of its securities without registering. Other activities relating to the internal affairs of the foreign corporation that do not constitute doing business under this section include having officers or representatives who reside within or are physically present in this state. While there, the officers or representatives may make executive decisions without imposing on the foreign corporation the requirement that it register, if these activities are not so regular and systematic as to cause the residence to be viewed as a business office.

### *3. Sales through Independent Contractors*

Under section 15.05(a)(5), a foreign corporation need not register if it sells goods in this state through independent contractors. These transactions are viewed as transactions by the independent contractors, not by the foreign corporation itself, even if the foreign corporation sets some limits or rules for its contractors. If these limits or rules are sufficiently pervasive, however, the foreign corporation may be deemed to be selling for itself in intrastate commerce, and not through the independent contractors and therefore doing business in this state.

### *4. Creating, Acquiring, or Collecting Debts*

The mere act of making a loan by a foreign corporation does not constitute doing 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 doing business. Similarly, a refunding or “roll over” of a loan or its adjustment or compromise does not involve doing business.

#### 5. *Isolated Transactions*

The concept of doing business involves regular, repeated, and continuing business activities in this state. A single agreement or isolated transaction within the state does not constitute doing business. An isolated transaction does not constitute “doing business” regardless of how long the transaction takes to complete.

#### 6. *Interstate Transactions*

A foreign corporation is not doing business within the meaning of this chapter if it is transacting business in interstate commerce (section 15.05(a)(11)) or soliciting or obtaining orders that must be accepted outside this state before they become contracts (section § 15.05(a)(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.

#### 7. *Other Activities*

Among other activities that do not give rise to the requirement that a registration statement be filed by a foreign corporation are the ownership of all the shares of a corporation that is engaged in activities in the state or as a limited partner in a limited partnership engaged in activities in the state, or taking ministerial actions such as filing financing statements or registering trademarks.

### **§ 15.06 Noncomplying Name of Foreign Corporation**

- (a) A foreign corporation whose name does not comply with section 4.01 may not register to do business in this state until it adopts, for the purpose of doing business in this state, an alternate name that complies with section 4.01 by filing a foreign registration statement under section 15.03, or if applicable, a transfer of registration statement under section 15.10, setting forth that alternate name. A foreign corporation adopting an alternate name as provided in this subsection need not file under this state’s assumed or fictitious name statute with respect that alternate name. After registering to do business in this state with an alternate name, a foreign corporation shall do business in this state under:
  - (1) the alternate name;
  - (2) the foreign corporation’s name, with the addition of its jurisdiction of formation; or
  - (3) a name the foreign corporation is authorized to use under the assumed or fictitious name statute of this state.
- (b) If a registered foreign corporation changes its name after registration to a name that does not comply with section 4.01, it may not do business in this state until it complies with subsection § 15.06(a) by amending its registration statement to adopt an alternate name that complies with section 4.01.

### **CROSS-REFERENCES**

Amendment of foreign registration statement, see § § 15.04.

Corporate names, see ch. 4.

Effective time and date of filing, see § § 1.23.

Filing requirements, see § § 1.20.

Foreign registration statement, see § § 15.03.

Registered name, see § § 4.03.

Reserved name, see § § 4.02.

## **OFFICIAL COMMENT**

A foreign corporation must register under its name if that name satisfies the requirements of section 4.01. If that name cannot be used because it does not comply with section 4.01, the foreign corporation may adopt and use an alternate name as provided in this section. Because the alternate name will be part of the records of the secretary of state by reason of the foreign registration statement, section 15.06(a) provides that an assumed or fictitious name filing with respect to the alternate name is not required. However, the assumed or fictitious name statute will apply to any other name under which the foreign corporation does business in this state.

A foreign corporation that registers to do business in this state may do business under a fictitious name to the same extent as a domestic corporation.

## **§ 15.07 Withdrawal of Registration of Registered Foreign Corporation**

- (a) (a) A registered foreign corporation may withdraw its registration by delivering a statement of withdrawal to the secretary of state for filing. The statement of withdrawal must be signed by the foreign corporation and state:
- (1) the name of the foreign corporation and its jurisdiction of formation;
  - (2) that the foreign corporation is not doing business in this state and that it withdraws its registration to do business in this state;
  - (3) that the foreign corporation revokes the authority of its registered agent in this state; and
  - (4) an address to which process on the foreign corporation may be sent by the secretary of state under section 5.04(c).
- (b) After the withdrawal of the registration of a foreign corporation, service of process in any proceeding based on a cause of action arising during the time the entity was registered to do business in this state may be made as provided in section 5.04.

## **CROSS-REFERENCES**

Administrative termination of foreign registration, see § § 15.11.

Changing registered office or agent, see § § 5.02.

Effective time and date of filing, see § § 1.23.

Filing requirements, see § § 1.20.

Foreign corporation included in definition of “corporation” for purposes of ch. 5, see § § 5.01.

Registered office and agent, see ch. 5.

Resignation of registered agent, see § § 5.03.

Service on foreign corporation, see § § 5.04.

### **OFFICIAL COMMENT**

The statement of withdrawal must set forth an address where service of process may be sent to the foreign corporation by the secretary of state pursuant to section 5.04(c).

### **§ 15.08 Deemed Withdrawal Upon Domestication or Conversion to Certain Domestic Entities**

A registered foreign corporation that domesticates to a domestic business corporation or converts to a domestic nonprofit corporation or any type of domestic filing entity or to a domestic limited liability partnership is deemed to have withdrawn its registration on the effectiveness of such event.

### **CROSS-REFERENCES**

Conversion, see ch. 9C.

Domestication, see ch. 9B.

“Filing entity” defined, see § § 1.40.

### **OFFICIAL COMMENT**

When a registered foreign corporation has domesticated or converted to a domestic entity of the type set forth in this section, information about that entity in its capacity as a domestic entity will continue to be of record in the office of the secretary of state. At that point, there is no further reason for it to be registered and this section automatically treats its prior registration as withdrawn.

### **§ 15.09 Withdrawal Upon Dissolution Or Conversion to Certain Nonfiling Entities**

- (a) A registered foreign corporation that has dissolved and completed winding up or has converted to a domestic or foreign nonfiling entity other than a limited liability partnership shall deliver to the secretary of state for filing a statement of withdrawal. The statement must be signed by the dissolved corporation or the converted domestic or foreign nonfiling entity and state:
- (1) in the case of a foreign corporation that has completed winding up:
    - (i) its name and jurisdiction of formation;
    - (ii) that the foreign corporation withdraws its registration to do business in this state and revokes the authority of its registered agent to accept service on its behalf; and
    - (iii) an address to which process on the foreign corporation may be sent by the secretary of state under section 5.04(c); or
  - (2) in the case of a foreign corporation that has converted to a domestic or foreign nonfiling entity other than a limited liability partnership:
    - (i) the name of the converting foreign corporation and its jurisdiction of formation;
    - (ii) the type of the nonfiling entity to which it has converted and its name and jurisdiction of formation;



- (iii) that it withdraws its registration to do business in this state and revokes the authority of its registered agent to accept service on its behalf; and
  - (iv) an address to which process on the foreign corporation may be sent by the secretary of state under § 5.04(c).
- (b) After the withdrawal of the registration of a foreign corporation, service of process in any proceeding based on a cause of action arising during the time the entity was registered to do business in this state may be made as provided in section 5.04.

### **CROSS-REFERENCES**

Annual report, see § § 16.21.

Change of registered agent, see § § 5.02.

Conversion, see ch. 9C.

Effective time and date of filing, see § § 1.23.

Filing requirements, see § § 1.20.

Foreign corporation included in definition of “corporation” for purposes of ch. 5, see § § 5.01.

“Nonfiling entity” defined, see § § 1.40.

Registered agent, see § § 5.01 and § 5.02.

Service on foreign corporations, see § § 5.04.

### **OFFICIAL COMMENT**

When a registered foreign corporation has dissolved and completed winding up, or has converted to a nonfiling entity other than a limited liability partnership, there is no further reason for information about it to appear in the records of the secretary of state. This section thus requires delivery of a statement of withdrawal for the purpose of removing the entity from the rolls of active entities.

### **§ 15.10 Transfer of Registration**

- (a) If a registered foreign corporation merges into a nonregistered foreign corporation or converts to a foreign corporation required to register with the secretary of state to do business in this state, the foreign corporation shall deliver to the secretary of state for filing a transfer of registration statement. The transfer of registration statement must be signed by the surviving or converted foreign corporation and state:
- (1) the name of the registered foreign corporation and its jurisdiction of formation before the merger or conversion;
  - (2) the name of the surviving or converted foreign corporation and its jurisdiction of formation after the merger or conversion and, if the name does not comply with section 4.01, an alternate name adopted pursuant to section 15.06; and
  - (3) the following information regarding the surviving or converted foreign corporation after the merger or conversion:
    - (i) the street and mailing addresses of the principal office of the foreign corporation and, if the law of the foreign corporation’s jurisdiction of formation requires it to

maintain an office in that jurisdiction, the street and mailing addresses of that office; and

- (ii) the street and mailing addresses of the foreign corporation's registered office in this state and the name of its registered agent at that office.
- (b) On the effective date of a transfer of registration statement as determined in accordance with section 1.23, the registration of the registered foreign corporation to do business in this state is transferred without interruption to the foreign corporation into which it has merged or to which it has been converted.

## **CROSS-REFERENCES**

Annual report, see § § 16.21.

Corporate name, see ch. 4.

Notices and other communications, see § § 1.41.

“Principal office”:

defined, see § § 1.40.

designated in annual report, see § § 16.21.

Service on foreign corporation, see § § 5.04.

## **OFFICIAL COMMENT**

The purpose of this section is to clarify the status of the merged or converted registered foreign corporation in the public records of this state, and to reflect the status of the surviving or converted foreign corporation as a registered foreign corporation. A filing under this section has the effect of canceling the authority of the foreign corporation to do business in this state while at the same time reregistering it as the new foreign corporation. If the reregistered foreign corporation subsequently wishes to withdraw its registration to do business in this state, it may do so under section 15.07.

### **§ 15.11 Administrative Termination of Registration**

- (a) The secretary of state may terminate the registration of a registered foreign corporation in the manner provided in subsections (b) and (c) if:
  - (1) the foreign corporation does not pay within 60 days after they are due any fees, taxes, interest or penalties imposed by this Act or other laws of this state;
  - (2) the foreign corporation does not deliver its annual report to the secretary of state within 60 days after it is due;
  - (3) the foreign corporation is without a registered agent or registered office in this state for 60 days or more; or
  - (4) the secretary of state has not been notified within 60 days that the foreign corporation's registered agent or registered office has been changed, that its registered agent has resigned, or that its registered office has been discontinued.
- (b) The secretary of state may terminate the registration of a registered foreign corporation by:
  - (1) filing a certificate of termination; and
  - (2) delivering a copy of the certificate of termination to the foreign corporation's registered agent or, if the foreign corporation does not have a registered agent, to the foreign corporation's principal office.

- (c) The certificate of termination must state:
  - (1) the effective date of the termination, which must be not less than 60 days after the secretary of state delivers the copy of the certificate of termination as prescribed in subsection (b)(2); and
  - (2) the grounds for termination under subsection (a).
- (d) The registration of a registered foreign corporation to do business in this state ceases on the effective date of the termination as set forth in the certificate of termination, unless before that date the foreign corporation cures each ground for termination stated in the certificate of termination. If the foreign corporation cures each ground, the secretary of state shall file a statement that the certificate of termination is withdrawn.
- (e) After the effective date of the termination as set forth in the certificate of termination, service of process in any proceeding based on a cause of action arising during the time the entity was registered to do business in this state may be made as provided in section 5.04.

### **CROSS-REFERENCES**

Activities not constituting doing business, see § § 15.05.

Annual report, see § § 16.21.

Change of registered office or agent, see § § 5.02.

“Deliver” defined, see § § 1.40.

Effective time and date of filing, see § § 1.23.

Foreign corporation included in definition of “corporation” for purposes of ch. 5, see § § 5.01.

“Principal office” defined, see § § 1.40.

Registered office and agent required, see § § 5.01.

Resignation of registered agent, see § § 5.01.

Service on foreign corporation, see § § 5.04.

### **OFFICIAL COMMENT**

This section describes the circumstances under and manner in which the secretary of state may terminate the registration of a foreign corporation.

#### **§ 15.12 Action by [Attorney General]**

The [attorney general] may maintain an action to enjoin a foreign corporation from doing business in this state in violation of this Act.

### **CROSS-REFERENCES**

Activities not constituting doing business in this state, see § § 15.05.

### **OFFICIAL COMMENT**

Although the Act provides no fines or penalties for failure to register to do business when required, this section confirms that the [attorney general] can nevertheless bring an action to enforce the laws of the state.

## CHAPTER 16

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# Records and Reports

### **Subchapter A.**

#### **RECORDS**

- § 16.01. Corporate Records
- § 16.02. Inspection Rights of Shareholders
- § 16.03. Scope of Inspection Right
- § 16.04. Court-Ordered Inspection
- § 16.05. Inspection Rights of Directors

### **Subchapter B.**

#### **REPORTS**

- § 16.20. Financial Statements for Shareholders
- § 16.21. Annual Report for Secretary of State

### **Subchapter A.**

#### **RECORDS**

#### **§ 16.01 Corporate Records**

- (a) A corporation shall maintain the following records:
  - (1) its articles of incorporation as currently in effect;
  - (2) any notices to shareholders referred to in section 1.20(k)(5) specifying facts on which a filed document is dependent if those facts are not included in the articles of incorporation or otherwise available as specified in section 1.20(k)(5);
  - (3) its bylaws as currently in effect;
  - (4) all written communications within the past three years to shareholders generally;
  - (5) minutes of all meetings of, and records of all actions taken without a meeting by, its shareholders, its board of directors, and board committees established under section 8.25;
  - (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.
- (b) A corporation shall maintain all annual financial statements prepared for the corporation for its last three fiscal years (or such shorter period of existence) and any audit or other reports with respect to such financial statements.
- (c) A corporation shall maintain accounting records in a form that permits preparation of its financial statements.

- (d) A corporation shall maintain a record of its current shareholders in alphabetical order by class or series of shares showing the address of, and the number and class or series of shares held by, each shareholder. Nothing contained in this subsection shall require the corporation to include in such record the electronic mail address or other electronic contact information of a shareholder.
- (e) A corporation shall maintain the records specified in this section in a manner so that they may be made available for inspection within a reasonable time.

## **CROSS-REFERENCES**

- Annual report of corporation, see §§ 16.21.
- Articles of amendment, see §§ 10.06.
- Articles of incorporation, see § 2.02.
- Bylaws, see §§ 2.06 and ch. 10B.
- Committees of board of directors, see §§ 8.25.
- Directors' action without meeting, see §§ 8.21.
- Inspection of corporate records, see §§ 16.02 and § 16.04.
- Meetings of board of directors, see § 8.20.
- Officers, see § 8.40.
- Restated articles of incorporation, see §§ 10.07.
- Series of shares, see §§ 6.01 and § 6.02.
- Shareholders' action without meeting, see §§ 7.04.
- Shareholders' meeting, see §§ 7.01 through § 7.03.
- Shareholders' voting list, see § 7.20.

## **OFFICIAL COMMENT**

### *1. Records to be Maintained*

Section 16.01(a) requires certain basic records to be maintained by the corporation. The Act does not generally specify how records must be maintained (other than in a manner so that they may be made available for inspection within a reasonable time), where they must be located or, with the exception of section 16.02(a), where they must be available. They may be maintained in one or more offices within or without the state and in some cases, such as shareholder records, may be maintained by agents of the corporation; indeed, in the case of records in intangible form, it may be impossible to determine where they are located.

### *2. Minutes and Related Documents*

Section 16.01(a) does not address the amount of detail that should appear in minutes or written actions. Minutes of meetings customarily include the formalities of notice, the time and place of the meeting, those in attendance, and the results of any votes. Minutes of meetings and written actions without a meeting show formal action taken. The extent to which further detail is included is a matter of judgment which may depend upon the circumstances. Section 7.04, which addresses written actions taken by shareholders, requires that written consents by shareholders be delivered to the corporation for filing with corporate records.

### 3. *Financial Statements and Accounting Records*

The Act does not provide normative standards for the financial statements and accounting records to be prepared or maintained. The financial statements to be maintained under section 16.01(b) are those that the corporation prepares in the operation of its business, including in response to third party requirements. The form of the financial statements prepared by a corporation depends to some extent on the nature and complexity of the corporation's business and third party requirements such as those governing the preparation and filing of tax returns with applicable tax authorities. To accommodate the needs of the many different types of business corporations that may be subject to these provisions, including closely held corporations, the Act does not require that the corporation prepare and maintain financial statements on the basis of generally accepted accounting principles ("GAAP") if it is not otherwise required to prepare GAAP financial statements. The Act does not define what accounting records must be maintained or mandate how long they must be maintained. The accounting records to be maintained under section 16.01(c) depend upon the form of the corporation's financial statements. For example, annual tax returns filed with the relevant taxing authorities may be the only annual financial statements prepared by small businesses operating on a cash basis and, in those instances, the requisite accounting records to be maintained might consist of only a check register, vouchers and receipts.

### 4. *Shareholders' Lists*

Section 16.01(d) requires the corporation to maintain such records of its shareholders as will permit it to compile a list of current shareholders when required. These records may vary from stubs from which certificates have been detached in the case of corporations with a few shareholders to elaborate electronic data in the case of large corporations whose shares are publicly traded. The record may be maintained by the corporation or an agent, who traditionally is the transfer agent but may be another agent. A corporation may maintain additional information regarding its shareholders, such as a list of nominees and nonobjecting beneficial owners if its shares are publicly traded.

## **§ 16.02 Inspection Rights of 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(a), excluding minutes of meetings of, and records of actions taken without a meeting by, the corporation's board of directors and board committees established under section 8.25, if the shareholder gives the corporation a signed 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 § 16.02(c) and gives the corporation a signed 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) the financial statements of the corporation maintained in accordance with section 16.01(b);
  - (2) accounting records of the corporation;

- (3) excerpts from minutes of any meeting of, or records of any actions taken without a meeting by, the corporation's board of directors and board committees maintained in accordance with section 16.01(a); and
- (4) the record of shareholders maintained in accordance with section 16.01(d).
- (c) A shareholder may inspect and copy the records described in subsection § 16.02(b) only if:
  - (1) the shareholder's demand is made in good faith and for a proper purpose;
  - (2) the shareholder's demand 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 corporation may impose reasonable restrictions on the confidentiality, use or distribution of records described in subsection § 16.02(b).
- (e) For any meeting of shareholders for which the record date for determining shareholders entitled to vote at the meeting is different than the record date for notice of the meeting, any person who becomes a shareholder subsequent to the record date for notice of the meeting and is entitled to vote at the meeting is entitled to obtain from the corporation upon request the notice and any other information provided by the corporation to shareholders in connection with the meeting, unless the corporation has made such information generally available to shareholders by posting it on its website or by other generally recognized means. Failure of a corporation to provide such information does not affect the validity of action taken at the meeting.
- (f) The right of inspection granted by this section may not be abolished or limited by a corporation's articles of incorporation or bylaws.
- (g) 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 and to impose reasonable restrictions as provided in section 16.04(c), provided that, in the case of production of records described in subsection § 16.02(b) of this section at the request of a shareholder, the shareholder has met the requirements of subsection § 16.02(c).
- (h) For purposes of this section, "shareholder" means a record shareholder, a beneficial shareholder, and an unrestricted voting trust beneficial owner.

## CROSS-REFERENCES

Articles of incorporation, see § § 2.02.

"Beneficial owner," "record shareholder" and "unrestricted voting trust beneficial owner" defined, see § § 1.40.

Bylaws, see § § 2.06 and ch. 10B.

Committees of board of directors, see § § 8.25.

Corporate records, see § § 16.01.

Court-ordered inspection, see § § 16.04.

"Deliver" defined, 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.
- Notices and other communications, 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 through § 7.03.
- Voting trusts, see § § 7.30.

## OFFICIAL COMMENT

### 1. *Section 16.02(a)*

Under section 16.02(a), each shareholder is entitled to inspect all documents that deal with the shareholder’s interest in the corporation. The right to inspection includes the right to make copies, as further described in section 16.03. Although some of these documents may also be a matter of public record in the office of the 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. The “principal office” of the corporation is defined in section 1.40 to be the location of the executive offices of the corporation at its address as set forth by the corporation in its annual report required by section 16.21.

### 2. *Section 16.02(b)*

In contrast to the right to inspect minutes of meetings of, and written actions taken without a meeting by, shareholders, a shareholder is entitled to inspect only excerpts of meetings of, and records of written actions taken by, the board of directors and board committees related to the purpose of the inspection. A shareholder is entitled to inspect the record of shareholders under section 16.02(b) without regard to the size or value of the shareholder’s holding. This right is independent of the right to inspect a shareholders’ list under section 7.20.

### 3. *Section 16.02(c)*

Section 16.02(c) permits inspection of the financial statements and records described in section 16.02(b) by a shareholder only if the demand is made in good faith and for a “proper purpose.” Although not defined in the Act, “proper purpose” under section 16.02(c) has been defined in case law to involve a purpose that is reasonably relevant to the demanding shareholder’s interest as a shareholder.

Section 16.02(c) requires that a shareholder designate “with reasonable particularity” the purpose for the demand and the records he or she desires to inspect. Also, the records demanded must 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 examination of the records.

### 4. *Section 16.02(d)*



The reasonable restrictions on the confidentiality, use or distribution of financial statements and records permitted by section 16.02(d) allow for the protection of confidential or proprietary information in the corporation's records or sensitive matters that might be disclosed in a shareholder inspection. Such restrictions might include, for example, requiring the demanding shareholder to sign a confidentiality and use agreement. A similar provision is found in section 16.04(d) in connection with court ordered inspections.

5. *Section 16.02(e)*

Section 16.02(e) provides shareholders of a corporation the right to receive from the corporation the notice and other information provided by the corporation to shareholders in connection with a meeting if the record date for voting is subsequent to the record date for notice and the shareholder became entitled to vote after the record date for notice. This provision does not apply to information provided to shareholders by persons other than the corporation.

6. *Section 16.02(f) and (g)*

The prohibition in section 16.02(f) does not apply to a shareholder agreement permissible under section 7.32. No inference should be drawn from the prohibition in section 16.02(f) as to whether other, unrelated sections of the Act may be modified by provisions in the articles of incorporation or bylaws.

Section 16.02(g) preserves whatever independent rights of inspection exist under the referenced sources and does not create any rights, either expressly or by implication. A shareholder also has the right to obtain financial statements under section 16.20.

### **§ 16.03 Scope of Inspection Right**

- (a) A shareholder may appoint an agent or attorney to exercise the shareholder's inspection and copying rights under section 16.02.
- (b) The corporation may, if reasonable, satisfy the right of a shareholder to copy records under section 16.02 by furnishing to the shareholder copies by photocopy or other means chosen by the corporation, including furnishing copies through an electronic transmission.
- (c) The corporation may comply at its expense with a shareholder's demand to inspect the record of shareholders under section 16.02(b)(4) 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 to cover the costs of providing copies of documents to the shareholder, which may be based on an estimate of such costs.

### **CROSS-REFERENCES**

Corporate records, see § § 16.01.

Court-ordered inspection, see § § 16.04.

“Electronic transmission” defined, see § § 1.40.

Inspection right, see § § 16.02.

Shareholders' list inspection, see § § 7.20.

### **OFFICIAL COMMENT**

Section 16.03(a) provides that the rights of inspection and copying granted to shareholders in section 16.02 may be exercised by agents and attorneys of shareholders appointed by shareholders to conduct such inspection and copying. Providing the corporation with the right to choose among alternative delivery methods for copies in section 16.03(b), including by electronic transmissions, is intended to reduce burdens on the corporation. No consent by the shareholder is required under section 1.41 for the corporation to furnish copies to the shareholder under section 16.03 by electronic transmission.

Section 16.03(c) gives the corporation, at its option and expense, the right to provide a list of its shareholders instead of granting the right of inspection. Such a list must be compiled no earlier than the date of the written demand.

Section 16.03(d) permits the corporation to be reimbursed for the expense of providing copies of documents to a shareholder.

#### **§ 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 section to be available for inspection, the [name or describe court] 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 who complies with section 16.02(b) to inspect and copy the records required by that section, the shareholder who complies with section 16.02(c) may apply to the [name or describe court] 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 under section 16.02(b), it may impose reasonable restrictions on their confidentiality, use or distribution by the demanding shareholder and it shall also order the corporation to pay the shareholder's expenses incurred to obtain the order unless the corporation establishes that it refused inspection in good faith because the corporation had:
  - (1) a reasonable basis for doubt about the right of the shareholder to inspect the records demanded; or
  - (2) required reasonable restrictions on the confidentiality, use or distribution of the records demanded to which the demanding shareholder had been unwilling to agree.

#### **CROSS-REFERENCES**

Corporate records, see § § 16.01.

“Expenses” defined, see § § 1.40.

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 at the corporation's expense. A summary order is appropriate since the right of inspection under section 16.02(a) 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), a number of matters may be at issue, including the shareholder's good faith and proper purpose for demands under section 16.02(c) or the reasonableness of the restrictions required by the corporation on the confidentiality, use or distribution of the records. Accordingly, section 16.04(b) directs the court to handle the proceeding "on an expedited basis" instead of in a summary proceeding. 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.

The principal sanction against unreasonable delay or refusal to grant inspection is provided by section 16.04(c), which imposes on the corporation the shareholder's expenses to obtain the order unless the corporation establishes that it refused inspection in good faith on the grounds specified in section 16.04(c)(1) or (2). For example, a corporation may point to conduct of the shareholder involving improper use of information obtained from the corporation in the past as indicating that reasonable doubt existed as to the shareholder's present purpose or by showing that the corporation refused inspection because the shareholder had been unwilling to agree to reasonable restrictions on the confidentiality, use or distribution of records demanded under section 16.02(b).

### **§ 16.05 Inspection Rights of 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 board committee, but not for any other purpose or in any manner that would violate any duty to the corporation.
- (b) The [name or describe court] 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.

### **OFFICIAL COMMENT**

The purpose of section 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 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. In addition, section 16.05 sets forth a remedy for the director in circumstances where the corporation improperly denies the right of inspection.

Section 16.05(b) provides for a court order on an expedited basis because there is a presumption that significant latitude and discretion should be granted to the director, and the corporation has the burden of establishing that the director is not entitled to inspection of the documents requested. There may be circumstances where the director's inspection right might be denied, for example, when it would be contrary to the interest of the corporation because of adversity with the director, and the courts have broad discretion to address these circumstances. 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.

## **Subchapter B.**

### **REPORTS**

#### **§ 16.20 Financial Statements for Shareholders**

- (a) Upon the written request of a shareholder, a corporation shall deliver or make available to such requesting shareholder by posting on its website or by other generally recognized means annual financial statements for the most recent fiscal year of the corporation for which annual financial statements have been prepared for the corporation. If financial statements have been prepared for the corporation on the basis of generally accepted accounting principles for such specified period, the corporation shall deliver or make available such financial statements to the requesting shareholder. If the annual financial statements to be delivered or made available to the requesting shareholder are audited or otherwise reported upon by a public accountant, the report shall also be delivered or made available to the requesting shareholder.
- (b) A corporation shall deliver, or make available and provide written notice of availability of, the financial statements required under subsection § 16.20(a) to the requesting shareholder within five business days of delivery of such written request to the corporation.
- (c) A corporation may fulfill its responsibilities under this section by delivering the specified financial statements, or otherwise making them available, in any manner permitted by the applicable rules and regulations of the United States Securities and Exchange Commission.
- (d) Notwithstanding the provisions of subsections (a), (b) and (c) of this section:
  - (1) as a condition to delivering or making available financial statements to a requesting shareholder, the corporation may require the requesting shareholder to agree to reasonable restrictions on the confidentiality, use and distribution of such financial statements; and

- (2) the corporation may, if it reasonably determines that the shareholder's request is not made in good faith or for a proper purpose, decline to deliver or make available such financial statements to that shareholder.
- (e) If a corporation does not respond to a shareholder's request for annual financial statements pursuant to this section in accordance with subsection 16.20(b) within five business days of delivery of such request to the corporation:
  - (1) The requesting shareholder may apply to the [name or describe court] for an order requiring delivery of or access to the requested financial statements. The court shall dispose of an application under this subsection on an expedited basis.
  - (2) If the court orders delivery or access to the requested financial statements, it may impose reasonable restrictions on their confidentiality, use or distribution.
  - (3) In such proceeding, if the corporation has declined to deliver or make available such financial statements because the shareholder had been unwilling to agree to restrictions proposed by the corporation on the confidentiality, use and distribution of such financial statements, the corporation shall have the burden of demonstrating that the restrictions proposed by the corporation were reasonable.
  - (4) In such proceeding, if the corporation has declined to deliver or make available such financial statements pursuant to section 16.20(d)(2), the corporation shall have the burden of demonstrating that it had reasonably determined that the shareholder's request was not made in good faith or for a proper purpose.
  - (5) If the court orders delivery or access to the requested financial statements it shall order the corporation to pay the shareholder's expenses incurred to obtain such order unless the corporation establishes that it had refused delivery or access to the requested financial statements because the shareholder had refused to agree to reasonable restrictions on the confidentiality, use or distribution of the financial statements or that the corporation had reasonably determined that the shareholder's request was not made in good faith or for a proper purpose.

## **CROSS-REFERENCES**

- "Deliver" defined, see § § 1.40.  
"Expenses" defined, see § § 1.40.  
Inspection of records, see § § 16.02.  
Notices and other communications, see §§ 1.41.  
Shareholder agreements, see § § 7.32.  
"Shareholder" defined, see § § 1.40.

## **OFFICIAL COMMENT**

### *1. Section 16.20(a)*

Although section 16.20 requires a corporation, upon the written request of a shareholder, to deliver or make available annual financial statements that have been prepared, it does not require a corporation to prepare financial statements. This recognizes that many small, closely held corporations do not regularly prepare formal financial statements unless required by banks, suppliers or other third parties.

Section 16.20 does not limit the financial statements to be delivered or made available to shareholders to financial statements prepared on the basis of generally accepted accounting principles. 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. Smaller 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. 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 U.S. Internal Revenue Service (if that is all that is prepared), will suffice for these types of corporations and they may satisfy their obligations under section 16.20 by delivering or making available the requested financial statements in whatever form that they have been prepared for other purposes. If a corporation does prepare financial statements on a GAAP basis for any purpose for the particular year, however, it must send or make available those statements to the requesting shareholder as provided by section 16.20(a).

The last sentence of section 16.20(a) requires that if the financial statements to be delivered or made available have been reported upon by a public accountant, that report must be furnished. Section 16.20(a) refers to a “public accountant.” The same terminology is used in section 8.30 (standards of conduct for directors). 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 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.

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.

A shareholder may also seek access to the financial statements of the corporation through the inspection rights established in section 16.02.

## 2. *Section 16.20(d)*

In establishing restrictions with respect to confidentiality, use or distribution that are reasonable under the circumstances, a corporation may consider a number of factors, including the potential competitive harm to the corporation and its other shareholders that could result if the confidential financial information were used to compete with the corporation or disclosed to third parties such as competitors. As provided in section 16.20(d)(2), a corporation may withhold delivery or making available its financial statements to a requesting shareholder if it reasonably determines that the shareholder’s request is not made in good faith and for a proper purpose.

## 3. *Section 16.20(e)*

If a corporation fails to comply with section 16.20(b) in a timely manner the judicial remedy of § 16.20(e) directs the court to handle the proceeding on an expedited basis to discourage dilatory tactics to avoid or delay delivery or access to financial statements, but does not require the court to resolve these issues on a summary basis. Section 16.20(e), like section 16.04, establishes a sanction against unreasonable delay or refusal to deliver or provide access to

financial statements by imposing on the corporation the shareholder's expenses in obtaining the court's order unless the corporation can establish that the shareholder had been unwilling to agree to reasonable restrictions on the confidentiality, use or distribution of the requested financial statements or the corporation had reasonably determined that the shareholder's request was not made in good faith or for a proper purpose.

### **§ 16.21 Annual Report for Secretary Of State**

- (a) Each domestic corporation shall deliver to the secretary of state for filing an annual report that sets forth:
  - (1) the name of the corporation;
  - (2) the street and mailing address of its registered office and the name of its registered agent at that office in this state;
  - (3) the street and mailing address of its principal office;
  - (4) the 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) Each foreign corporation registered to do business in this state shall deliver to the secretary of state for filing an annual report that sets forth:
  - (1) the name of the foreign corporation and, if the name does not comply with section 4.01, an alternate name as required by section 15.06;
  - (2) the foreign corporation's jurisdiction of formation;
  - (3) the street and mailing addresses of the foreign corporation's principal office and, if the law of the foreign corporation's jurisdiction of formation requires the foreign corporation to maintain an office in that jurisdiction, the street and mailing addresses of that office;
  - (4) the street and mailing addresses of the foreign corporation's registered office in this state and the name of its registered agent at that office;
  - (5) the names and business addresses of its directors and principal officers; and
  - (6) a brief description of the nature of its business conducted in this state.
- (c) Information in the annual report must be current as of the date the annual report is signed on behalf of the corporation.
- (d) The first annual report shall 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 registered to do business. Subsequent annual reports shall be delivered to the secretary of state between January 1 and April 1 of the following calendar years.
- (e) 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 notice from the secretary of state becomes effective as determined in accordance with section 1.41, it is deemed to be timely filed.

## **CROSS-REFERENCES**

Administrative termination of registration to do business, see § § 15.11.

Annual report form prescribed by secretary of state, see § § 1.21.

Authorized shares, see § § 2.02.

Effective time and date of filing, see § § 1.23.

Filing fees, see § § 1.22.

Filing requirements, see § § 1.20.

Grounds for administrative dissolution, see § § 14.20.

Issuance of shares, see §§ § 6.01 through § 6.03.

Notices and other communications, see § § 1.41.

Officers, see § § 8.40.

“Principal office” defined, see § § 1.40.

Registered agent and registered office, see § § 5.01.

## **OFFICIAL COMMENT**

The purpose of the annual report by a domestic corporation 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 in section 1.40 as the location of its principal executive offices as set forth in its annual report or foreign registration statement.

The reference to “principal officers” in sections 16.21(a)(4) and (5) simplifies 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 secretary and treasurer, no matter what their designation.

An annual report is also required of foreign corporations registered to do business in the state, and serves functions similar to those served with respect to domestic corporations. For both domestic and foreign corporations, the failure to file an annual report, like the failure to satisfy other mandatory requirements of the Act, is a ground for administrative dissolution of a domestic corporation or termination of the registration of a foreign corporation to do business. See sections 14.09 and 15.11.



## CHAPTER 17

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# Transition Provisions

§ 17.01. Application to Existing Domestic Corporations

§ 17.02. Application to Existing Foreign Corporations

§ 17.03. Saving Provisions

§ 17.04. Severability

§ 17.05. Repeal

### **NOTE ON ADOPTION OF THE ACT**

Chapter 17 addresses various transitional and interpretational issues that merit consideration by the legislature adopting the Act, especially as an entirety. This Note summarizes and explains some of those issues. Each adopting state will need to consider the differences between the Act and its existing corporation statute to determine if additional transitional provisions will be necessary.

#### *Special Circumstances Warranting Delayed Effectiveness*

The Act has been drafted to apply to domestic business corporations in existence on its effective date. See section 17.01. To the extent that some of the provisions of the Act differ in significant respects from earlier laws, it may be appropriate to delay the effective date of such provisions to give existing corporations adequate time to revise controlling corporate documents to take into account the provisions of the Act, or in unusual circumstances, to allow existing corporations to continue to be governed by a preexisting law until a later election to be governed by the pertinent provision of the Act. Two examples of such transitional problems are discussed below.

- Changes in Voting Requirements

The Act, unlike some corporation statutes, requires by virtue of section 7.25 only that votes cast in favor exceed votes cast against, in a meeting at which a quorum is present, to approve transactions such as mergers, sale of assets outside the usual and regular course of business, important amendments to the articles of incorporation, and dissolution. When considering adoption of the Act's voting requirements, it is important to recognize that specific control arrangements may have been established on the assumption that the existing statutory voting requirements would not be reduced. Rather than defeat those reasonable assumptions by effectively eliminating a shareholder's power to veto changes when there was a higher statutory vote requirement, a state that adopts the Act's lesser voting requirement may wish to consider "grandfathering" existing corporations and afford them an option to elect to be governed by the new requirement.

- Increased Power of the Board of Directors

The Act generally grants the board of directors authority to increase or decrease its own size without specific authority (section 8.03) unless the articles of incorporation restrict this power. Some corporation 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 Act, and a delayed effective date therefore may be appropriate.

### *Foreign Corporations*

Although chapter 15 of the Act may change the rules applicable to foreign corporations in some states, these changes are not of a type that requires 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. See section 17.02.

### *Savings and Severability Provisions*

The Act contains its own savings and severability provisions, in sections 17.03 and 17.04, respectively. If the state has a savings statute of general application, however, it may be unnecessary to adopt section 17.03. Likewise, if the state has a severability provision of general application, or if the state's highest court has established a general rule of severability, it may be unnecessary to adopt section 17.04.

### *Repeal*

Although section 17.05 provides for repeal of previously enacted general corporation statutes that are specified, such repeal is generally unnecessary with regard to statutes providing special incorporation and regulatory provisions for corporations engaged in specific businesses, like banking and insurance. If these specialized statutes expressly incorporate by reference provisions from the general business corporation act, however, these statutes should be 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 apply.

## **§ 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 Act's application to all domestic corporations in existence on the effective date of the Act, as well as to all new domestic corporations formed after that date, avoids a confusing coexistence of different and overlapping rules of corporation law. The Act does not, however, supersede statutes governing nonprofit corporations or associations, nor does it apply to

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 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 domestic corporations to which the Act will not be applicable under this section.

### **§ 17.02 Application to Existing Foreign Corporations**

A foreign corporation registered or authorized to do business in this state on the effective date of this Act is subject to this Act, is deemed to be registered to do business in this state, and is not required to file a foreign registration statement under this Act.

#### **OFFICIAL COMMENT**

Section 17.02 makes the Act applicable on its effective date to all foreign corporations that are registered or authorized to do business in the state on that date without action by the foreign corporation.

### **§ 17.03 Saving Provisions**

- (a) Except as to procedural provisions, this Act does not affect a pending action or proceeding or a right accrued before the effective date of this Act, and a pending civil action or proceeding may be completed, and a right accrued may be enforced, as if this Act had not become effective.
- (b) If a penalty or punishment for violation of a statute or rule is reduced by this Act, the penalty, if not already imposed, shall be imposed in accordance with this Act.

### **§ 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 this Act that can be given effect without the invalid provision or application.

### **§ 17.05 Repeal**

The following laws and parts of laws are repealed: [to be inserted by the adopting state].

#### **OFFICIAL COMMENT**

The Act is a complete substitute for earlier statutes of general applicability to business corporations and earlier statutes have been repealed.