Changes in the Model Business Corporation Act—Proposed Amendments Relating to Chapter 1 and Chapter 8 (including Subchapters F and G and Duties of Directors and Officers)

*By the Committee on Corporate Laws**

The Committee on Corporate Laws of the Section of Business Law (Committee) develops, and from time to time proposes changes in, the Model Business Corporation Act (Act).

The Committee has approved the changes described in this Report on second reading and invites comments from interested persons. **Comments should be addressed to Mary Ann Jorgenson, Chair, Committee on Corporate Laws, 4900 Key Tower, 127 Public Square, Cleveland, Ohio 44114-1304, or sent to her by email at MJorgenson@ssd.com**. Comments should be received by May 21, 2004 in order to be considered by the Committee before adoption of the amendments on third reading.

This report covers the following areas:

Part I. Subchapter F of Chapter 8

Part I of this report, beginning at page 572, covers proposed amendments to Subchapter F (sections 8.60-8.63) of the Act pertaining to directors' conflicting interest transactions.

The proposed amendments do not alter the fundamental elements and approach of Subchapter F which creates bright-line rules with respect to directors' conflicting interest transactions. The Committee has determined that the definition of directors' conflicting interest transactions should be refined, the text of the statute should be simplified and within the basic approach of the original subchapter, various clarifying and substantive changes should be made throughout the text and comments. The revisions clarify the coverage of Subchapter F while ensuring that a transaction that poses a significant risk of adversely affecting a director's judgment will not escape statutory coverage. See the Introductory Comment to Subchapter F below for a further description.

Part I is presented in the following order: clean copy of the Introductory Comment and the Official Comment, followed by marked copy of the Introductory Comment and the Official Comment; followed by a clean copy of sections 8.60–8.63 and a marked copy of sections 8.60–8.63.

*Mary Ann Jorgenson, Chair.

Part II. Subchapter G

Part II of this report, beginning at page 635, covers a proposed new provision to be designated Subchapter G (section 8.70) of Chapter 8 of the Act pertaining to business opportunities.

The proposed new Subchapter G provides a safe harbor for a director considering possible involvement with a prospective business opportunity that might constitute a "corporate opportunity." Under state corporate law, the corporate opportunity doctrine stands for the proposition that the corporation has a right prior to that of its director to act on certain business opportunities that come to the attention of the director. Inappropriate usurpation of this right can lead to a breach of the duty of loyalty. The fact-intensive nature of the corporate opportunity doctrine resists statutory definition and thus Subchapter G does not define corporate opportunities. Instead, Subchapter G allows a director to present a business opportunity that might come within the judicial definition of a corporate opportunity to the board or its shareholders for consideration. By following the procedures set forth in Subchapter G before proceeding with such involvement, the director can receive a disclaimer of the corporation's interest in the matter by action of the board of directors or the shareholders of the corporation. See the Official Comment to Subchapter G Below for a further description.

Part II is presented in the following order: new section 8.70 followed by new Official Comment.

Part III. Role and Responsibilities of Corporate Directors

Part III of this report, beginning at page 639, covers revisions to sections 8.01, 8.25 (Official Comment only), 8.30 and a number of related provisions of the Act (mostly relating to the definition of "public corporation"). In August 2003, the ABA House of Delegates approved several policies responsive to recent corporate upheavals involving public corporations such as Enron. Among those policies were several that directed or encouraged revisions to aspects of the Act relating to the role and responsibilities of corporate directors. Based upon the work of a special task force to consider those policies, the Committee has approved upon second reading revisions to sections 8.01, 8.25 (Official Comment only), 8.30 and a number of related provisions.

These revisions accomplish three principal things. First, the amendments to section 8.01 outline oversight responsibilities for directors of the public corporation, a newly defined term in proposed section 1.40(18A). Because proposed subsection (c)(viii) refers to "independent directors," the Committee plans to consider revisions to sections that use this or similar terminology, in order to differentiate "independent directors" generally from those directors who are qualified to act in the specific matters addressed in those statutes. Second, the revisions would amend the Official Comment to section 8.25 to take into account recent changes resulting from enactment of the Sarbanes-Oxley Act of 2002 and the adoption of related listing standards for public securities markets. And finally, the amendments to section 8.30 include a new subsection (c) codifying a director's obligation to disclose material corporate information to fellow members of the board of directors and committees of the board.

Part III is presented in the following order: clean copy of new section 1.40(18A), Official Comment to section 1.40, section 7.32, Official Comment to section 7.32(d), section 14.31(d), section 14.34(a), Official Comment to section 14.34, section 8.01 and Official Comment, section 8.25 and Official Comment, and section 8.30 and Official Comment; these are followed by marked copy in the same order.

Part IV. Functions of Officers

Part IV of this report, beginning at page 681, covers proposed amendments to sections 8.41 and 8.42 of the Act. The same upheavals that gave rise to the proposals to revise provisions dealing with the responsibilities of directors also have drawn particular attention to the appropriate role of officers in the corporate governance arena. The Committee and a special task force of the Committee have deliberated upon the issues raised by those events and have formulated proposed amendments to sections 8.41 and 8.42 of the Act designed to emphasize the responsibility of officers to inform others in the corporation of particular matters which come to their attention.

Part IV is presented in the following order: clean copy of section 8.41, Official Comment to section 8.41, section 8.42, and Official Comment to section 8.42; these are followed by marked copy in the same order.

PART I. SUBCHAPTER F OF CHAPTER 8

DIRECTORS' CONFLICTING INTEREST TRANSACTIONS INTRODUCTORY COMMENT

1. PURPOSES AND SPECIAL CHARACTERISTICS OF SUBCHAPTER F

The common law, drawing by analogy on the fiduciary principles of the law of trusts, initially took the position that any transaction between a corporation and a director of that corporation was contaminated by the director's conflicting interest, that the transaction was null and void or at least voidable and, suggesting by implication, that the interested director who benefited from the transaction could be required to disgorge any profits and be held liable for any damages.

Eventually, it was perceived that a flat void/voidable rule could work against a corporation's best interests. Although self-interested transactions carry a potential for injury to the corporation, they also carry a potential for benefit. A director who is self-interested may nevertheless act fairly, and there may be cases where a director either owns a unique asset that the corporation needs or is willing to offer the corporation more favorable terms than are available on the market (for example, where the director is more confident of the corporation's financial ability to perform than a third person would be). Accordingly, the courts dropped the flat void/voidable rule, and substituted in its stead the rule that a self-interested transaction will be upheld if the director shoulders the burden of showing that the transaction was fair.

Later still, the Model Act and the state legislatures entered the picture by adopting statutory provisions that sheltered the transaction from any challenge that the transaction was void or voidable where it was approved by disinterested directors or shareholders. Until 1989, the successive Model Act provisions concerning director conflict-of-interest transactions and the statutory provisions in force in most states reflected basically the same objective; that is, their safe-harbor procedures concentrated on protection for the transaction, with no attention given to the possible vulnerability of the director whose conflicting interest would give rise to the transaction's potential challenge. However, in 1989 the relevant provisions were significantly reworked in subchapter F of Chapter 8. Four basic elements in the architecture of the 1989 version of subchapter F distinguished the approach of the subchapter from most other statutory provisions of the time.

First, most other statutory provisions did not define what constituted a director's conflict-of-interest transaction. In contrast, subchapter F defined, with bright-line rules, the transactions that were to be treated as director's conflict-of-interest transactions.

Second, because most other statutory provisions did not define what constitutes a director's conflict-of-interest transaction, they left open how to deal with transactions that involved only a relatively minor conflict. In contrast, subchapter F explicitly provided that a director's transaction that was not within the statutory definition of a director's conflict of interest transaction was not subject to judicial review for fairness on the ground that it involved a conflict of interest (although circumstances that fall outside the statutory definition could, of course, afford the basis for a legal attack on the transaction on some other ground), even if the

transaction involved some sort of conflict lying outside the statutory definition, such as a remote familial relationship.

Third, subchapter F made explicit, as many other statutory provisions did not, that if a director's conflict-of-interest transaction, as defined, was properly approved by disinterested (or "qualified") directors or shareholders, the transaction was thereby insulated from judicial review for fairness (although, again, it might be open to attack on some basis other than the conflict).

Fourth, subchapter F also made explicit, as no other statutory provisions had done, that if a director's conflict-of-interest transaction, as defined, was properly approved by disinterested (or "qualified") directors or shareholders, the conflicted director could not be subject to an award of damages or other sanctions with respect thereto (although the director could be subject to claims on some basis other than the conflict).

Bright-line provisions of any kind represent a trade-off between the benefits of certainty, and the danger that some transactions or conduct that fall outside the area circumscribed by the bright-lines may be so similar to the transactions and conduct that fall within the area that different treatment may seem anomalous. Subchapter F reflected the considered judgment that in corporate matters, where planning is critical, the clear and important efficiency gains that result from certainty through defining director's conflict-of-interest transactions clearly exceeded any potential and uncertain efficiency losses that might occasionally follow from excluding other director's transactions from judicial review for fairness on conflict-of-interest grounds.

The 2004 revisions of subchapter F rest on the same basic judgment that animated the original subchapter. Accordingly, the revisions made do not alter the fundamental elements and approach of the subchapter. However, the revisions refine the definition of director's conflict-of-interest transactions, simplify the text of the statute, and, within the basic approach of the original subchapter, make various clarifying and substantive changes throughout the text and comments. One of these substantive changes expands the category of persons whose interest in a transaction will be attributed to the director for purposes of subchapter F. At the same time, the revisions delete coverage of a director's interest that lies outside the transaction itself but might be deemed to be "closely related to the transaction." The latter phraseology was determined to be excessively vague and unhelpful. In combination, these revisions clarify the coverage of subchapter F, while ensuring that a transaction that poses a significant risk of adversely affecting a director's judgment will not escape statutory coverage.

2. SCOPE OF SUBCHAPTER F

The focus of subchapter F is sharply defined and limited.

First, the subchapter is targeted on legal challenges based on interest conflicts only. Subchapter F does not undertake to define, regulate, or provide any form of procedure regarding other possible claims. For example, subchapter F does not address a claim that a controlling shareholder has violated a duty owed to the corporation or minority shareholders.

Second, subchapter F does not shield misbehavior by a director or other person that is actionable under other provisions of the Model Act, such as section 8.31, or under other legal rules, regardless of whether the misbehavior is incident to a transaction with the corporation and regardless of whether the rule is one of corporate law.

Third, subchapter F does not preclude the assertion of defenses, such as statute of limitations or failure of a condition precedent, that are based on grounds other than a director's conflicting interest in the transaction.

Fourth, the subchapter is applicable only when there is a "transaction" by or with the corporation. For purposes of subchapter F, "transaction" generally connotes negotiations or consensual arrangements between the corporation and another party or parties that concern their respective and differing economic rights or interests—not simply a unilateral action by the corporation or a director, but rather a "deal." Whether safe harbor procedures of some kind might be available to the director and the corporation with respect to non-transactional matters is discussed in numbered paragraph 4 of this Introductory Comment.

Fifth, subchapter F deals with directors only. Correspondingly, subchapter F does not deal with controlling shareholders in their capacity as such. If a corporation is wholly owned by a parent corporation or other person, there are no outside shareholders who might be injured as a result of transactions entered into between the corporation and the owner of its shares. However, transactions between a corporation and a parent corporation or other controlling shareholder who owns less than all of its shares may give rise to the possibility of abuse of power by the controlling shareholder. Subchapter F does not speak to proceedings brought on that basis because section 8.61 concerns only proceedings that are brought on the ground that a "director has an interest respecting the transaction."

Sixth, it is important to stress that the voting procedures and conduct standards prescribed in subchapter F deal solely with the complicating element presented by the director's conflicting interest. A transaction that receives favorable directors' or shareholders' action complying with subchapter F may still fail to satisfy a different quorum requirement or to achieve a different vote that may be needed for substantive approval of the transaction under other applicable statutory provisions or under the articles of incorporation, and vice versa. (Under the Model Act, latitude is granted for setting higher voting requirements and different quorum requirements in the articles of incorporation. See sections 2.02(b)(2) and 7.27.)

Seventh, a few corporate transactions or arrangements in which directors inherently have a special personal interest are of a unique character and are regulated by special procedural provisions of the Model Act. See sections 8.51 and 8.52 dealing with indemnification arrangements, section 7.44 dealing with termination of derivative proceedings by board action and section 8.11 dealing with directors' compensation. Any corporate transactions or arrangements affecting directors that are governed by such regulatory sections of the Act are not governed by subchapter F.

3. STRUCTURE OF SUBCHAPTER F

Subchapter F has only four parts. Definitions are in section 8.60. Section 8.61 prescribes what a court may or may not do in various situations. Section 8.62 prescribes procedures for action by boards of directors or duly authorized committees regarding a director's conflicting interest transaction. Section 8.63 prescribes corresponding procedures for shareholders. Thus, the most important operative section of the subchapter is section 8.61.

4. NON-TRANSACTIONAL SITUATIONS INVOLVING INTEREST CONFLICTS

Many situations arise in which a director's personal economic interest is or may be adverse to the economic interest of the corporation, but which do not entail a "transaction" by or with the corporation. How does the subchapter bear upon those situations?

Corporate opportunity

The corporate opportunity doctrine is anchored in a significant body of case law clustering around the core question whether the corporation has a legitimate interest in a business opportunity, either because of the nature of the opportunity or the way in which the opportunity came to the director, of such a nature that the corporation should be afforded prior access to the opportunity before it is pursued (or, to use the case law's phrase, "usurped") by a director. Because judicial determinations in this area often seem to be driven by the particular facts of a case, outcomes are often difficult to predict.

The subchapter, as such, does not apply by its terms to corporate or business opportunities since no transaction between the corporation and the director is involved in the taking of an opportunity. However, new subchapter G of chapter 8 of the Model Act provides, in effect, that the safe harbor procedures of section 8.62 or 8.63 may be employed, at the interested director's election, to protect the taking of a business opportunity that might be challenged under the doctrine. Otherwise, subchapter F has no bearing on enterprise rights or director obligations under the corporate opportunity doctrine.

Other situations

Many other kinds of situations can give rise to a clash of economic interests between a director and the corporation. For example, a director's personal financial interests can be impacted by a non-transactional policy decision of the board, such as where it decides to establish a divisional headquarters in the director's small hometown. In other situations, simple inaction by a board might work to a director's personal advantage, or a flow of ongoing business relationships between a director and that director's corporation may, without centering upon any discrete "transaction," raise questions of possible favoritism, unfair dealing, or undue influence. If a director decides to engage in business activity that directly competes with the corporation's own business, the economic interest in that competing activity ordinarily will conflict with the best interests of the corporation and put in issue the breach of the director's duties to the corporation. Basic

conflicts and improprieties can also arise out of a director's personal appropriation of corporate assets or improper use of corporate proprietary or inside information.

The circumstances in which such non-transactional conflict situations should be brought to the board or shareholders for clearance, and the legal effect, if any, of such clearance, are matters for development under the common law and lie outside the ambit of subchapter F. While these non-transactional situations are unaffected one way or the other by the provisions of subchapter F, a court may well recognize that the subchapter F procedures provide a useful analogy for dealing with such situations. Where similar procedures are followed, the court may, in its discretion, accord to them an effect similar to that provided by subchapter F.

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Note on Terms Used in Comments

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

§8.60 OFFICIAL COMMENT

The definitions set forth in section 8.60 apply only to subchapter F's provisions and, except to the extent relevant to subchapter G, have no application elsewhere in the Model Act. (For the meaning and use of certain terms used below, such as "*D*," "*X* Co." and "*Y* Co.", see the Note at the end of the Introductory Comment of subchapter F.)

1. DIRECTOR'S CONFLICTING INTEREST TRANSACTION

The definition of "director's conflicting interest transaction" in subdivision (1) is the core concept underlying subchapter F, demarcating the transactional area that lies within—and without—the scope of the subchapter's provisions. The definition operates preclusively in that, as used in section 8.61, it denies the power of a court to invalidate transactions or otherwise to remedy conduct that falls outside the statutory definition of "director's conflicting interest transaction" solely on the ground that the director has a conflict of interest in the transaction. (Nevertheless, as stated in the Introductory Comment, the transaction might be open to attack under rules of law concerning director misbehavior other than rules based solely on the existence of a conflict of interest transaction, as to which subchapter F is preclusive).

a. Transaction

For a director's conflicting interest transaction to arise, there must first be a transaction effected or proposed to be effected by the corporation or an entity controlled by the corporation to which the director or a related person is a party or in which the director or a related person has a material financial interest. As discussed in the Introductory Comment, the provisions of subchapter F do not

apply where there is no "transaction" by the corporation—no matter how conflicting the director's interest may be. For example, a corporate opportunity usurped by a director by definition does not involve a transaction by the corporation, and thus is not covered by subchapter F, even though it may be proscribed under fiduciary duty principles.

Moreover, for purposes of subchapter F, "transaction" means (and requires) a bilateral (or multilateral) arrangement to which the corporation or an entity controlled by the corporation is a party. Subchapter F does not apply to transactions to which the corporation is not a party. Thus, a purchase or sale by the director of the corporation's shares on the open market or from or to a third party is not a "director's conflicting interest transaction" within the meaning of subchapter F because the corporation is not a party to the transaction.

b. Party to the transaction—the corporation

In the usual case, the transaction would be effected by *X* Co. Assume, however, that *X* Co. controls the vote for directors of *S* Co. *D* wishes to sell a building *D* owns to *X* Co. and *X* Co. is willing to buy it. As a business matter, it makes no difference to *X* Co. whether it takes the title directly or indirectly through its subsidiary *S* Co. or some other entity that *X* Co. controls. The applicability of subchapter F does not depend upon that formal distinction, because the subchapter includes within its operative framework transactions by entities controlled by *X* Co. Thus, subchapter F would apply to a sale of the building by *D* to *S* Co.

c. Party to the transaction—the director or a related person

To constitute a director's conflicting interest transaction, *D* must, at the relevant time, (i) be a party to the transaction, or (ii) know of the transaction and *D*'s material financial interest in it, or (iii) know that a related person of *D* was a party to the transaction or (iv) know that a related person of *D* has a material financial interest in the transaction. A material financial interest (as defined in subdivision (4)) is one that would reasonably be expected to influence the director's judgment if *D* were to participate in any vote by the directors (or by a committee thereof) taken on the authorization of the transaction.

Routine business transactions frequently occur between companies with overlapping directors. If *X* Co. and *Y* Co. have routine, frequent business dealings whose terms are dictated by competitive market forces, then even if a director of *X* Co. has a relevant relationship with *Y* Co., the transactions would almost always be defensible, regardless of approval by disinterested directors or shareholders, on the ground that they are "fair." For example, a common transaction involves a purchase of the corporation's product line by *Y* Co., or perhaps by *D* or a related person, at prices normally charged by the corporation. In such circumstances, it usually will not be difficult for *D* to show that the transaction was on arms-length terms and was fair. Even a purchase by *D* of a product of *X* Co. at a usual "employee's discount," while technically assailable as a conflicting interest transaction, would customarily be viewed as a routine incident of the office of director and, thus, "fair" to the corporation.

D can have a conflicting interest in only two ways.

First, a conflicting interest can arise under either subdivision (1)(i) or (ii). This will be the case if, under clause (i), the transaction is between *D* and *X* Co. A conflicting interest also will arise under clause (ii) if *D* is not a party to the transaction, but knows about it and knows that he or she has a material financial interest in it. The personal economic stake of the director must be in the transaction itself—that is, the director's gain must flow directly from the transaction. A remote gain (for example, a future reduction in tax rates in the local community) is not enough to give rise to a conflicting interest under subdivision (1)(ii).

Second, a conflicting interest for *D* can arise under subdivision (1)(iii) from the involvement in the transaction of a "related person" of *D* that is either a party to the transaction or has a "material financial interest" in it. "Related person" is defined in subdivision (5).

Circumstances may arise where a director could have a conflicting interest under more than one clause of subdivision (1). For example, if *Y* Co. is a party to or interested in the transaction with *X* Co. and *Y* Co. is a related person of *D*, the matter would be governed by subdivision (1)(iii), but *D* also may have a conflicting interest under subdivision (1)(ii) if *D*'s economic interest in *Y* Co. is sufficiently material and if the importance of the transaction to *Y* Co. is sufficiently material.

A director may have relationships and linkages to persons and institutions that are not specified in subdivision (1)(iii). Such relationships and linkages fall outside subchapter F because the categories of persons described in subdivision (1)(iii) constitute the exclusive universe for purposes of subchapter F. For example, in a challenged transaction between *X* Co. and *Y* Co., suppose the court confronts the argument that *D* also is a major creditor of *Y* Co. and that creditor status in *Y* Co. gives D a conflicting interest. The court should rule that *D*'s creditor status in *Y* Co. does not fit any category of subdivision (1); and therefore, the conflict of interest claim must be rejected by reason of section 8.61(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 subdivision (1)(ii) or, if it placed *D* in control of *Y* Co., it would fall under subdivision (1)(iii) (because *Y* Co. is a related person of *D* under subdivision (5)(iv)). To explore the example further, if *D* is also a shareholder of *Y* Co., but *D* does not have a material financial interest in the transaction and does not control *Y* Co., no director's conflicting interest transaction arises and the transaction cannot be challenged on conflict of interest grounds. To avoid any appearance of impropriety, *D*, nonetheless, should consider recusal from the other directors' deliberations and voting on the transaction between *X* Co. and *Y* Co.

It should be noted that any director's interest in a transaction that meets the criteria of section 8.60(1) is considered a "director's conflicting interest transaction." If the director's interest satisfies those criteria, subchapter F draws no distinction between a director's interest that clashes with the interests of the corporation and a director's interest that coincides with, or is parallel to, or even furthers the interests of the corporation. In any of these cases, if the director's "interest" is present, a "conflict" will exist.

2. CONTROL

The definition of "control" in subdivision (2) contains two independent clauses. The first clause addresses possession of the voting or other power, directly or indirectly, to elect or remove a majority of the members of an entity's governing body. That power can arise, for example, from articles of incorporation or a shareholders' agreement. The second clause addresses the circumstances where a person is (i) subject to a majority of the risk of loss from the entity's activities, or (ii) entitled to receive a majority of the entity's residual returns. The second clause of the definition includes, among other circumstances, complex financial structures that do not have voting interests or a governing body in the traditional sense, such as special purpose entities. Although the definition of "control" operates independently of the accounting rules adopted by the U.S. accounting profession, it is consistent with the relevant generally accepted accounting principle (made effective in 2003) that governs when an entity must be included in consolidated financial statements.

3. RELEVANT TIME

The definition of director's conflicting interest transaction requires that, except where he or she is a party, the director know of the transaction. It also requires that where not a party, the director know of the transaction either at the time it is brought before the corporation's board of directors or, if it is not brought before the corporation's board of directors (or a committee thereof), at the time the corporation (or an entity controlled by the corporation) becomes legally bound to consummate the transaction. Where the director lacks such knowledge, the risk to the corporation that the director's judgment might be improperly influenced, or the risk of unfair dealing by the director, is not present. In a corporation of significant size, routine transactions in the ordinary course of business, which typically involve decisionmaking at lower management levels, normally will not be known to the director and, if that is the case, will be excluded from the "knowledge" requirement of the definition in subdivision (1)(ii) or (iii).

4. MATERIAL FINANCIAL INTEREST

The "interest" of a director or a related person in a transaction can be direct or indirect (*e.g.*, as an owner of an entity or a beneficiary of a trust or estate), but it must be financial for there to exist a "director's conflicting interest transaction." Thus, for example, an interest in a transaction between *X* Co. and a director's alma mater, or any other transaction involving *X* Co. and a party with which *D* might have emotional involvement but no financial interest, would not give rise to a director's conflicting interest transaction. Moreover, whether a financial interest is material does not turn on any assertion by the possibly interested director that the interest in question would not influence him or her 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 a reasonable director in similar circumstances would have been influenced by the financial interest when voting on the matter. Thus, the standard is objective, not subjective.

Under subdivision (1)(ii), at the relevant time a director must have knowledge of his or her financial interest in the transaction in addition to knowing about the transaction itself. As a practical matter, a director could not be influenced by a financial interest about which that director had no knowledge. For example, the possibly interested director might know about *X* Co.'s transaction with *Y* Co., but might not know that his or her money manager recently established a significant position in *Y* Co. stock for the director's portfolio. In such circumstances, the transaction with *Y* Co. would not give the director a "material financial interest", notwithstanding the portfolio investment's significance. Analytically, if the director did not know about the *Y* Co. portfolio investment, it could not reasonably be expected to influence that director's judgment.

Similarly, under subdivision (1)(iii), a director must know about his or her related person's financial interest in the transaction for the matter to give rise to a "material financial interest" under subdivision (4). If there is such knowledge and "interest" (*i.e.*, the financial interest could be expected to influence the director's judgment), then the matter involves a director's conflicting interest transaction under subdivision (1).

5. RELATED PERSON

Six categories of "related person" of the director are set out in subdivision (5). These categories are specific, exclusive and preemptive.

The first three categories involve closely related family, or near-family, individuals as specified in clauses (i) through (iii). The clauses are exclusive insofar as family relationships are concerned and include adoptive relationships. The references to a "spouse" include a common law spouse. Clause (iii) covers personal, as opposed to business, relationships; for example, clause (iii) does not cover a lessee.

Regarding the subcategories of persons described in clause (v) from the perspective of *X* Co., certain of *D*'s relationships with other entities and *D*'s fiduciary relationships are always a sensitive concern, separate and apart from whether *D* has a financial interest in the transaction. Clause (v) reflects the policy judgment that *D* cannot escape *D*'s legal obligation to act in the best interests of another person for whom *D* has such a relationship and, accordingly, that such a relationship (without regard to any financial interest on *D*'s part) should cause the relevant entity to have "related person" status.

The term "employer" as used in subdivision (5)(vi) is not separately defined but should be interpreted sensibly in light of the purpose of the subdivision. The relevant inquiry is whether *D*, because of an employment relationship with an employer who has a significant stake in the outcome of the transaction, is likely to be influenced to act in the interest of that employer rather than in the interest of *X* Co.

6. FAIR TO THE CORPORATION

The term "fair" accords with traditional language in the case law, but for purposes of subchapter F it also has a special meaning. The transaction, viewed as a whole, must have been beneficial to the corporation, in addition to satisfying the

traditional "fair price" and "fair dealing" concepts. In determining whether the transaction was beneficial, the consideration and other terms of the transaction and the process (including the conflicted director's dealings with the corporation) are relevant, but whether the transaction advanced the corporation's commercial interests is to be viewed "as a whole."

In considering the "fairness" of the transaction, the court will be required to consider not only the market fairness of the terms of the deal—whether it is comparable to what might have been obtainable in an arm's length transaction—but also (as the board would have been required to do) whether the transaction was one that was reasonably likely to yield favorable results (or reduce detrimental results). Thus, if a manufacturing company that lacks sufficient working capital allocates some of its scarce funds to purchase a sailing yacht owned by one of its directors, it will not be easy to persuade the court that the transaction was "fair" in the sense that it was reasonably made to further the business interests of the corporation. The facts that the price paid for the yacht was a "fair" market price, and that the full measure of disclosures made by the director is beyond challenge, may still not be enough to defend and uphold the transaction.

a. Consideration and other terms of the transaction

The fairness of the consideration and other transaction terms are to be judged at the relevant time. The relevant inquiry is whether the consideration paid or received by the corporation or the benefit expected to be realized by the corporation was adequate in relation to the obligations assumed or received or other consideration provided by or to the corporation. If the issue in a transaction is the "fairness" of a price, "fair" is not to be taken to imply that there is one single "fair" price, all others being "unfair." It is settled law that a "fair" price is any price within a range that an unrelated party might have been willing to pay or willing to accept, as the case may be, for the relevant property, asset, service or commitment, following a normal arm's-length business negotiation. The same approach applies not only to gauging the fairness of price, but also to the fairness evaluation of any other key term of the deal.

Although the "fair" criterion used to assess the consideration under section 8.61(b)(3) is also a range rather than a point, the width of that range may be narrower than would be the case in an arm's-length transaction. For example, the quality and completeness of disclosures, if any, made by the interested director that bear upon the consideration in question are relevant in determining whether the consideration paid or received by the corporation, although otherwise commercially reasonable, was "fair" for purposes of section 8.61(b)(3).

b. Process of decision and the director's conduct

In some circumstances, the behavior of the director having the conflicting interest may affect the finding and content of "fairness." Fair dealing requires that the director make required disclosure (per subdivision (7)) at the relevant time (per subdivision (3)) even if the director plays no role in arranging or negotiating the terms of the transaction. One illustration of unfair dealing is the director's failure to disclose fully the director's interest or hidden defects known to the

director regarding the transaction. Another illustration would be the exertion by the director of improper pressure upon the other directors or other parties that might be involved with the transaction. Whether a transaction can be successfully challenged by reason of deficient or improper conduct, notwithstanding the fairness of the economic terms, will turn on the court's evaluation of the conduct and its impact on the transaction.

7. REQUIRED DISCLOSURE

A critically important element of subchapter F's safe harbor procedures is that those acting for the corporation be able to make an informed judgment. In view of this requirement, subdivision (7) defines "required disclosure" to mean disclosure of all facts known to *D* about the subject of the transaction that a director free of the conflicting interest would reasonably believe to be material to the decision whether to proceed with the transaction. For example, if *D* knows that the land the corporation is proposing to buy from *D* is sinking into an abandoned coal mine, *D* must disclose not only *D*'s interest in the transaction but also that the land is subsiding. As a director of *X* Co., *D* may not invoke caveat emptor. On the other hand, *D* does not have any obligation to reveal the price that *D* paid for the property ten years ago, or the fact that *D* inherited the property, because that information is not material to the board's evaluation of the property and its business decision whether to proceed with the transaction. Further, while material facts respecting the subject of the transaction must be disclosed, *D* is not required to reveal personal or subjective information that bears upon *D*'s negotiating position (such as, for example, *D*'s urgent need for cash, or the lowest price *D* would be willing to accept). This is true even though such information would be highly relevant to the corporation's decisionmaking in the sense that, if the information were known to the corporation, it could enable the corporation to hold out for more favorable terms.

§ 8.61 OFFICIAL COMMENT

Section 8.61 is the operational section of subchapter F, as it prescribes the judicial consequences of the other sections.

Speaking generally:

(i) If the section 8.62 or section 8.63 procedures are complied with, or if it is established that at the relevant time a director's conflicting interest transaction was fair to the corporation, then a director's conflicting interest transaction is immune from attack on the ground of an interest of the director. However, the narrow scope of subchapter F must again be strongly emphasized; if the transaction is vulnerable to attack on some other ground, observance of subchapter F's procedures does not make it less so.

(ii) If a transaction is not a director's conflicting interest transaction, as defined in section 8.60(1), then the transaction may not be the subject of equitable relief or give rise to an award of damages or be made the basis of other sanction on the ground of an interest of a director, regardless of whether the transaction was approved under section 8.62 or 8.63. In that

sense, subchapter F is specifically intended to be both comprehensive and exclusive.

(iii) If a director's conflicting interest transaction that was not at any time the subject of action taken in compliance with section 8.62 or section 8.63 is challenged on grounds of the director's conflicting interest, and is not shown to be fair to the corporation, then the court may take such remedial action as it considers appropriate under the applicable law of the jurisdiction.

1. Section 8.61(a)

As previously noted, section 8.61(a) makes clear that a transaction between a corporation and another person cannot be the subject of equitable relief, or give rise to an award of damages or other sanctions against a director, on the ground that the director has an interest respecting the transaction, unless the transaction falls within the bright-line definition of "director's conflicting interest transaction" in section 8.60. So, for example, a transaction will not constitute a director's conflicting interest transaction and, therefore, will not be subject to judicial review on the ground that a director had an interest in the transaction, where the transaction is made with a relative of a director who is not one of the relatives specified in section 8.60(5), or on the ground of an alleged interest other than a material financial interest, such as a financial interest of the director that is not material, as defined in section 8.60(4), or a nonfinancial interest. (As noted in the Introductory Comment, however, subchapter F does not apply to, and therefore does not preclude, a challenge to such a transaction based on grounds other than the director's interest.)

If there is reason to believe that the fairness of a transaction involving *D* could be questioned, *D* is well advised to subject the transaction to the safe harbor procedures of subchapter F. Sometimes, a director may be uncertain whether a particular person would be held to fall within a related person category, or whether the scale of the financial interest is material as defined in Section 8.60. In such circumstances, the obvious avenue to follow is to clear the matter with qualified directors under section 8.62 or with the holders of qualified shares under section 8.63. If it is later judicially determined that a conflicting interest in the challenged transaction did exist, the director will have safe harbor protection. It may be expected, therefore, that the procedures of section 8.62 (and, to a lesser extent, section 8.63) will probably be used for many transactions that may lie outside the sharp definitions of section 8.60—a result that is healthy and constructive.

It is important to stress that subchapter F deals only with "transactions." If a non-transactional corporate decision is challenged on the ground that *D* has a conflicting personal stake in it, subsection 8.61(a) is irrelevant.

2. Section 8.61(b)

Clause (1) of subsection (b) provides that if a director has a conflicting interest respecting a transaction, neither the transaction nor the director is legally vulnerable on the ground of the director's conflict if the procedures of section 8.62 have been properly followed. If board action under section 8.62(b)(1) is inter-

posed as a defense in a proceeding challenging a director's conflicting interest transaction, the plaintiff then bears the burden of overcoming that defense under section 8.31.

Challenges to that board action may be based on a failure to meet the specific requirements of section 8.62 or to conform with general standards of director conduct. For example, a challenge addressed to section 8.62 compliance might question whether the acting directors were "qualified directors" or might dispute the quality and completeness of the disclosures made by *D* to the qualified directors. If such a challenge is successful, the board action is ineffective for purposes of subsection (b)(1) and both *D* and the transaction may be subject to the full range of remedies that might apply, absent the safe harbor, unless the fairness of the transaction can be established under subsection (b)(3). The fact that a transaction has been nominally passed through safe harbor procedures does not preclude a subsequent challenge based on any failure to meet the requirements of section 8.62. Recognizing the importance of traditional corporate procedures where the economic interests of a fellow director are concerned, a challenge to the effectiveness of board action for purposes of subsection (b)(1) might also assert that, while the interested director's conduct in connection with the process of approval by qualified directors may have been consistent with the statute's expectations, the qualified directors dealing with the matter did not act in good faith or on reasonable inquiry. The kind of relief that may be appropriate when qualified directors have approved a transaction but have not acted in good faith or have failed to become reasonably informed—and, again, where the fairness of the transaction has not been established under subsection (b)(3)—will depend heavily on the facts of the individual case; therefore, it must be largely a matter of sound judicial discretion.

Clause (2) of subsection (b) regarding shareholders' approval of the transaction is the matching piece to clause (1) regarding directors' approval.

The language "at any time" in clauses (1) and (2) of subsection (b) permits the directors or the shareholders to ratify a director's conflicting interest transaction after the fact for purposes of subchapter F. However, good corporate practice is to obtain appropriate approval prior to consummation of a director's conflicting interest transaction.

Clause (3) of subsection (b) provides that a director's conflicting interest transaction will be secure against the imposition of legal or equitable relief if it is established that, although neither directors' nor shareholders' action was taken in compliance with section 8.62 or 8.63, the transaction was fair to the corporation within the meaning of section 8.60(6). Under section 8.61(b)(3) the interested director has the burden of establishing that the transaction was fair.

* * *

Note on Directors' Compensation

Directors' fees and other forms of director compensation are typically set by the board and are specially authorized (though not regulated) by sections 8.11 and 8.57 of the Model Act. Although in the usual case a corporation's directors' compensation practices fall within normal patterns and their fairness can be read-

ily established, they do involve a conflicting interest on the part of most if not all of the directors and, in a given case, may be abused. Therefore, while as a matter of practical necessity these practices will normally be generally accepted in principle, it must be kept in mind that board action on directors' compensation and benefits would be subject to judicial sanction if they are not favorably acted upon by shareholders pursuant to section 8.63 or if they are not in the circumstances fair to the corporation pursuant to section 8.61(b)(3).

§8.62 OFFICIAL COMMENT

Section 8.62 provides the procedure for action by the board of directors or by a board committee under subchapter F. In the normal course this section, together with section 8.61(b), will be the key method for addressing directors' conflicting interest transactions. Any discussion of section 8.62 must be conducted in light of the overarching requirements that directors act in good faith and on reasonable inquiry. Director action that does not comply with those requirements, even if otherwise in compliance with section 8.62, will be subject to challenge and not be given effect under section 8.62. See the Official Comment to section 8.61(b).

1. Section 8.62(a)

The safe harbor for a transaction in which a director has a conflicting interest is effective under section 8.62 if and only if it is approved by qualified directors (a term that is defined in subsection (d)). Action by the board of directors is effective for purposes of section 8.62 if the transaction is approved by the affirmative vote of a majority (but not less than two) of the qualified directors on the board. Action may also be taken by a duly authorized committee of the board but, for the action to be effective, all members of the committee must be qualified directors and the committee must either be composed of all of the qualified directors on the board or must have been appointed by the affirmative vote of a majority of the qualified directors on the board. This requirement for effective committee action is intended to preclude the appointment as committee members of a favorably inclined minority from among all the qualified directors. Except to the limited extent found in subsection (b), approval by the board or a committee must be preceded by required disclosure followed by deliberation and voting outside the presence and without the participation of the conflicted director. After the qualified directors have had the opportunity to question the conflicted director about the material facts, action complying with subsection (a) may be taken at any time before or after the completion of the transaction becomes a legal obligation. A written record of the qualified directors' deliberation and action is strongly encouraged.

2. Section 8.62(b)

Subsection (b) is a special provision designed to accommodate, in a practical way, situations where a director who has a conflicting interest is not able to comply fully with the disclosure requirement of subsection (a) because of an extrinsic duty of confidentiality that such director reasonably believes to exist. The director

may, for example, be prohibited from making full disclosure because of legal restrictions that happen to apply to the transaction (*e.g.*, grand jury seal or national security statute) or professional canon (*e.g.,* attorney-client privilege). The most frequent use of subsection (b), however, will likely involve common directors who find themselves in a position of dual fiduciary obligations that clash. If *D* is also a director of *Y Co., D* may have acquired privileged 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 to be presented for consideration under subsection (a), and thereby enables *X Co.* (and *Y Co*.) and *D* to secure for the transaction the protection afforded by subchapter F even though *D* cannot, by reason of applicable law, confidentiality strictures or a professional ethics rule, make the full disclosure otherwise required.

To comply with subsection (b), *D* must disclose the conflicting interest and all information required to be disclosed that does not violate the duty not to disclose, as the case may be, to which *D* reasonably believes he or she is subject, inform the qualified directors who are to vote on the transaction of the nature of the duty (*e.g.*, that the duty arises out of an attorney-client privilege or out of a duty as a director of *Y Co.* that prevents *D* from making required disclosure as otherwise mandated by clause (ii) of section 8.60(7)). *D* must then play no personal role in the board's (or committee's) ultimate deliberations or action. The purpose of subsection (b) is to make it clear that the provisions of subchapter F may be employed to "safe harbor" a transaction in circumstances where an interested director cannot, because of enforced fiduciary silence, disclose all the known facts.[1] Of course, if *D* invokes subsection (b) and does not make required disclosure before leaving the boardroom, the qualified directors may decline to act on the transaction out of concern that *D* knows (or may know) something they do not. On the other hand, if *D* is subject to an extrinsic duty of confidentiality but has no knowledge of material facts that should otherwise be disclosed, *D* would normally state just that and subsection (b) would be irrelevant. Having disclosed the existence and nature of the conflicting interest, *D* would thereby comply with section 8.60(7).

While subchapter F explicitly contemplates that subsection (b) will apply to the frequently recurring situation where transacting corporations have common directors (or where a director of one party is an officer of the other), that subsection should not otherwise be read as attempting to address the scope, or mandate the consequences, of various silence-privileges. That is a topic reserved for local law.

1. 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 can arise in situations other than transactions involving a conflicting interest of a director. It could happen that at the same board meeting of *X Co.* at which *D* invokes §8.62(b), another director who has absolutely no financial interest in the transaction might conclude that under local law he or she is bound to silence (because of attorney-client privilege, for example) and under general principles of sound director conduct would withdraw from participation in the board's deliberations and action.

Subsection (b) is available to *D* if a transaction is a director's conflicting interest transaction only because a related person described in section 8.60(5)(v) or (vi) is a party to or has a material financial interest in the transaction. Its availability is so limited because in those instances a director owes a fiduciary duty to such a related person. If *D* or a related person of *D* other than a related person described in section 8.60(5)(v) or (vi) is a party to or has a material financial interest in the transaction, *D*'s only options are satisfying the required disclosure obligation on an unrestricted basis, abandoning of the transaction, or accepting the risk of establishing fairness in a court proceeding, under section 8.61(b)(3), if the transaction is challenged.

Whenever an interested director proceeds in the manner provided in subsection (b), the other directors should recognize that the interested director may have information that in usual circumstances *D* would be required to reveal to the qualified directors who are acting on the transaction—information that could well indicate that the transaction would be either favorable or unfavorable for *X Co.*

3. Section 8.62(d)

Obviously, a director's conflicting interest transaction and *D* cannot be provided safe harbor protection by fellow directors who themselves have conflicting interests; only "qualified directors" can do so under subsection (a). "Qualified director" is defined in subsection (d). The definition is of a limiting character and its exclusions are broad. The definition excludes not only a director who has a conflicting interest respecting the matter, but also—going significantly beyond the persons specified in the categories of section 8.60(5) for purposes of the "related person" definition—any director whose familial or financial connection with *D* or whose employment or professional relationship with *D* would be likely to influence the director's vote on the transaction. The determination of whether there is a familial, financial, employment or professional relationship should be based on the practicalities of the situation rather than formalistic circumstances. For example, a director employed by a corporation controlled by *D* should be regarded as having an employment relationship with *D*.

4. Section 8.62(e)

This subsection underscores that the directors' voting procedures and requirements set forth in subsections (a) through (d) treat only the director's conflicting interest. A transaction that receives a directors' vote that complies with subchapter F may well fail to achieve a different vote or quorum that may be required for substantive approval of the transaction under other applicable statutory provisions or provisions contained in *X Co.*'s articles of incorporation or bylaws, and vice versa. Thus, in any case where the quorum and/or voting requirements for substantive approval of a transaction differ from the quorum and/or voting requirements for "safe harbor" protection under section 8.62, 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 OFFICIAL COMMENT

Section 8.63 provides the machinery for shareholders' action that confers safe harbor protection for a director's conflicting interest transaction, just as section 8.62 provides the machinery for directors' action that confers subchapter F safe harbor protection for such a transaction.

1. SECTION 8.63(a)

Subsection (a) specifies the procedure required to confer effective safe harbor protection for a director's conflicting interest transaction through a vote of shareholders. In advance of the vote, three steps must be taken: (1) shareholders must be given timely and adequate notice describing the transaction; (2) *D* must disclose the information called for in subsection (b); and (3) disclosure must be made to the shareholders entitled to vote, as required by section 8.60(7). In the case of smaller closely-held corporations, this disclosure shall be presented by the director directly to the shareholders gathered at the meeting place where the vote is to be held, or provided in writing to the secretary of the corporation for transmittal with the notice of the meeting. In the case of larger publicly held corporations where proxies are being solicited, the disclosure is to be made by the director to those responsible for preparing the proxy materials, for inclusion therein. If the holders of a majority of all qualified shares (as defined in subsection (b)) entitled to vote on the matter vote favorably, the safe harbor provision of section 8.61(b)(2) becomes effective. Action that complies with subsection (a) may be taken at any time, before or after the time when the corporation becomes legally obligated to complete the transaction.

Section 8.63 does not contain a "limited disclosure" provision that is comparable to section 8.62(b). Thus, the safe harbor protection of subchapter F is not available through shareholder action under section 8.63 in a case where *D* either remains silent or makes less than required disclosure because of an extrinsic duty of confidentiality. This omission is intentional. While the section 8.62(b) procedure is workable in the collegial setting of the boardroom, that is far less likely in the case of action by the shareholder body, especially in large corporations where there is heavy reliance upon the proxy mechanic. Unlike the dynamic that would normally occur in the boardroom, in most situations no opportunity exists for shareholders to quiz *D* about the confidentiality duty and to discuss the implications of acting without the full benefit of *D*'s knowledge about the conflict transaction. In a case of a closely held corporation where section 8.63 procedures are followed, but with *D* acting in a way that would be permitted by section 8.62(b), a court could attach significance to a favorable shareholder vote in evaluating the fairness of the transaction to the corporation.

2. SECTION 8.63(b)

In many circumstances, the secretary or other vote tabulator of *X Co*. will have no way to know which of *X Co.'s* outstanding shares should be excluded from the tabulation. Subsection (b) (together with subsection (c)) therefore obligates a director who has a conflicting interest respecting the transaction, as a prerequisite to safe harbor protection by shareholder action, to inform the secretary, or other

officer or agent authorized to tabulate votes, of the number and holders of shares known to be held by the director or by a related person described in clauses (i) through (v) of section 8.60(5).

If the tabulator of votes knows, or is notified under subsection (b), that particular shares should be excluded but for some reason fails to exclude them from the count and their inclusion in the vote does not affect its outcome, the shareholders' vote will stand. If the improper inclusion determines the outcome, the shareholders' vote fails because it does not comply with subsection (a). But see subsection (e) as to cases where the notification under subsection (b) is defective but not determinative of the outcome of the vote.

3. Section 8.63(c)

Under subsection (a), only "qualified shares" may be counted in the vote for purposes of safe harbor action under section 8.61(b)(2). Subsection (b) defines "qualified shares" to exclude all shares that, before the vote, the secretary or other tabulator of the vote knows, or is notified under subsection (b), are held by the director who has the conflicting interest, or by any specified related person of that director.

The definition of "qualified shares" excludes shares held by *D* or a "related person" as defined in the first five categories of section 8.60(5). That definition does not exclude shares held by entities or persons described in clause (vi) of section 8.60(5), i.e., a person that is, or is an entity that is controlled by, an employer of *D*. If *D* is an employee of *Y Co.*, that fact does not prevent *Y Co.* from exercising its usual rights to vote any shares it may hold in *X Co*. *D* may be unaware of, and would not necessarily monitor, whether his or her employer holds *X Co.* shares. Moreover, *D* will typically have no control over his or her employer and how it may vote its *X Co.* shares.

4. Section 8.63(e)

If *D* did not provide the information required under subsection (d), on its face the shareholders' action is not in compliance with subsection (a) and *D* has no safe harbor under subsection (a). In the absence of that safe harbor, *D* can be put to the burden of establishing the fairness of the transaction under section 8.61(b)(3).

That result is proper where *D's* failure to inform was determinative of the vote results or, worse, was part of a deliberate effort on *D's* part to influence the outcome. But if *D's* omission was essentially an act of negligence, if the number of unreported shares if voted would not have been determinative of the outcome of the vote, and if the omission was not motivated by *D's* effort to influence the integrity of the voting process, then the court should be free to fashion an appropriate response to the situation in light of all the considerations at the time of its decision. The court should not, in the circumstances, be automatically forced by the mechanics of subchapter F to a lengthy and retrospective trial on "fairness." Subsection (e) grants the court that discretion in those circumstances and permits it to accord such effect, if any, to the shareholders' vote, or to grant such relief respecting the transaction or *D*, as the court may find appropriate.

Despite the presumption of regularity customarily accorded the secretary's record, a plaintiff may go behind the secretary's record for purposes of subsection (e).

5. Section 8.63(f)

This subsection underscores that the shareholders' voting procedures and requirements set forth in subsections (a) through (e) treat only the director's conflicting interest. A transaction that receives a shareholders' vote that complies with subchapter F may well fail to achieve a different vote or quorum that may be required for substantive approval of the transaction under other applicable statutory provisions or provisions contained in *X Co.*'s articles of incorporation or bylaws, and vice versa. Thus, in any case where the quorum and/or voting requirements for substantive approval of a transaction differ from the quorum and/or voting requirements for "safe harbor" protection under section 8.63, the corporation may find it necessary to conduct (and record in the minutes of the proceedings) two separate shareholder votes—one for section 8.63 purposes and the other for substantive approval purposes (or, if appropriate, conduct two separate tabulations of one vote).

Proposed changes to Subchapter F are shown below with additions underlined and deletions in strikethrough.

Subchapter F.

DIRECTORS' CONFLICTING INTEREST TRANSACTIONS INTRODUCTORY COMMENT

1. PURPOSES AND SPECIAL CHARACTERISTICS OF SUBCHAPTER F

The common law, drawing by analogy on the fiduciary principles of the law of trusts, initially took the position that any transaction between ~~*X Co.*~~**a corporation** and a director of ~~X~~**that** ~~Co.~~**corporation** was contaminated by the director's conflicting interest, that the transaction was null and void or **at least** voidable and, ~~at least~~**suggesting** by implication, that the interested director who benefited from the transaction could be required to disgorge any profits and be held liable for any damages. ~~**In time, this rule was perceived to be demonstrably unworkable in the real business world and contrary to the best interests of the corporation. Accordingly, some courts modified their initial rigidity and, in addition, corrective legislation was enacted as a part of the business corporation acts.**~~

~~**Those statutory provisions on directors' conflicting interest**~~

Eventually, it was perceived that a flat void/voidable rule could work against a corporation's best interests. Although self-interested transactions ~~**allowed the courts to develop the substantive content of the duty of loyalty owed by agents to their principals, by employees to their employers, and by directors to their corporations. The statutes themselves concentrated on creating procedures by which interest-conflict transactions between corporations and their directors could be salvaged while, at the same time, corporations and their shareholders could be protected against unfair dealing by**~~

~~self-aggrandizing directors. Section 41 of the 1969 Model Act was such a procedural provision; so was its successor, section 8.31 of the Model Act.~~

~~The replacement for section 8.31, now embodied as subchapter F of chapter 8 of the Model Act, is of the same procedural character. But new subchapter F has some important new features.~~

~~1. PURPOSES AND SPECIAL CHARACTERISTICS OF SUBCHAPTER F~~

~~Predecessor provisions to subchapter F were sweeping and generalized in character. Subchapter F is not. Its key objectives are to increase predictability and to enhance practical administrability. To that end, the new subchapter spells out a safe harbor procedure more meticulously than its predecessors. To the same end, the subchapter goes further. Earlier statutes left entirely to judicial interpretation—and to the guess of corporate counsel—the central question as to what does and what does not constitute a conflicting interest of a director. Great uncertainty has arisen as to the scope of that concept. Subchapter F takes the new step of spelling out a practical working definition of "conflicting interest" and declares that definition to be exclusive. Circumstances that fall outside the statutory definition of conflicting interest cannot constitute the basis for an attack on a transaction on grounds of a director's interest conflict, although they may, of course, afford basis for legal attack on some other ground. Finally, to a greater degree than its predecessors, the subchapter specifies when judicial intervention is appropriate and when it is not.~~

~~In sum, subchapter F is new in that it adopts a "bright-line" statutory approach. An inevitable feature of any bright-line statute or regulation is that, no matter where the line may be set, some situations that fall outside the line will closely resemble other situations that fall inside it. Some observers find that outcome anomalous and argue that a bright-line approach is inferior to a statement of broad principles. But the legislative draftsman who chooses to suppress marginal anomalies by resorting to generalized statements of principle will pay a cost in terms of predictability. The choice between these two drafting approaches is a matter of judgment; an experienced legislative draftsman would never write a bright-line constitutional "due process" clause, nor would he provide, in a business corporation act, for a "reasonable period" of notice for a shareholders' meeting.~~

~~For a number for reasons, subchapter F is deliberately weighted towards a bright-line specificity and predictability. That there will be imaginable situations at the margin that are similar but yield different results can be anticipated and is accepted.~~

~~One consideration arguing for the bright-line approach in subchapter F is that the existing case law governing interest conflicts of directors is in a state of unhealthy uncertainty, reflecting differing judicial attitudes toward and varying levels of comprehension concerning the subject. Equal uncertainty surrounds the working of the procedural machinery for dealing with transactions that involve a director's conflicting interest.~~

~~A second consideration arguing for a bright-line approach is that the fundamental perspective of subchapter F is prospective. In the real business world, a decision must be made *now* whether or not to proceed with the transaction and legal counsel's opinion must be delivered *now* as to whether clearance procedures are available and have been complied with. The business executive can accept either "yes" or "no" as an answer but he cannot effectively function in an environment in which the law, lawyers, or the courts say, "Go ahead and I will tell you later—perhaps years later—whether the transaction is vulnerable to attack."~~

~~Further, the essential character of interest conflict is often, unfortunately, misunderstood by the public and the media (and sometimes misunderstood, too, by lawyers and judges). Interest conflicts can and often do lead to baneful acts. The law regulates interest conflict transactions because experience shows that people do often yield to the temptation to advance their self-interests and, if they do, other people may be injured. That contingent fear is sufficient reason to warrant caution and to apply special standards and procedures to interest conflict transactions.~~

~~Nonetheless, it is important to keep firmly in mind that it is a contingent risk we are dealing with, that an interest conflict is not in itself a crime or a tort or necessarily injurious to others. Contrary to much popular usage, having a "conflict of interest" is not something one is "guilty of"; it is simply a state of affairs. Indeed, in many situations, the corporation and the shareholders may secure major benefits from a transaction despite the presence of a director's conflicting interest. Further, while history is replete with selfish acts, it is also oddly counterpointed by numberless acts taken contrary to self-interest.~~

~~And, as an additional consideration, while conflicting interests surely~~ carry a potential ~~danger, other important social values, such as economic efficiency, predictability and business finality are also at stake and should be accorded heavy countering weight in the law.~~

~~One last point. Even if one were to disregard these considerations and draft statutory language governing directors' interest conflicts in the most generalized form in an effort to catch the last malefactor, "anomalous" results still would not be avoided. One reason is that generalized drafting invites varying judicial and practitioner interpretation, as has in fact occurred in the cases on director's conflicts of interest. But the ultimate unresolvable problem in seeking to regulate interest conflicts is that human beings are motivated by unimaginably varied and indeterminable mixes of ambitions, likes, dislikes, and biases. At the end of the day, who can say in respect of any matter that a particular director was, in a deeper sense, "disinterested" in a particular transaction and acted objectively on the merits? In regulating the conflicting interests of directors, the courts (and pertinent statutes) have limited inquiry to the financial interests of the director and his immediate family and associates. That is the wise course and, indeed, the only practical course. But in adopting that course, one obviously excludes a large fraction~~

~~of the interests that actually drive the actions of human beings. Thus, the law may preclude a director from voting on a transaction in which he has an economic interest even if, given his resources, the amount at stake will have no real impact upon his decisionmaking, yet the law does not prohibit the same director from voting on a transaction which significantly benefits a religious institution to whose creed he is deeply devoted and that guides his life. Such deeper anomalies cannot be eradicated and the law should not seek to eradicate them. But it is worthwhile to be reminded that they exist,~~ for ~~in this field a degree of anomaly is a condition that must be accepted and lived with.~~injury to the corporation, they also carry a potential for benefit. A director who is self-interested may nevertheless act fairly, and there may be cases where a director either owns a unique asset that the corporation needs or is willing to offer the corporation more favorable terms than are available on the market (for example, where the director is more confident of the corporation's financial ability to perform than a third person would be). Accordingly, the courts dropped the flat void/voidable rule, and substituted in its stead the rule that a self-interested transaction will be upheld if the director shoulders the burden of showing that the transaction was fair.

Later still, the Model Act and the state legislatures entered the picture by adopting statutory provisions that sheltered the transaction from any challenge that the transaction was void or voidable where it was approved by disinterested directors or shareholders. Until 1989, the successive Model Act provisions concerning director conflict-of-interest transactions and the statutory provisions in force in most states reflected basically the same objective; that is, their safe-harbor procedures concentrated on protection for the transaction, with no attention given to the possible vulnerability of the director whose conflicting interest would give rise to the transaction's potential challenge. However, in 1989 the relevant provisions were significantly reworked in subchapter F of Chapter 8. Four basic elements in the architecture of the 1989 version of subchapter F distinguished the approach of the subchapter from most other statutory provisions of the time.

First, most other statutory provisions did not define what constituted a director's conflict-of-interest transaction. In contrast, subchapter F defined, with bright-line rules, the transactions that were to be treated as director's conflict-of-interest transactions.

Second, because most other statutory provisions did not define what constitutes a director's conflict-of-interest transaction, they left open how to deal with transactions that involved only a relatively minor conflict. In contrast, subchapter F explicitly provided that a director's transaction that was not within the statutory definition of a director's conflict of interest transaction was not subject to judicial review for fairness on the ground that it involved a conflict of interest (although circumstances that fall outside the statutory definition could, of course, afford the basis for a legal attack on the transaction on some other ground), even if the transaction involved some sort of conflict lying outside the statutory definition, such as a remote familial relationship.

Third, subchapter F made explicit, as many other statutory provisions did not, that if a director's conflict-of-interest transaction, as defined, was properly approved by disinterested (or "qualified") directors or shareholders, the transaction was thereby insulated from judicial review for fairness (although, again, it might be open to attack on some basis other than the conflict).

Fourth, subchapter F also made explicit, as no other statutory provisions had done, that if a director's conflict-of-interest transaction, as defined, was properly approved by disinterested (or "qualified") directors or shareholders, the conflicted director could not be subject to an award of damages or other sanctions with respect thereto (although the director could be subject to claims on some basis other than the conflict).

Bright-line provisions of any kind represent a trade-off between the benefits of certainty, and the danger that some transactions or conduct that fall outside the area circumscribed by the bright-lines may be so similar to the transactions and conduct that fall within the area that different treatment may seem anomalous. Subchapter F reflected the considered judgment that in corporate matters, where planning is critical, the clear and important efficiency gains that result from certainty through defining director's conflict-of-interest transactions clearly exceeded any potential and uncertain efficiency losses that might occasionally follow from excluding other director's transactions from judicial review for fairness on conflict-of-interest grounds.

The 2003 revisions of subchapter F rest on the same basic judgment that animated the original subchapter. Accordingly, the revisions made do not alter the fundamental elements and approach of the subchapter. However, the revisions refine the definition of director's conflict-of-interest transactions, simplify the text of the statute, and, within the basic approach of the original subchapter, make various clarifying and substantive changes throughout the text and comments. One of these substantive changes expands the category of persons whose interest in a transaction will be attributed to the director for purposes of subchapter F. At the same time, the revisions delete coverage of a director's interest that lies outside the transaction itself but might be deemed to be "closely related to the transaction." The latter phraseology was determined to be excessively vague and unhelpful. In combination, these revisions clarify the coverage of subchapter F, while ensuring that a transaction that poses a significant risk of adversely affecting a director's judgment will not escape statutory coverage.

2. SCOPE OF SUBCHAPTER F

The focus of subchapter F is sharply defined and limited.

First, the subchapter is targeted on legal challenges based on interest conflicts only. Subchapter F does not undertake to define, regulate, or provide any form of procedure regarding other possible claims. For example, subchapter F does not address a claim that a controlling shareholder has violated a duty owed to the corporation or minority shareholders.

Second, **subchapter F does not shield misbehavior by a director or other person that is actionable under other provisions of the Model Act, such as**

section 8.31, or under other legal rules, regardless of whether the misbehavior is incident to a transaction with the corporation and regardless of whether the rule is one of corporate law.

Third, subchapter F does not preclude the assertion of defenses, such as statute of limitations or failure of a condition precedent, that are based on grounds other than a director's conflicting interest in the transaction.

Fourth, the subchapter is applicable only when there is a "transaction" by or with the corporation. For purposes of subchapter F, "transaction" generally connotes negotiations or ~~a~~ consensual ~~bilateral arrangement~~**arrangements** between the corporation and another party or parties that concern their respective and differing economic rights or interests—not simply a unilateral action by the corporation **or a director,** but rather a "deal." ~~See the discussion regarding "transaction" under clause (2) of Section 8.60(2).~~ Whether safe harbor procedures of some kind might be available to the director and the corporation with respect to non—transactional matters is discussed ~~at division~~**in numbered paragraph** 4 of this Introductory Comment.

~~Third~~**Fifth**, subchapter F deals with directors only. ~~(The same was true of predecessor section 8.31 and section 41 of the 1969 Model Act~~**Correspondingly, subchapter F does not deal with controlling shareholders in their capacity as such.)** ~~Conflicts of interest of non-director officers or employees of the corporation are dealt with by the law of agency prescribing loyalty of agent to principal. Moreover, most large corporations today have internal regulations governing the business conduct of all personnel, including loyalty to the employer and avoidance of conflicting personal interests. A corporate employee can also deal with~~**If** a ~~personal conflict situation~~**corporation is wholly owned** by ~~going to his supervisor. Thus the conflict of interest problems of all corporate personnel except directors can be satisfactorily handled by general law~~**a parent corporation or other person**, ~~internal rules, and personnel procedures. For the directors, however—those who~~**there** are ~~ultimately responsible for~~**no outside shareholders who might be injured as a result of transactions entered into between** the corporation~~—special provision in~~ **and** the ~~business corporation statute is required~~**owner of its shares. However, transactions between a corporation and a parent corporation or other controlling shareholder who owns less than all of its shares may give rise to the possibility of abuse of power by the controlling shareholder. Subchapter F does not speak to proceedings brought on that basis because section 8.61 concerns only proceedings that are brought on the ground that a "director has an interest respecting the transaction."**

~~Fourth~~**Sixth**, it is important to stress that the voting procedures and **conduct** standards prescribed in subchapter F deal solely with the **complicating** element ~~of~~**presented by** the director's conflicting interest. A transaction that receives ~~a~~ **favorable** directors' or shareholders' ~~vote that complies~~**action complying** with subchapter F may ~~well~~**still** fail to **satisfy a different quorum requirement or** to achieve a different vote ~~or quorum~~ that may be ~~requisite~~**needed** for substantive approval of the transaction under other applicable statutory provisions or under

the articles of incorporation, and vice versa. (Under the Model Act, latitude is granted for setting higher voting requirements and different quorum requirements in the articles of incorporation. See sections ~~7.27 and~~ 2.02(b)(2)**. and 7.27.**)

~~Fifth~~**Seventh**, a few corporate transactions or arrangements in which directors inherently have a special personal interest are of a unique character and are regulated by special procedural provisions of the **Model** Act. See sections 8.51 and 8.52 dealing with indemnification arrangements ~~and~~**,** section ~~7.44,~~**7.44** dealing with termination of derivative proceedings by board action **and section 8.11 dealing with directors' compensation**. Any corporate transactions or arrangements affecting directors that are governed by such regulatory sections of the Act are not governed by subchapter F.

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

3. STRUCTURE OF SUBCHAPTER F

~~**The skeleton of subchapter**~~**Subchapter** F has only four parts. Definitions are in section 8.60. Section 8.61 prescribes what a court may or may not do in various situations. Section 8.62 prescribes procedures for action by boards of directors **or duly authorized committees** regarding a director's ~~**conflict**~~**conflicting** interest transaction. Section 8.63 prescribes corresponding procedures for shareholders. Thus, the most important operative section of the subchapter is section 8.61.

4. NON-TRANSACTIONAL SITUATIONS INVOLVING INTEREST CONFLICTS

Many situations arise in which a director's personal economic interest is or may be adverse to the economic interest of the corporation, but which do not entail a "transaction" by or with the corporation. How does the subchapter bear upon those situations?

Corporate opportunity

~~**An authoritative succinct statement of the**~~**The** corporate opportunity doctrine is ~~**that "the corporation has**~~**anchored in** a ~~**prior claim to opportunities**~~ **significant body** of ~~**business and profit which may be regarded as incident to its business . . . " (M. Ballantine, Ballantine on Corporations**, 79 (1946)). Whether a court will declare a "corporate opportunity" to have been presented has always been wholly dependent on the facts of the~~ case ~~**and**~~**law clustering around the core question whether the corporation has a legitimate interest in a business opportunity, either because of the nature of the opportunity or the way in which the opportunity came to the director, of such a nature that the corporation should be afforded prior access to the opportunity before it is pursued (or, to use the case law's phrase, "usurped") by a director. Because judicial determinations in this area often seem to be driven by the particular facts of a case, outcomes are** often difficult to predict. ~~**And the scope of the "incident to its business" concept has become even more murky in an era in**~~

~~**which it is not unknown for a manufacturer of electrical equipment to become an investment bank, or a builder of concert pianos to become an insurance underwriter. If, however, one assumes a situation in which the circumstances presented are such that all would agree that it constitutes a corporate opportunity, to what extent are the procedures provided for in subchapter F relevant?**~~

~~**Obviously, the**~~**The subchapter, as** ~~**subchapter**~~**such,** does not apply by its terms to ~~**such as situation**~~**corporate or business opportunities** since no transaction between the corporation and the director is involved~~**. Yet, on analysis, a director's conflicting interest transaction and a director's corporate opportunity are fundamentally alike. If at the same board meeting the transaction and the opportunity are brought before the board with adequate disclosure of the relevant facts about each and the board, by action of disinterested directors, votes to enter into the transaction and votes to decline the opportunity (which the director then takes up), the integrity of the board's informed decisional process has been satisfied**~~ in ~~**both instances**~~**the taking of an opportunity**.~~**The legal outcome should**~~ **However**, ~~**therefore**~~**new subchapter G of chapter 8 of the Model Act provides, in effect, that the safe harbor procedures of section 8.62 or 8.63 may** be ~~**the same in both instances; i.e.**~~ **employed, at** the ~~**board**~~**interested director**'s ~~**action should afford safe harbor protection against later attack**~~**election, to protect the taking of a business opportunity that might be challenged under the doctrine. Otherwise, subchapter F has no bearing on enterprise rights or director obligations under the corporate opportunity doctrine.**

~~**The procedures of subchapter F, specifically designed for transactions, however, cannot simply be mechanically transferred and applied to the corporate opportunity situation. The reason is that the subchapter's rules declaring which directors are legally qualified to vote are structurally dependent upon the subchapter's basic definition of "conflicting interest"—a definition that has no bearing on a corporate opportunity situation. Thus, the board will have to derive out of general common law the principles for determining which directors are, and which ones are not, to be considered qualified for this purpose. That question will usually not be difficult to resolve, but it is one that is not answered by the subchapter itself. For the corporate opportunity situation, therefore, the subchapter F procedure can be utilized, except for one missing component that in most cases can be readily supplied in the first instance by the board, and if challenged, ultimately determined by the court.**~~

Other situations

Many other kinds of situations can give rise to a clash of economic ~~**interest**~~ **interests** between a director and the corporation. For example, a director's personal financial interests can be impacted by a non—transactional policy decision of the board~~**—for example**~~**, 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**~~**, or** a flow of

ongoing business relationships between a director and ~~**his**~~**that director's** corporation may, without centering upon any discrete "transaction," raise questions of possible favoritism, unfair dealing, or undue influence. If a director ~~**wishes**~~**decides** to engage in business activity that directly competes with the corporation's own business, ~~**his**~~**the** economic interest in ~~**the**~~**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. ~~**Obvious interest clash**~~**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 non—transactional conflict situations should be brought to the board or shareholders for clearance, and the legal ~~**effects**~~**effect**, if any, of such clearance, are matters for development under the common law and lie outside the ambit of subchapter F. While these non—transactional situations are unaffected one way or the other by the provisions of subchapter F, a court may well recognize **that** the subchapter F procedures ~~**as**~~**provide** a useful analogy for dealing with such situations. Where similar procedures are followed ~~**in such situations**~~, the court may, in its discretion, accord to them ~~**the same or**~~**an effect** similar ~~**effect**~~ to that provided by subchapter F.

* * *

Note on Terms ***Used*** *in* ~~***Comments***~~***Comments***

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

§8.60 OFFICIAL COMMENT

The definitions set forth in section 8.60 apply **only** to subchapter F**'s** ~~**only**~~ **provisions** and**, except to the extent relevant to subchapter G,** have no application elsewhere in the Model Act.

~~**1. CONFLICTING INTEREST**~~

~~**The definition**~~ **(For the meaning and use** of ~~**conflicting interest requires that**~~**certain terms used below, such as "*D*," "*X* Co." and "*Y* Co.", see** the ~~**director know**~~**Note at the end** of the ~~**transaction. More than that, it requires that he know of his interest conflict at the time of the corporation's commitment to the transaction. Absent that knowledge by the director, the risk to the corporation addressed by subchapter F is not present. In a corporation of significant size, routine transactions in the ordinary course of business, involving decisionmaking at lower management levels, will usually not be known to the director and will thus be excluded by the "knowledge" criterion in the definition.**~~

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

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

~~*D* can have a conflicting interest in only three ways.~~

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

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

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

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

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

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

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

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

~~Any director will, of course, have countless relationships and linkages to persons and institutions other than those specified in subdivision (1)(ii) and those defined in subdivision (3) to be related persons. But, for the reasons~~

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

~~Subdivision (1)(ii) has a differentiated threshold keyed to the significance of the transaction. See the Official Comment to subdivision (2).It is to be noted that under subdivision (1) of Section 8.60, any interest that the director has that meets the criteria set forth is considered a "conflicting interest." If a director has an interest that meets those criteria,~~ subchapter F ~~draws no further distinction between a director's interest that clashes with the interests of the corporation and a director's interest that coincides with or is parallel to the interests of the corporation. If the director's "interest" is present, "conflict" is assumed.)~~

~~2.~~ **1.** DIRECTOR'S CONFLICTING INTEREST TRANSACTION

The definition of "director's conflicting interest transaction" in subdivision (~~2~~ **1**) is the ~~key~~**core** concept ~~of~~**underlying** subchapter F, ~~establishing~~**demarcating** the **transactional** area that lies within**—**and without**—**the scope of the subchapter's provisions. The definition operates preclusively~~;~~ **in that, as used in section 8.61,** it ~~not only designates the area within which the rules of subchapter F are to be applied but also~~ denies the power of ~~the~~**a** court ~~to act with respect~~**invalidate transactions or otherwise** to ~~conflict of interest claims against directors in circumstances~~**remedy conduct** that ~~lie~~**falls** outside the statutory definition of "director's conflicting interest transaction~~.~~" **solely on the ground that the director has a conflict of interest in the transaction.** ~~See section 8.61~~(**Nevertheless, as stated in the Introductory Comment, the transaction might be open to attack under rules of law concerning director misbehavior other than rules based solely on the existence of a conflict of interest transaction, as to which subchapter F is preclusive**).

~~*(1)*~~***a.*** **Transaction**

~~To constitute~~**For** a director's conflicting interest transaction **to arise**, there must first be a transaction **effected or proposed to be effected** by the corporation~~, its subsidiary,~~ or **an entity** controlled ~~entity~~**by the corporation to which the director or a related person is a party or** in which the director **or a related person** has a **material** financial interest. As discussed ~~earlier,~~**in** the ~~safe harbor~~ **Introductory Comment, the** provisions ~~provided by~~**of** subchapter F ~~have no application to circumstances in which~~**do not apply where** there is no "transaction" by the corporation~~, however apparent—~~**no matter how conflicting** the

director's ~~conflicting~~ interest **may be**. ~~Other strictures of the law prohibit~~**For example,** a ~~director from seizing~~ corporate ~~opportunities for himself~~**opportunity usurped by a director by definition does not involve a transaction by the corporation,** and ~~from competing against the corporation of which he~~**thus** is ~~a director;~~**not covered by** subchapter F ~~has no application to such situations~~**, even though it may be proscribed under fiduciary duty principles.** ~~Moreover, a director might personally benefit if the corporation takes no action, as where the corporation decides not to make a bid. Subchapter F has no application to such instances. The limited thrust of the subchapter is to establish procedures which, if followed, immunize a corporate transaction and the interested director against the common law doctrine of voidability grounded on the director's conflicting interest. See the Introductory Comment for further discussion.~~

~~However, a policy decision and a transactional decision can blur and overlap. Assume *X* Co. operates a steel mini-mill that is running at a loss. A real estate developer offers to buy the land on which the mill is located and the *X* Co. board, having no other use for the land, accepts the offer. This corporate action can readily be characterized either as a transaction—the sale of the land or as a business policy decision—to go out of an unprofitable business. If *D* is a partner of the real estate developer, *D* has a stake in the sale transaction and subdivision (1)(i) and (1)(ii) and all of subchapter F apply. But what if *D*, having no such interest, is in the local trucking business and a predictable consequence of closing the local mini-mill is that *D* will benefit from a future increase in demand for hauling services to bring in steel from more distant supply sources. An intent of the words "in or so closely linked to the transaction" in subdivisions (1)(i) and (1)(ii) is to focus subchapter F on the transaction itself. *D*'s financial stake as a trucker in this situation lies not in the transaction, which is governed by subchapter F, but in the corporate business decision, which is not; accordingly, section 8.61(a) is inapplicable and imposes no bar to the court's discretion. Board action, though in compliance with section 8.62, will not, ipso facto, yield safe harbor protection for *D* or the transaction under section 8.61(b). The matter will be treated as provided in numbered paragraph 4 of the Introductory Comment.~~

~~As another feature of the key term "transaction," the text of subdivision (1) emphasizes that the term implies and is limited to action by the corporation itself. The language~~**Moreover, for purposes** of subchapter F ~~has no application one way~~**, "transaction" means (and requires) a bilateral (**or ~~the~~ **multilateral)** ~~other~~**arrangement** to ~~economic actions by~~**which** the ~~director in~~ **corporation or an entity controlled by the corporation is a party. Subchapter F does not apply to transactions to** which the corporation is not a party ~~or in which the corporation takes no action~~. Thus, a purchase **or sale** by the director of the corporation's shares on the open market or from **or to** a third party is not a "**director's conflicting interest** transaction" within the ~~scope~~**meaning** of subchapter F ~~and~~**because** the ~~subchapter~~**corporation** ~~does~~**is** not ~~govern an attack made on the propriety of such~~ a ~~share purchase~~**party to the transaction**.

~~**If the board of directors of *X* Co. decides to distribute "poison pill" rights in order to fend off a possible takeover, that occurrence does not constitute a "transaction" as contemplated by subchapter F. See the discussion in division 4 of the Introductory Comment as to the character of a "transaction." If, on the other hand, a board of directors commits the corporation to a "crown jewel" option granted to a third party, there would be a "transaction."**~~

~~**But as noted earlier, for the transaction to be covered by subchapter F, the director (or other person designated by Section 8.60(1)(ii) must have a beneficial interest respecting the transaction. Subchapter F would obviously govern such a crown jewel contract if a director was himself (or had a defined relationship to) the third party. But the fact that the crown jewel contract was in part motivated by the directors' desire to keep themselves on the board would not, taken alone, constitute a sufficiently direct interest in the transaction to bring it within subchapter F.**~~

~~*(2)*~~ ***b.*** ***Party to the transaction—the corporation***

~~**Transaction by what entity?**~~ In the usual case, the transaction ~~**in question**~~ would be **effected** by *X* Co. ~~**But**~~**Assume**, ~~**assume**~~**however**, that *X* Co. ~~**is**~~**controls** the ~~**controlling corporation**~~**vote for directors** of *S* Co. ~~**(i.e., it controls the vote for directors of *S* Co.).**~~ *D* wishes to sell a building ~~**he**~~***D*** owns to *X* Co. and *X* Co. is willing to buy it. As a business matter, it ~~**will often make**~~**makes** no difference to *X* Co. whether it takes the title ~~**itself**~~**directly** or ~~**places it with**~~**indirectly through** its subsidiary *S* Co. or ~~**another**~~**some other** entity that *X* Co. controls. The applicability of subchapter F ~~**cannot be allowed to**~~**does not** depend upon that formal distinction~~. **The**~~**, because the** subchapter ~~**therefore**~~ includes within its operative framework transactions by ~~**a subsidiary or**~~**entities** controlled ~~**entity of**~~**by** *X* Co. ~~**See**~~**Thus, subchapter F would apply to a sale of** the ~~**Note on parent companies and subsidiaries below**~~**building by *D* to *S* Co**.

~~(3)~~c. Party to the transaction—the director or **a related person**

~~**Subdivision (1)(i) and subdivision (1)(ii) differ as to the persons covered and as to the threshold of transactional significance. Subdivision (1)(i), addressed to *D* and related persons of *D*, includes as directors' conflicting interest transactions all transactions that meet the substantive criteria prescribed. By contrast, subdivision (1)(ii), addressed to transactions involving other designated persons, excludes from its coverage transactions that are not sufficiently significant to the corporation to warrant decision at the boardroom level.**~~

~~**As**~~

To constitute a ~~**generalization, the linkage between a director and a "related person" is closer than that between the director and those persons and entities specified in subdivision (1)(ii). Correspondingly, the threshold of conflicting interest under subdivision (1)(i) is lower than that set for subdivision (1)(ii). Thus, all routine transactions of *X* Co. are excluded from the definition of**~~ director's conflicting interest transaction ~~**unless they fall within subdivision (1)(i). If *Y* Co., a computer company**~~**, *D* must, at the relevant time, (i) be a party to the transaction, or (ii) know** of ~~**which**~~**the transaction and** *D* ~~**is**~~

~~also an outside director, sells office machinery to *X* Co., the transaction will not normally give rise to a conflicting interest for *D* from the perspective of either company since the transaction is a routine matter that would not come before either board. If, however, the transaction is of such significance to one of the two companies that it would come before the board of that company, then *D* has a conflicting~~**'s material financial** interest in ~~the transaction with respect to~~**it, or (iii) know** that ~~company~~**a related person of *D* was a party to the transaction or (iv) know that a related person of *D* has a material financial interest in the transaction. A material financial interest (as defined in subdivision (4)) is one that would reasonably be expected to influence the director's judgment if *D* were to participate in any vote by the directors (or by a committee thereof) taken on the authorization of the transaction.**

~~Implicit in subdivision (1)(ii) is a recognition that~~**Routine business transactions frequently occur between companies with overlapping directors. If** *X* Co. and *Y* Co.~~, particularly if large enterprises, are likely to~~ have routine, ~~perhaps~~ frequent~~,~~ business dealings ~~with each other as they buy and sell goods and services in the marketplace. The~~**whose** terms ~~of these dealings~~ are dictated by competitive market forces ~~and the transactions are conducted at personnel levels far below the board room~~**, then even if a director of *X* Co.** ~~The fact that *D*~~ has ~~some~~**a relevant** relationship with *Y* Co. ~~is not in itself sufficient reason to open these smaller scale impersonal business~~**, the** transactions ~~to challenge if not passed through~~**would almost always be defensible, regardless of approval by disinterested directors or shareholders, on** the ~~board in accordance with section 8.62 procedures~~**ground that they are "fair."** ~~It would be doubly impractical to do so twice where *X* Co. and *Y* Co. have~~**For example,** a common ~~director.~~

~~Subchapter F takes the practical position. The definition in subdivision (1)(ii) excludes most such transactions both by its "knowledge" requirement and by its higher threshold of economic significance. In almost all cases, any such transaction, if challenged, would be easily defensible as being "fair." In respect of day-to-day business dealings, the main practical risk of impropriety would be that a director having a conflicting interest might seek to exert inappropriate influence upon the interior operations of the enterprise, or might try to use his status as a director to pressure lower level employees to divert their business out of ordinary channels to his advantage. But a director's affirmative misconduct goes well beyond a claim that he has a conflicting interest, and judicial action against such improper behavior remains available. See also the Official Comment to section 8.62(b) regarding common directors.The absence of the significance threshold in subdivision (1)(i) does not impose an inappropriate burden on directors and related persons. The commonplace and oftentimes recurring~~ transaction ~~will~~**involves** ~~involve~~**a** purchase of the corporation's product line~~;~~ **by *Y* Co., or perhaps by *D* or a related person, at prices normally charged by the corporation. In such circumstances,** it ~~will~~ usually **will** not be difficult for *D* to show that the transaction was on ~~commercial~~**arms-length** terms and was fair~~, or indeed, that he had no~~

~~**knowledge of the transaction. As**~~**Even** a~~**result, these transactions do not invite harassing lawsuits against the director. A**~~ purchase by *D* of a product of *X* Co. at a usual "employee's discount," while technically assailable as a conflicting interest transaction, would customarily be viewed as ~~**"fair" to the corporation as**~~ a routine incident of the office of director~~**. For other transactions between**~~ **and, thus, "fair" to** the corporation ~~**and the director or those close to him, *D* can, and should, have the burden of establishing the fairness of the transaction if it is not passed upon by the arm's length review of qualified directors or the holders of qualified shares. If there are any reasons to believe that the terms of the transaction might be questioned as unfair to *X Co.*, *D* is well advised to pass the transaction through the safe harbor procedures of subchapter F.**~~

* * *

~~***Note on Parent Companies and Subsidiaries***~~

~~**If a subsidiary is wholly owned, there is no outside holder of shares of the subsidiary to be injured with respect to transactions between the two corporations.**~~

~~**Transactions between a parent corporation and a partially-owned subsidiary may raise the possibility of abuse of power by a majority shareholder to the disadvantage of a minority shareholder. Subchapter F has no relevance as to how a court should deal with that claim.**~~

~~**If there are not at least two outside directors of the subsidiary, the subsidiary and the board of directors must operate on the basis that any transaction between the subsidiary and the parent that reaches the significance threshold in subdivision (1)(ii) may, as a technical matter, be challengeable by a minority shareholder of the subsidiary on grounds that it is a director's conflicting interest transaction. In that case, the directors of the subsidiary will**~~

***D* can** have ~~**to establish the fairness of the transaction to the subsidiary. In practice, however, the case law has dealt with such claims under the rubric of the duties of a majority shareholder and that is, in reality, the better approach**~~**conflicting interest in only two ways**.~~**See the Official Comment to section 8.61(b)**~~

First, a conflicting interest can arise under either subdivision (1)(i) or (ii). * * * This will be the case if, under clause (i), the transaction is between *D* and *X* Co. A conflicting interest also will arise under clause (ii) if *D* is not a party to the transaction, but knows about it and knows that he or she has a material financial interest in it. The personal economic stake of the director must be in the transaction itself—that is, the director's gain must flow directly from the transaction. A remote gain (for example, a future reduction in tax rates in the local community) is not enough to give rise to a conflicting interest under subdivision (1)(ii).

Second, a conflicting interest for *D* can arise under subdivision (1)(iii) from the involvement in the transaction of a "related person" of *D* that is either a party to the transaction or has a "material financial interest" in it. "Related person" is defined in subdivision (5).

Circumstances may arise where a director could have a conflicting interest under more than one clause of subdivision (1). For example, if *Y* Co. is a party to or interested in the transaction with *X* Co. and *Y* Co. is a related person of *D*, the matter would be governed by subdivision (1)(iii), but *D* also may have a conflicting interest under subdivision (1)(ii) if *D*'s economic interest in *Y* Co. is sufficiently material and if the importance of the transaction to *Y* Co. is sufficiently material.

A director may have relationships and linkages to persons and institutions that are not specified in subdivision (1)(iii). Such relationships and linkages fall outside subchapter F because the categories of persons described in subdivision (1)(iii) constitute the exclusive universe for purposes of subchapter F. For example, in a challenged transaction between *X* Co. and *Y* Co., suppose the court confronts the argument that *D* also is a major creditor of *Y* Co. and that creditor status in *Y* Co. gives *D* a conflicting interest. The court should rule that *D*'s creditor status in *Y* Co. does not fit any category of subdivision (1); and therefore, the conflict of interest claim must be rejected by reason of section 8.61(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 subdivision (1)(ii) or, if it placed *D* in control of *Y* Co., it would fall under subdivision (1)(iii) (because *Y* Co. is a related person of *D* under subdivision (5)(iv)). To explore the example further, if *D* is also a shareholder of *Y* Co., but *D* does not have a material financial interest in the transaction and does not control *Y* Co., no director's conflicting interest transaction arises and the transaction cannot be challenged on conflict of interest grounds. To avoid any appearance of impropriety, *D*, nonetheless, should consider recusal from the other directors' deliberations and voting on the transaction between *X* Co. and *Y* Co.

It should be noted that any director's interest in a transaction that meets the criteria of section 8.60(1) is considered a "director's conflicting interest transaction." If the director's interest satisfies those criteria, subchapter F draws no distinction between a director's interest that clashes with the interests of the corporation and a director's interest that coincides with, or is parallel to, or even furthers the interests of the corporation. In any of these cases, if the director's "interest" is present, a "conflict" will exist.

2. CONTROL

The definition of "control" in subdivision (2) contains two independent clauses. The first clause addresses possession of the voting or other power, directly or indirectly, to elect or remove a majority of the members of an entity's governing body. That power can arise, for example, from articles of incorporation or a shareholders' agreement. The second clause addresses the circumstances where a person is (i) subject to a majority of the risk of loss from the entity's activities, or (ii) entitled to receive a majority of the entity's residual returns. The second clause of the definition includes, among other circumstances, complex financial structures that do not have voting interests

or a governing body in the traditional sense, such as special purpose entities. Although the definition of "control" operates independently of the accounting rules adopted by the U.S. accounting profession, it is consistent with the relevant generally accepted accounting principle (made effective in 2003) that governs when an entity must be included in consolidated financial statements.

3. RELEVANT TIME

The definition of director's conflicting interest transaction requires that, except where he or she is a party, the director know of the transaction. It also requires that where not a party, the director know of the transaction either at the time it is brought before the corporation's board of directors or, if it is not brought before the corporation's board of directors (or a committee thereof), at the time the corporation (or an entity controlled by the corporation) becomes legally bound to consummate the transaction. Where the director lacks such knowledge, the risk to the corporation that the director's judgment might be improperly influenced, or the risk of unfair dealing by the director, is not present. In a corporation of significant size, routine transactions in the ordinary course of business, which typically involve decision-making at lower management levels, normally will not be known to the director and, if that is the case, will be excluded from the "knowledge" requirement of the definition in subdivision (1)(ii) or (iii).

4. MATERIAL FINANCIAL INTEREST

The "interest" of a director or a related person in a transaction can be direct or indirect (*e.g.*, as an owner of an entity or a beneficiary of a trust or estate), but it must be financial for there to exist a "director's conflicting interest transaction." Thus, for example, an interest in a transaction between *X* Co. and a director's alma mater, or any other transaction involving *X* Co. and a party with which *D* might have emotional involvement but no financial interest, would not give rise to a director's conflicting interest transaction. Moreover, whether a financial interest is material does not turn on any assertion by the possibly interested director that the interest in question would not influence him or her 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 a reasonable director in similar circumstances would have been influenced by the financial interest when voting on the matter. Thus, the standard is objective, not subjective.

Under subdivision (1)(ii), at the relevant time a director must have knowledge of his or her financial interest in the transaction in addition to knowing about the transaction itself. As a practical matter, a director could not be influenced by a financial interest about which that director had no knowledge. For example, the possibly interested director might know about *X* Co.'s transaction with *Y* Co., but might not know that his or her money manager

recently established a significant position in *Y* Co. stock for the director's portfolio. In such circumstances, the transaction with *Y* Co. would not give the director a "material financial interest", notwithstanding the portfolio investment's significance. Analytically, if the director did not know about the *Y* Co. portfolio investment, it could not reasonably be expected to influence that director's judgment.

Similarly, under subdivision (1)(iii), a director must know about his or her related person's financial interest in the transaction for the matter to give rise to a "material financial interest" under subdivision (4). If there is such knowledge and "interest" (*i.e.*, the financial interest could be expected to influence the director's judgment), then the matter involves a director's conflicting interest transaction under subdivision (1).

~~3.~~ **5.** RELATED PERSON

~~Two subcategories~~**Six categories** of "related person" of the director are set out in subdivision (~~3~~**5**). These ~~subcategories~~**categories** are ~~specified~~**specific**, exclusive, and preemptive.

The first ~~subcategory is made up of~~**three categories involve** closely related family, or near-family, individuals~~, trusts, and estates~~ as specified in ~~clause~~ **clauses** (i) **through (iii)**. The ~~clause~~**clauses** ~~is~~**are** exclusive insofar as family relationships are concerned **and include adoptive relationships**. The references to a "spouse" ~~are intended to~~ include a common law spouse~~ or unrelated cohabitant~~. **Clause (iii) covers personal, as opposed to business, relationships; for example, clause (iii) does not cover a lessee.**

~~The second subcategory is made up of persons specified in clause (ii) to whom or which the director is linked in a fiduciary capacity as, for example, in his status as a trustee or administrator. (Note that~~**Regarding** the ~~definition~~**subcategories** of ~~"person"~~**persons described** in ~~the Model Act includes both individuals and entities. See section 1.40~~**clause** (~~16~~**v**)~~.) From~~ **from** the perspective of *X* Co., **certain of *D*'s relationships with other entities and** *D*'s fiduciary relationships are always a sensitive concern~~. A conscientious director may be able to control his own greed arising~~**, separate and apart** from **whether *D* has** a ~~conflicting personal~~**financial** interest~~. And he may resist~~ **in** the ~~temptation to assist his wife or child~~**transaction**. ~~But he can never~~ **Clause (v) reflects the policy judgment that *D* cannot** escape ~~his~~***D*'s** legal obligation to act in the best interests of another person for whom ~~he is~~***D* has such** a ~~trustee or other fiduciary~~**relationship and, accordingly, that such a relationship (without regard to any financial interest on *D*'s part) should cause the relevant entity to have "related person" status.**

The term "employer" as used in subdivision (5)(vi) is not separately defined but should be interpreted sensibly in light of the purpose of the subdivision. The relevant inquiry is whether *D*, because of an employment relationship with an employer who has a significant stake in the outcome of the transaction, is likely to be influenced to act in the interest of that employer rather than in the interest of *X* Co.

6. FAIR TO THE CORPORATION

The term "fair" accords with traditional language in the case law, but for purposes of subchapter F it also has a special meaning. The transaction, viewed as a whole, must have been beneficial to the corporation, in addition to satisfying the traditional "fair price" and "fair dealing" concepts. In determining whether the transaction was beneficial, the consideration and other terms of the transaction and the process (including the conflicted director's dealings with the corporation) are relevant, but whether the transaction advanced the corporation's commercial interests is to be viewed "as a whole."

In considering the "fairness" of the transaction, the court will be required to consider not only the market fairness of the terms of the deal—whether it is comparable to what might have been obtainable in an arm's length transaction—but also (as the board would have been required to do) whether the transaction was one that was reasonably likely to yield favorable results (or reduce detrimental results). Thus, if a manufacturing company that lacks sufficient working capital allocates some of its scarce funds to purchase a sailing yacht owned by one of its directors, it will not be easy to persuade the court that the transaction was "fair" in the sense that it was reasonably made to further the business interests of the corporation. The facts that the price paid for the yacht was a "fair" market price, and that the full measure of disclosures made by the director is beyond challenge, may still not be enough to defend and uphold the transaction.

a. Consideration and other terms of the transaction

The fairness of the consideration and other transaction terms are to be judged at the relevant time. The relevant inquiry is whether the consideration paid or received by the corporation or the benefit expected to be realized by the corporation was adequate in relation to the obligations assumed or received or other consideration provided by or to the corporation. If the issue in a transaction is the "fairness" of a price, "fair" is not to be taken to imply that there is one single "fair" price, all others being "unfair." It is settled law that a "fair" price is any price within a range that an unrelated party might have been willing to pay or willing to accept, as the case may be, for the relevant property, asset, service or commitment, following a normal arm's-length business negotiation. The same approach applies not only to gauging the fairness of price, but also to the fairness evaluation of any other key term of the deal.

Although the "fair" criterion used to assess the consideration under section 8.61(b)(3) is also a range rather than a point, the width of that range may be narrower than would be the case in an arm's-length transaction. For example, the quality and completeness of disclosures, if any, made by the interested director that bear upon the consideration in question are relevant in determining whether the consideration paid or received by the corporation, although otherwise commercially reasonable, was "fair" for purposes of section 8.61(b)(3).

b. Process of decision and the director's conduct

In some circumstances, the behavior of the director having the conflicting interest may affect the finding and content of "fairness." Fair dealing requires that the director make required disclosure (per subdivision (7)) at the relevant time (per subdivision (3)) even if the director plays no role in arranging or negotiating the terms of the transaction. One illustration of unfair dealing is the director's failure to disclose fully the director's interest or hidden defects known to the director regarding the transaction. Another illustration would be the exertion by the director of improper pressure upon the other directors or other parties that might be involved with the transaction. Whether a transaction can be successfully challenged by reason of deficient or improper conduct, notwithstanding the fairness of the economic terms, will turn on the court's evaluation of the conduct and its impact on the transaction.

~~4.~~ 7. REQUIRED DISCLOSURE

~~**Two separate elements**~~**A critically important element of subchapter F's safe harbor procedures is that those acting for the corporation be able to** make ~~**up the defined term**~~**an informed judgment. In view of this requirement, subdivision (7) defines** "required disclosure~~.~~" ~~**They are**~~ **to mean** disclosure of ~~**the existence of the conflicting interest and then disclosure of the material**~~**all** facts known to *D* about the subject of the transaction~~**. Subdivision (4) calls for disclosure**~~ **that a director free** of ~~**all facts known**~~**the conflicting interest would reasonably believe** to **be material to the decision whether to proceed with the transaction. For example, if** *D* ~~**about the subject of the transaction that an ordinarily prudent person would reasonably believe to be material to a judgment by the person acting for the corporation as to whether to proceed or not to proceed with the transaction. If a director**~~ knows that the land the corporation is ~~**buying**~~**proposing to buy** from ~~**him**~~***D*** is sinking into an abandoned coal mine, ~~**he**~~***D*** must disclose not only ~~**that he is the owner and that he has an**~~***D*'s** interest in the transaction but also that the land is subsiding~~**; as**~~**. As** a director of *X* Co.**,** ~~**he**~~***D*** may not invoke caveat emptor. ~~**But in**~~**On** the ~~**same circumstances the director is**~~**other hand, *D* does** not ~~**under**~~**have** ~~**an**~~**any** obligation to reveal the price ~~**he**~~**that *D*** paid for the property ten years ago, or **the fact** that ~~**he**~~***D*** inherited ~~**it**~~**the property**, ~~**since**~~**because** that information is not material to the ~~**corporation**~~**board**'s **evaluation of the property and its** business ~~**judgment as to**~~**decision** whether ~~**or not**~~ to proceed with the transaction. Further, while material facts ~~**that pertain to**~~**respecting** the subject of the transaction must be disclosed, ~~**a director**~~***D*** is not required to reveal personal or subjective information that bears upon ~~**his**~~***D*'s** negotiating position (such as, for example, ~~**his**~~***D*'s** urgent need for cash, or the lowest price ~~**he**~~***D*** would be willing to accept). This is true ~~**despite the fact that**~~**even though** such information would ~~**obviously**~~ be **highly** relevant to the corporation's ~~**decision making**~~**decisionmaking** in the sense that, if **the information were** known to the corporation, it could ~~**equip**~~**enable** the corporation to hold out for ~~**terms**~~ more favorable ~~**to it.**~~

~~**Underlying the definition of the twin components of "required disclosure" is the critically important provision contained in subdivision (1) that a basic**~~

~~**precondition for the existence of a "conflicting interest" is that the director *know* of the transaction and also that he *know* of the existence of his conflicting interest.**~~

~~**5.TIME OF COMMITMENTThe time of the commitment by the corporation (or its subsidiary or other controlled entity) to the transaction is defined in operational**~~ terms ~~**geared to change of economic position.**~~

§ ~~8.61.~~ 8.61 OFFICIAL COMMENT

Section 8.61 is the operational section of subchapter **F,** as it prescribes the judicial consequences of the other sections.

Speaking generally:

(i) If the ~~**procedure set forth in**~~ section 8.62 or ~~**in**~~ **section 8.63** ~~**is**~~**procedures are** complied with, or if **it is established that at** the **relevant time a director's conflicting interest** transaction ~~**is**~~**was** fair to the corporation, then a director's conflicting interest transaction is immune from attack on ~~**any**~~**the** ground of ~~**a personal interest or conflict of**~~**an** interest of the director. However, the narrow scope of subchapter F must again be strongly emphasized; if the transaction is vulnerable to attack on some other ground, **observance of** subchapter F**'s procedures** does not make it less so ~~**for having been passed through the procedures of subchapter F. See, however, numbered paragraph 4 of the Introductory Comment.**~~

(ii) If a transaction is not a director's conflicting interest transaction**,** as defined in section ~~**8.60,**~~**8.60(1),** then the transaction may not be ~~**enjoined, rescinded,**~~**the subject of equitable relief** or **give rise to an award of damages or be** made the basis of other sanction on the ground of ~~***a conflict of***~~**an** interest of a director, **regardless of** whether ~~***or not it went through***~~ the ~~***procedures of subchapter F.***~~**transaction was approved under section 8.62 or 8.63.** In that sense, subchapter F is specifically intended to be both comprehensive and exclusive.

(iii) If a **director's conflicting interest** transaction that ~~**is a director's conflicting interest transaction**~~ was not at any time the subject of action taken in compliance with section 8.62 or section ~~**8.63, and it**~~**8.63** is ~~**attacked**~~ **challenged** on grounds of ~~**a**~~**the director's conflicting interest, and is not shown to be fair to the corporation, then the court may** ~~**grant**~~**take** such remedial action as it considers appropriate under the applicable law of the jurisdiction. ~~**If the attack is on other grounds, subchapter F has no relevance to the issue(s) before the court.**~~

1. Section 8.61(a)

~~**Section**~~ **As previously noted, section** 8.61(a) ~~**is**~~**makes clear that** a ~~**key component in the design of subchapter F. It draws**~~**transaction between** a ~~**bright-line circle, declaring that the definitions of section 8.60 wholly occupy**~~**corporation** and ~~**preempt the field of directors' conflicting interest transactions. Of course, outside this circle there is a penumbra of director interests, desires, goals, loyalties, and prejudices that may, in a particular context, run at odds with the best interests of the corporation, but section 8.61(a) forbids a**~~

court to ground remedial action on any of them. If a plaintiff charges that a director had a conflict of interest with respect to a transaction of the corporation because the other party was his cousin, the answer of the court shouldanother person cannot be: "No. A cousin the subject of equitable relief, as such and without more, is not included in section 8.60(3) as a related person—and under section 8.61(a), I have no authority to reach out farther." If a plaintiff contends that the director had a conflict of interest in a corporate transaction because the other party is president of the golf club the director wants desperately to join, the court should respond: "No. The only director's conflicting interest on the basis of which I can set aside a corporate transaction or imposegive rise to an award of damages or other sanctions isagainst a financialdirector, on the ground that the director has an interest as definedrespecting the transaction, unless the transaction falls within the bright-line definition of "director's conflicting interest transaction" in section 8.60." The reason why subchapter F adopts this bright-line approach 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 reviewedmade with a relative of a director who is not one of the relatives specified in section 8.60(5), or on the ground of an alleged interest other than a material financial interest, such as a financial interest of the director that is not material, as defined in section 8.60(4), or a nonfinancial interest. (As noted in the Introductory Comment, however, subchapter F does not apply to, and therefore does not preclude, a challenge to such a transaction based on grounds other than the director's interest.)

In the real world, however, matters are often not clear, and one cannot always predict with comfort a future judicial responseIf there is reason to believe that the fairness of a transaction involving *D* could be questioned, *D* is well advised to subject the transaction to the safe harbor procedures of subchapter F. It must be expected that quite oftenSometimes, a director (and his legal/business advisors) may be in doubt as touncertain whether a particular person would or would not be held to fall within a subcategory in section 8.60(3)related person category, or whether the economic impact on the director will be considered "in or closely linked" to the transaction, or whether the director is an "agent" or "employee," or whether the scale of the director'sfinancial interest is large enough to be likely to sway him if brought to a vote. Some directors will wish, too, to make it clear that they are leaning over backwards.material as defined in Section 8.60. In such circumstances, the obvious avenue to follow is to clear the matter with qualified directors under section 8.62 or with the holders of qualified shares under section 8.63. If it is later judicially determined that a conflicting interest ofin the directorchallenged transaction did exist, the director will be grateful for thehave safe harbor protection. If it should be ultimately held that there was no conflicting interest in the transaction as defined by subchapter F, no harm (other than nuisance) has been done by passing the transaction through the procedures of section

~~**8.62 or section 8.63.**~~ It may be expected, therefore, that the procedures of section 8.62 (and, to a lesser extent, section 8.63) will **probably** be used ~~**with regard to**~~**for** many transactions that **may** lie outside the sharp definitions of section 8.60—a result that is healthy and constructive.

~~**Once again, it**~~**It** is important to stress that subchapter F deals only with "transactions." If a non-transactional corporate decision is challenged on the ground that *D* has a conflicting personal stake in it, subsection 8.61(a) is irrelevant. ~~**For a discussion of corporate action that may be considered either a business decision or a transaction, see the Official Comment to section 8.60(1)(ii) and numbered paragraph 4 of the Introductory Comment.**~~

3. ~~2.~~ **Section 8.61(b)**

~~**Section 8.61(b) is the heart of subchapter F—the fundamental section that provides for the safe harbor.**~~

Clause (1) of subsection (b) provides that if a director has a conflicting interest respecting a transaction, neither the transaction nor the director is legally vulnerable on the ground of the director's conflict if the procedures of section 8.62 have been properly followed. ~~**Subsection (b)(1) is, however, subject to a critically important predicate condition.**~~

~~**The condition—an obvious one—is that the board's action must comply with the care, best interests and good faith criteria prescribed in section 8.30(a) for all directors' actions. If the directors who voted for the conflicting interest transaction were qualified directors under subchapter F, but approved the transaction merely as an accommodation to the director with the conflicting interest, going through the motions of board action without complying with the requirements of section 8.30(a), the action of the board would not be given effect for purposes of section 8.61(b)(1).**~~

~~**Board action on a director's conflicting interest transaction provides a context in which the function of the "best interests of the corporation" language in section 8.30(a) is brought into clear focus. Consider, for example, a situation in which it is established that the board of a manufacturing corporation approved a cash loan to a director where the duration, security and interest terms of the loan were at prevailing commercial rates, but (i) the loan was not made in the course of the corporation's ordinary business and (ii) the loan required a commitment of limited working capital that would otherwise have been used in furtherance of the corporation's business activities. Such a loan transaction would not be afforded safe harbor protection by section 8.62(b)(1) since the board did not comply with the requirements in section 8.30(a) that the board's action be, in its reasonable judgment, in the best interests of the corporation—that is, that the action will, as the board judges the circumstances at hand, yield favorable results (or reduce detrimental results) as judged from the perspective of furthering the corporation's business activities.**~~

~~**If a determination is made that the terms of a director's conflicting interest transaction, judged according to the circumstances at the time of commitment, were manifestly unfavorable to the corporation, that determination**~~

would be relevant to an allegation that the directors' action was not taken in good faith and therefore did not comply with section 8.30(a).The Model Act does not undertake to prescribe litigation procedures. If board action under section 8.62(b)(1) is interposed as a bar to a challenge to a director's conflicting interest transaction and the complainant wishes to putdefense in issue an alleged non-compliance with section 8.30(a) by the board, he would do so by proceeding under the same local pleadingchallenging a director's conflicting interest transaction, presumption andthe plaintiff then bears the burden of proof rulesovercoming that would govern any other attack on an action of a board of directors.defense under section 8.31.

Challenges to that board action may be based on a failure to meet the specific requirements of section 8.62 or to conform with general standards of director conduct. For example, a challenge addressed to section 8.62 compliance might question whether the acting directors were "qualified directors" or might dispute the quality and completeness of the disclosures made by *D* to the qualified directors. If such a challenge is successful, the board action is ineffective for purposes of subsection (b)(1) and both *D* and the transaction may be subject to the full range of remedies that might apply, absent the safe harbor, unless the fairness of the transaction can be established under subsection (b)(3). The fact that a transaction has been nominally passed through safe harbor procedures does not preclude a subsequent challenge based on any failure to meet the requirements of section 8.62. Recognizing the importance of traditional corporate procedures where the economic interests of a fellow director are concerned, a challenge to the effectiveness of board action for purposes of subsection (b)(1) might also assert that, while the interested director's conduct in connection with the process of approval by qualified directors may have been consistent with the statute's expectations, the qualified directors dealing with the matter did not act in good faith or on reasonable inquiry. The kind of relief that may be appropriate when qualified directors have approved a transaction but have not acted in good faith or have failed to become reasonably informed—and, again, where the fairness of the transaction has not been established under subsection (b)(3)—will depend heavily on the facts of the individual case; therefore, it must be largely a matter of sound judicial discretion.

Clause (2) of subsection (b) regarding shareholders' approval of the transaction is the matching piece to clause (1) regarding directors' approval **approval.**

The language "at any time" in clauses (1) and (2) of subsection (b) permits the directors or the shareholders to ratify a director's conflicting interest transaction after the fact for purposes of subchapter F. However, good corporate practice is to obtain appropriate approval prior to consummation of a director's conflicting interest transaction.

Clause (3) of subsection (b) provides that a director's conflicting interest transaction will be secure against judicial intervention if the interested director (or theimposition of legal or equitable corporation,relief if it chooses)is showsestablished that, although neither directors' nor shareholders' action was

taken ~~complying~~**in compliance** with ~~sections~~**section** 8.62 or 8.63, the transaction was fair to the corporation. ~~The term "fair" accords with traditional language in the cases. But it must be understood that, as used in~~ **within** the ~~context of those cases and of subchapter F, the term has a special, flexible~~ meaning ~~and a wide embrace~~**of section 8.60(6)**. **Under section 8.61(b)(3) the interested director has the burden of establishing that the transaction was fair.**

* * *

~~Note on Fair Transactions~~

~~(1) *Terms of the Transaction*. If the issue in a transaction is the "fairness" of a price, "fair" is not to be taken to imply that there is a single "fair" price, all others being "unfair." It has long been settled that a "fair" price is any price in that broad range which an unrelated party might have been willing to pay or willing to accept, as the case may be, for the property, following a normal arm's-length business negotiation, in the light of the knowledge that would have been reasonably acquired in the course of such negotiations, any result within that range being "fair." The same statement applies not only to price but to any other key term of the deal.~~

~~Although the "fair" criterion applied by the court is a range rather than a point, the width of that range is only a segment of the full spectrum of the directors' discretion associated with the exercise of business judgment under section 8.30(a). That is to say, the scope of decisional discretion that a court would have allowed to the directors if they had acted and had complied with section 8.30(a) is wider than the range of "fairness" contemplated for judicial determination where section 8.61(b)(3) is the governing provision.~~

~~(2) *Benefit to the Corporation*. In considering the "fairness" of the transaction, the court will in addition be required to consider not only the market fairness of the terms of the deal, but also, as the board would have been required to do, whether the transaction was one that was reasonably likely to yield favorable results (or reduce detrimental results) from the perspective of furthering the corporation's business activities. Thus, if a manufacturing company that is short of working capital allocates some of its scarce funds to purchase a sailing yacht owned by one of its directors, it will not be easy to persuade the court that the transaction is "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 stipulated to be a "fair" market price will not be enough alone to uphold the transaction. See also the discussion above regarding section 8.30(a).~~

~~(3) *Process of Decision*. In some circumstances, the behavior of the director having the conflicting interest can itself affect the finding and content of "fairness." The most obvious illustration of unfair dealing arises out of the director's failure to disclose fully his interest or hidden defects known to him regarding the transaction. Another illustration could be the exertion of improper pressure by the director upon the other directors. When the facts of such unfair dealing become known, the court should offer the corporation~~

~~its option as to whether to rescind the transaction on grounds of "unfairness" even if it appears that the terms were "fair" by market standards and the corporation profited from it. If the corporation decides not to rescind the transaction because of business advantages accruing to the corporation from it, the court may still find in the director's misconduct a basis for judicially imposed sanction against the director personally. Thus, the course of dealing—or process—is a key component to a "fairness" determination under subsection (b)(3).~~

* * *

Note on ~~Director~~**Directors**'~~s~~ Compensation

Directors' fees and ~~similar~~**other** forms of **director** compensation~~, expense reimbursement practices, directors' and officers' liability insurance and routine incidents of office (such as a privilege to buy the corporation's products at a discount) in the normal course of business~~ are typically set by the board and are specially authorized (though not regulated) by sections 8.11 and 8.57 of the Model Act. ~~These practices obviously involve a conflicting interest on the part of most if not all of the directors and are capable of being abused, although,~~**Although** in the usual case~~, they~~ **a corporation's directors' compensation practices** fall within ~~normative~~**normal** patterns and **their** fairness can be readily established**, they do involve a conflicting interest on the part of most if not all of the directors and, in a given case, may be abused**. ~~While~~**Therefore**, **while** as a matter of practical necessity~~,~~ these practices ~~are universally~~**will normally be generally** accepted in principle~~ by the law~~, **it must be kept in mind that** board action on directors' compensation and benefits would be subject to judicial sanction if **they are** not ~~in the circumstances fair to the corporation or~~ favorably acted upon by shareholders pursuant to section ~~8.63.~~**8.63 or if they are not in the circumstances fair to the corporation pursuant to section 8.61(b)(3).** ~~Sustainable action by the board in this regard must, of course, meet the general criteria for board action prescribed in Section 8.30(a); see the Official Comment to section 8.61(b).~~

* * *

~~Note on Directors' Personal Liability~~

~~At common law, articulation of the legal principles applicable to directors' conflicts of interest typically declare the transaction to be void or (sometimes) voidable. These formulations say little about the liabilities, if any, of the parties to the transaction. It is clear, however, that in some special circumstances a court would hold that the interested director must disgorge the profits he made from the transaction or must respond in damages for injury suffered by the corporation as a result of the transaction. Such sanctions could arise in contexts where the court leaves the transaction itself in place as well as in situations where the court rescinds the transaction. Subchapter F leaves these matters of sanction entirely to the judgment of the court.~~

~~In some situations, a transaction will contain an element of conflicting interest on the part of the director but in reality the director himself is a surrogate in the boardroom and not the real beneficiary of the transaction.~~

~~Thus, where *P* Co. is a majority or controlling shareholder in *X* Co., and some or all of the directors of *X* Co. are the employees or agents of *P* Co., there is always a risk that, in a transaction between *P* Co. and *X* Co., *P* Co. may take advantage of its position to press its agents and employees who are on the *X* Co. board to approve a transaction that is disadvantageous to *X* Co. but advantageous to *P* Co. Under Subchapter F, if *X* Co. has directors who are not affiliated with *P* Co., action pursuant to section 8.62 is possible. But many less-than-wholly-owned subsidiaries have no unaffiliated directors to pass on a transaction between *X* Co. and its controlling shareholder *P* Co. In such a circumstance, the minority shareholders of *X* Co. are entitled to fair treatment; if they are not treated fairly, the responsibility should, in most cases, be laid at the door of *P* Co. and not be placed upon *P* Co.'s agents or employees on the *X* Co. board.~~

~~As a matter of case law, the courts have arrived at that result by treating such cases under the rubric of the duty of fair dealing on the part of the controlling shareholder vis-a-vis the minority shareholders. In so doing, the courts have deliberately skipped over any analytically available alternative approach predicated on a theory of conflicting interest of the *X* Co. director who is an employee or agent of the controlling shareholder. All rights of minority shareholders against a controlling shareholder are preserved unaffected by subchapter F. All directors of *X* Co., regardless of their other affiliations, have duties to perform for the benefit of all *X* Co. shareholders, not just some of them. *D* is not relieved of those obligations merely because he happens to be an employee of the majority shareholder. At the same time, in these circumstances *D* often has little real discretion in voting to approve the transaction and the beneficiary of the transaction is not *D* but *P* Co., his employer.~~

~~In a transaction between *P* Co. and *X* Co., if the transaction is important to *X* Co., if *D* is an agent or employee of *P* Co., if the transaction is not protected by the procedures of section 8.62 or section 8.63, and if the transaction is not shown to be fair to *X* Co., then a court may well set aside the transaction or take other remedial action with regard to *P* Co., but it would not usually be equitable in such cases to hold *D* personally liable.~~

~~Parallels to this commonplace parent-subsidiary example can also arise under subchapter F out of almost any circumstance that meets the criteria of section 8.60(1)(ii). It is evident that a common director of *X* Co. and of *Y* Co. has a degree of conflicting interest in a transaction between the two corporations; but (assuming no valid safe harbor action under subchapter F) the sanction that would be appropriate would in most circumstances be addressed to the transaction itself and to one or both of the companies involved, rather than to *D* personally. See the Official Comment to section 8.60(2) and section 8.62(d).~~

§8.62 OFFICIAL COMMENT ~~(§8.62 DIRECTORS' ACTION)~~

Section 8.62 provides the procedure for action ~~of~~**by** the board of directors **or by a board committee** under subchapter F. In the normal course, this section,

~~**taken**~~ together with section 8.61(b), will be the key ~~**provision**~~**method** for ~~**dealing with**~~**addressing** directors' conflicting interest transactions.~~**All**~~ **Any** discussion of section 8.62 must be conducted in light of the overarching ~~**provisions of section 8.30(a) prescribing the criteria for decisions by**~~**requirements that** directors **act in good faith and on reasonable inquiry**. ~~**Board**~~**Director** action that does not comply with ~~**the**~~**those** requirements ~~**of**~~**, even if otherwise in compliance with** section ~~**8.30(a)**~~**8.62,** will **be subject to challenge and** not~~**, of course,**~~ be given effect under section 8.62. See the Official Comment to section 8.61 (b).

1. Section 8.62(a)

~~A~~The safe harbor for a transaction in which a director has a conflicting interest is ~~**approve**~~**deffective** under section 8.62 if and only if it is approved by qualified directors~~**, as**~~ **(a term that is** defined in subsection ~~**8.62**~~(d)**)**. Action by the board of directors ~~**as a whole**~~ is effective **for purposes of section 8.62** if **the transaction is** approved by the affirmative vote of a majority (but not less than two) of the qualified directors on the board. Action may also be taken by a duly authorized committee of the board but, **for the action** to be effective, all members of the committee must be qualified directors and the committee must either ~~**contain**~~**be composed of** all of the qualified directors on the board or must have been appointed by the affirmative vote of a majority of the qualified directors on the board. ~~**The effect of the limitation on**~~**This requirement for effective** committee action is **intended** to ~~**make it impossible to handpick**~~**preclude the appointment** as committee members **of** a favorably inclined minority from among **all** the qualified directors. Except to the limited extent ~~**provided**~~**found** in subsection (b), approval by the board or **a** committee must be preceded by required disclosure **followed by deliberation and voting outside the presence and without the participation of the conflicted director**.~~**Action**~~ **After the qualified directors have had the opportunity to question the conflicted director about the material facts, action** complying with subsection ~~**8.62**~~(a) may be taken ~~**by the board of directors**~~ at any time~~,~~ before or after the **completion of the** transaction~~,~~ **becomes a legal obligation. A written record of the qualified directors' deliberation** and ~~**may deal with a single transaction or a specified category of similar transactions**~~**action is strongly encouraged**.

2. Section 8.62(b)

Subsection (b) is a ~~**new**~~**special** provision designed to ~~**deal**~~**accommodate**, in a practical way, ~~**with**~~ situations ~~**in which**~~**where** a director who has a conflicting interest is not able to comply fully with the disclosure requirement of subsection (a) because of an extrinsic duty of confidentiality. The director may, for example, be prohibited from making full disclosure because of **legal** restrictions ~~**of law**~~ that happen to apply to the transaction (*e.g.*, grand jury seal or national security statute) or professional canon (*e.g.* ~~**lawyers' or doctors' ,**~~ **attorney-**client privilege). The most frequent use of subsection (b), however, will ~~**undoubtedly be in connection with**~~**likely involve** common directors who find themselves in a position of dual fiduciary obligations that clash. If *D* is also a director of *Y Co., D* may have acquired privileged confidential information from one or both ~~**sources**~~**di-**

rectorships relevant to a transaction between *X Co.* and *Y Co.***,** that ~~he~~**D** cannot reveal to one without violating ~~his~~**a** fiduciary duty **owed** to the other. In such circumstances, subsection (b) ~~makes it possible for such a matter~~**enables the conflicting interest** to be ~~brought to the board~~**presented** for consideration under subsection (a)**,** and ~~thus~~**thereby** ~~enable~~**enables** *X Co.*~~,~~ **(and *Y Co.*) and *D*** to secure **for the transaction** the protection afforded by subchapter F ~~for the transaction despite the fact that~~**even though** *D* cannot**, by reason of applicable law, confidentiality strictures or a professional ethics rule,** make the full disclosure ~~usually~~**otherwise** required.

To comply with subsection (b), *D* must disclose ~~that he has a~~**the** conflicting interest **and all information required to be disclosed that does not violate the duty not to disclose, as the case may be, to which *D* is subject**, inform the **qualified** directors who **are to** vote on the transaction of the nature of ~~his~~**the** duty **or obligation** of confidentiality (*e.g.*, ~~inform them~~ that ~~it~~**the duty** arises out of an attorney-client privilege or ~~his~~**out of a** duty as a director of *Y Co.* that prevents ~~him~~***D*** from making ~~the~~**required** disclosure ~~called for~~**as otherwise mandated by clause (ii) of section 8.60(47)**)~~,~~**.** ***D*** ~~and~~**must** then play no personal ~~part~~**role** in the board's **(or committee's) ultimate** deliberations **or action**. The ~~point~~**purpose** of subsection (b) is ~~simply~~ to make **it** clear that the provisions of subchapter F may be employed ~~with regard~~ to **"safe harbor"** a transaction in circumstances where an interested director cannot, because of enforced fiduciary silence, ~~make disclosure of~~**disclose all** the ~~facts~~ known ~~to him~~**facts**.[1] Of course, if *D* invokes subsection (b) and ~~then remains silent~~**does not make required disclosure** before leaving the boardroom, the ~~remaining~~**qualified** directors may decline to act on the transaction ~~if troubled by a~~**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, ~~he~~***D*** would normally ~~so~~ state **just that** and ~~disregard~~ subsection (b)~~, and (having~~ **would be irrelevant. Having** disclosed the existence and nature of ~~his~~**the** conflicting interest~~)~~**, D would** thereby comply with section 8.60(47).

While subchapter F explicitly contemplates ~~the application of~~**that** subsection (b) **will apply** to the frequently ~~recurrent problem of~~**recurring situation where transacting corporations have** common directors ~~and officers~~**(or where a director of one party is an officer of the other)**, ~~it~~**that subsection**, should not otherwise be read as attempting to ~~define~~**address** the scope**,** or mandate the consequences**,** ~~or~~**of** various silence-privileges~~; that~~**. That** is a topic **reserved** for local law.

[1] A director could, ~~or~~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~~**can arise in situations other than** transactions involving a conflicting interest of a director. It could ~~easily~~ happen that at the same board meeting of *X Co.* at which *D*~~, the interested director,~~ invokes §8.62(b) ~~and excuses himself~~, another director who has absolutely no financial interest in the transaction might conclude that under local law he **or she** is bound to silence (because of attorney-client privilege, for example) and ~~would~~ under general principles of sound director conduct **would** withdraw from participation in the board's deliberations and action.

Subsection (b) is ~~**not**~~ available ~~**to *D* if the transaction is directly between the corporation and *D* or his related person—if, that is, the director or a related person is a party to the transaction. If**~~ *D* ~~or~~**if a transaction is a director's conflicting interest transaction only because** a related person **described in section 8.60(5)(v) or (vi)** is a party to **or has a material financial interest in the transaction. Its availability is so limited because in those instances a director owes a fiduciary duty to such a related person. If *D* or a related person of *D* other than a related person described in section 8.60(5)(v) or (vi) is a party to or has a material financial interest in** the transaction, *D*'s only options are **satisfying the** required disclosure **obligation** on an ~~**unqualified**~~**unrestricted** basis, ~~**abandonment**~~**abandoning** of the transaction, or ~~**acceptance of**~~**accepting** the risk of establishing fairness in a court proceeding**, under section 8.61(b)(3),** if the transaction is challenged.

Whenever ~~*D*~~**an interested director** proceeds ~~as~~**in the manner** provided in subsection ~~8.62~~(b), the ~~**board**~~**other directors** should recognize that ~~he~~**the interested director** may ~~**well**~~ have information that in usual circumstances ~~**he**~~***D*** would be required to reveal to the ~~**board**~~**—qualified directors who are acting on the transaction—**information that ~~**may could well indicate that the transaction is a**~~**would be either** favorable or unfavorable ~~**one**~~ for *X Co.*

~~3. SECTION 8.62(c)~~

~~**Subsection (c) contains technical provisions dealing with quorum and superfluous votes by interested directors.**~~

~~4.~~3. SECTION 8.62(d)

Obviously, a director's conflicting interest transaction and *D* cannot be provided safe harbor protection by fellow directors who themselves have conflicting interests; only "qualified directors" can ~~**provide such safe harbor protection pursuant to**~~**do so under** subsection (a). "Qualified director" is defined in subsection (d). The definition is **of a limiting character and its exclusions are** broad. ~~It~~**The definition** excludes not only ~~**any**~~**a** director who has a conflicting interest respecting the matter, but also—going significantly beyond the persons specified ~~in the **subcategories**~~**categories** of section 8.60(~~1)(ii~~**5**) for purposes of the "~~**conflicting**~~**related** ~~**interest**~~**person**" definition—any director whose familial or financial ~~**relationship**~~**connection** with *D* or whose employment or professional relationship with *D* would be likely to influence the director's vote on the transaction. The determination of whether there is a **familial,** financial, employment or professional relationship should be based on the practicalities of the situation rather than formalistic circumstances. For example, a director employed by a corporation controlled by *D* should be regarded as having an employment relationship with *D*.

4. SECTION 8.62(e)

This subsection underscores that the directors' voting procedures and requirements set forth in subsections (a) through (d) treat only the director's conflicting interest. A transaction that receives a directors' vote that complies with subchapter F may well fail to achieve a different vote or quorum that

may be required for substantive approval of the transaction under other applicable statutory provisions or provisions contained in *X Co*.'s articles of incorporation or bylaws, and vice versa. Thus, in any case where the quorum and/or voting requirements for substantive approval of a transaction differ from the quorum and/or voting requirements for "safe harbor" protection under section 8.62, 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 OFFICIAL COMMENT~~(§8.63 SHAREHOLDERS' ACTION)~~

Section 8.63 provides the machinery for shareholders' **action that confers** safe harbor ~~of~~**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 ~~by action of directors~~**protection for such a transaction**.

1. SECTION 8.63(a)

Subsection (a) specifies the procedure required to ~~establish~~**confer** effective safe harbor protection ~~of~~**for** a director's conflicting interest transaction through **a** vote of shareholders. In advance of the vote, three steps must be taken~~.~~**:** ~~Shareholders~~**(1) shareholders** must be given **timely and adequate** notice describing **the transaction; (2) *D* must disclose the information called for in subsection (b); and (3) disclosure must be made to the shareholders entitled to vote, as required by section 8.60(7). In the case of smaller closely-held corporations, this disclosure shall be presented by the director directly to the shareholders gathered at the meeting place where the vote is to be held, or provided in writing to the secretary of the corporation for transmittal with the notice of the meeting. In the case of larger publicly-held corporations where proxies are being solicited, the disclosure is to be made by the director to those responsible for preparing the proxy materials, for inclusion therein. If the holders of a majority of all qualified shares (as defined in subsection (b)) entitled to vote on the matter vote favorably, the safe harbor provision of section 8.61(b)(2) becomes effective. Action that complies with subsection (a) may be taken at any time, before or after the time when the corporation becomes legally obligated to complete** the transaction. ~~*D* must provide the information called for in subsection (d), discussed below. And required disclosure must be made, as defined in section 8.60(4). If, then, a majority of all qualified shares that are entitled to vote on the matter vote favorably, the safe harbor provision of section 8.61(b)(2) becomes effective.~~

~~Action that complies with subsection 8.63(a) may be taken at any time, before or after the transaction.~~

~~Note that section~~**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 ~~cannot be made~~**is not** available through shareholder action under section 8.63 in a case where *D* **either** remains silent **or makes less than required disclosure** because of an extrinsic duty of confidentiality. This **omission** is ~~advertent~~**intentional**. While ~~it is believed that~~ the section 8.62(b) procedure is

workable in the collegial setting of the boardroom, ~~**have reservations whether**~~ **that is far less likely in** the ~~**same is true vis-a-vis**~~**case of action by** the shareholder body, especially in ~~**larger**~~**large** corporations where there is heavy reliance upon the proxy mechanic. ~~**In**~~**Unlike the dynamic that would normally occur in the boardroom, in** most situations no opportunity exists for shareholders to quiz *D* about ~~**his**~~**the confidentiality** duty and to discuss the implications of acting without the **full** benefit of *D*'s knowledge ~~**concerning**~~**about** the **conflict** transaction. In a case ~~**involving**~~**of** a closely held corporation where section 8.63 procedures are followed, but with *D* acting ~~**as provided**~~ in **a way that would be permitted by** section 8.62(b), a court could~~**, of course,**~~ attach significance to a favorable shareholder vote in evaluating the fairness of the transaction to the corporation. ~~**See the discussion in numbered paragraph 4 of the Introductory Comment.**~~

2. Section 8.63(b)

~~**Under subsection (a), only "qualified shares" may be counted in the vote for purposes of safe harbor action pursuant to section 8.61(b)(2). Subsection (b) defines "qualified shares" to exclude all shares that, prior to the vote, the secretary or other tabulator of the votes *knows*** to be owned or controlled by the director who has the conflicting interest or any related person of that director. It should be stressed that this definition is dependent upon the tabulator's actual knowledge. If the tabulator does not know that certain shares are owned by the director who has the conflicting interest, he cannot be expected to exclude those shares from the vote count. But see the Official Comment to subsection (e).~~

~~**The category of persons whose shares are excluded from the vote count under subsection (b) is not the same as the category of persons specified in section 8.60(1)(ii) for purposes of defining *D's* "conflicting interest" and—*importantly*—is not the same as the category of persons excluded for purposes of the definition of non-qualified directors under section 8.62(d). The distinctions among these three categories are deliberate and carefully drawn.**~~

~~**The definition of "qualified shares" excludes shares owned by *D* or a related person as defined in section 8.60(3). If *D* is an employee or director of *Y* Co., *Y* Co. is *not* prevented by that fact from exercising its usual voting rights as to any shares it may hold in *X* Co. *D's* linkage to a related person is close. But the net of section 8.60(1)(ii) specifying other persons and entities for purposes of the "conflicting interest" definition is cast so wide that *D* will never be able to know whether, nor have a reason to try to monitor whether, some person within those subcategories holds *X* Co. shares. Typically, moreover, *D* will have no control over those persons and how they vote their *X* Co. shares. There is, in reality, no reason to strip those persons of their voting rights as shareholders, for in the usual commercial situation they will vote in accordance with their own interests, which may well not coincide with the personal interest of *D*.**~~

~~**To illustrate the operation of subsection (b), consider a case in which *D* is also a director of *Y* Co., and to his knowledge: thirty percent of *Y* Co.'s stock is owned by *X* Co.: *D*, his wife, a trust of which *D* is the trustee, and**~~

~~a corporation he controls, together own ten percent of *X* Co.'s stock but not stock of *Y* Co.; and *X* Co. and *Y* Co. wish to enter into a transaction that is of major significance to both.~~

~~From the perspective of *X* Co., *D* has a conflicting interest since he is a director of *Y* Co. If *X* Co. submits the transaction to a vote of its shareholders under section 8.63, the shares held by *D*, his wife, the trust of which he is the trustee, and the corporation he controls are not qualified shares and may not be counted in the vote.~~

~~From the perspective of *Y* Co., *D* has a conflicting interest since he is a director of *X* Co. If *Y* Co. submits the transaction to a vote of its shareholders under section 8.63, the thirty percent of *Y* Co. shares held by *X* Co. *are* qualified shares and may be counted for purposes of section 8.63. The same would be equally true if *X* Co. were the majority shareholder of *Y* Co., but as emphasized elsewhere, the vote under section 8.63 has not effect whatever of exonerating or protecting *X* Co. if *X* Co. fails to meet any legal obligation that, as the majority shareholder of *Y* Co., it may owe to the minority shareholders of *Y* Co.~~

~~3. Section 8.63(c)~~

~~Subsection (c) contains administratively useful quorum provisions and provides that superfluous voting of shares that were not qualified to vote does not vitiate the effectiveness of the vote. But see subsection (e).~~

~~The fact that certain shares are not qualified and are not countable for purposes of subsection (a) says nothing as to whether they are property countable for other purposes such as, for example, a statutory requirement that a certain fraction of the total vote or a special majority vote be obtained.~~

~~4. Section 8.63(d)~~

In ~~most~~**many** circumstances, the secretary **or other vote tabulator** of *X Co.* will have no way to know ~~whether certain~~**which** of *X Co.'s* outstanding shares should be excluded from the ~~teller's count because of the identity of the owners or of those persons who control the voting of the shares~~**tabulation**. Subsection (~~a~~**b**) **(**together with subsection (~~d~~**c**)) therefore ~~impose on~~**obligates** a director who has a conflicting interest respecting the transaction, as a prerequisite to safe harbor protection by shareholder ~~vote~~**action**, ~~the obligation~~ to inform the secretary, or other officer or agent authorized to tabulate votes, of the number and holders of shares known ~~by him~~ to be ~~owned~~**held by** ~~him~~**the director** or by a related person **described in clauses (i) through (v)** of ~~his~~**section 8.60(5)**. ~~Thus, a director who has a conflicting interest respecting the transaction, because he stands to make a commission from it, is obligated to report shares owned or the vote of which is controlled by him and by all related persons of his; a director who has a conflicting interest respecting the transaction because his brother stands to make a commission from it has the same reporting obligation. The tabulator may also, of course, have other independent knowledge of shares that are owned or controlled by a related person of the director.~~

If the tabulator of votes knows, **or is notified under subsection (b),** that particular shares should be excluded but **for some reason** fails to exclude them from the count and their inclusion in the vote does not affect its outcome, ~~**subsection (c) governs and the**~~ shareholders' vote **s standswill stand**. If the improper inclusion determines the outcome, the shareholders' vote fails ~~**to**~~**because it does not** comply with subsection (a). ~~**If**~~**But see subsection (e) as to cases where** the ~~**tabulator *does***~~**notification under subsection (b) is defective but** not ~~***know* that certain shares are owned**~~**determinative of the outcome of the vote.**

3. Section 8.63(c)

Under subsection (a), only "qualified shares" may be counted in the vote for purposes of safe harbor action under section 8.61(b)(2). Subsection (b) defines "qualified shares" to exclude all shares that, before the vote, the secretary or ~~**controlled**~~**other tabulator of the vote knows, or is notified under subsection (b), are held** by the director who has the conflicting interest ~~**or a related person of his, the shares are "qualified" pursuant to the definition in subsection (b), and the vote cannot be attacked on**~~**or by any specified related person of** that ~~**ground for failure to comply with subsection (a); but see subsection (e)**~~**director**.

The definition of "qualified shares" excludes shares held by *D* or a "related person" as defined in the first five categories of section 8.60(5). That definition does not exclude shares held by entities or persons described in clause (vi) of section 8.60(5), i.e., a person that is, or is an entity that is controlled by, an employer of *D*. If *D* is an employee of *Y Co*., that fact does not prevent *Y Co*. from exercising its usual rights to vote any shares it may hold in *X Co*. *D* may be unaware of, and would not necessarily monitor, whether his or her employer holds *X Co*. shares. Moreover, *D* will typically have no control over his or her employer and how it may vote its *X Co*. shares.

~~5.~~ 4. Section 8.63(e)

If *D* did not provide the information required under subsection (d), on ~~**the**~~**its** face ~~**of it**~~**the** shareholders' action is not in compliance with subsection (a) and *D* has no safe harbor under subsection (a). In the absence of ~~**such**~~**that** safe harbor**,** *D* can be put to the ~~**challenge**~~**burden** of establishing the fairness of the transaction under section 8.61(b)(3).

That result is ~~**the**~~ proper ~~**one**~~ 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 ~~**of the vote**~~. But if *D's* omission was essentially an act of negligence, if the number of unreported shares ~~**was**~~**if voted would** not **have been** determinative of the outcome of the vote, and if the omission was not motivated by *D's* effort to influence the integrity of the voting process, **then** the court should be free to fashion an appropriate response to the situation in ~~**the**~~ light of all the considerations at the time of ~~**trial**~~**its decision**. The court should not**, in the circumstances,** be automatically forced by the mechanics of ~~**the**~~ subchapter **F** to a lengthy and retrospective trial on "fairness." Subsection (e) grants the court that discretion in those circumstances and permits it to accord such effect, if any, to

the shareholders' vote, or **to** grant such relief respecting the transaction or *D*, as the court may find appropriate.

Despite the presumption of regularity customarily accorded the secretary's record, a plaintiff may go behind the secretary's record for ~~purpose~~**purposes** of subsection (e).

5. Section 8.63(f)

This subsection underscores that the shareholders' voting procedures and requirements set forth in subsections (a) through (e) treat only the director's conflicting interest. A transaction that receives a shareholders' vote that complies with subchapter F may well fail to achieve a different vote or quorum that may be required for substantive approval of the transaction under other applicable statutory provisions or provisions contained in *X Co*.'s articles of incorporation or bylaws, and vice versa. Thus, in any case where the quorum and/or voting requirements for substantive approval of a transaction differ from the quorum and/or voting requirements for "safe harbor" protection under section 8.63, the corporation may find it necessary to conduct (and record in the minutes of the proceedings) two separate shareholder votes—one for section 8.63 purposes and the other for substantive approval purposes (or, if appropriate, conduct two separate tabulations of one vote).

§8.60. SUBCHAPTER DEFINITIONS

In this subchapter:

(1) "Director's conflicting interest transaction" means a transaction effected or proposed to be effected by the corporation (or by an entity controlled by the corporation)
   (i) to which, at the relevant time, the director is a party; or
   (ii) respecting which, at the relevant time, the director had knowledge and a material financial interest known to the director; or
   (iii) respecting which, at the relevant time, the director knew that a related person was a party or had a material financial interest.

(2) "Control" (including the term "controlled by") means (i) having the power, directly or indirectly, to elect or remove a majority of the members of the board of directors or other governing body of an entity, whether through the ownership of voting shares or interests, by contract, or otherwise, or (ii) being subject to a majority of the risk of loss from the entity's activities or entitled to receive a majority of the entity's residual returns.

(3) "Relevant time" means (i) the time at which directors' action respecting the transaction is taken in compliance with section 8.62, or (ii) if the transaction is not brought before the board of directors of the corporation (or its committee) for action under section 8.62, at the time the corporation (or an entity controlled by the corporation) becomes legally obligated to consummate the transaction.

(4) "Material financial interest" means a financial interest in a transaction that would reasonably be expected to influence the director's judgment in any vote by the directors taken on the authorization of the transaction.

(5) "Related person" means:
   (i) the director's spouse;
   (ii) a child, stepchild, grandchild, parent, step parent, grandparent, sibling, step sibling, half sibling, aunt, uncle, niece or nephew (or spouse of any thereof) of the director or of the director's spouse;
   (iii) an individual living in the same home as the director;
   (iv) an entity (other than the corporation or an entity controlled by the corporation) controlled by the director or any person specified above in this subdivision (5);
   (v) a domestic or foreign (A) business or nonprofit corporation (other than the corporation or an entity controlled by the corporation) of which the director is a director, (B) unincorporated entity of which the director is a general partner or a member of the governing body, or (C) individual, trust or estate for whom or of which the director is a trustee, guardian, personal representative or like fiduciary; or
   (vi) a person that is, or an entity that is controlled by, an employer of the director.

(6) "Fair to the corporation" means, for purposes of section 8.61(b)(3), that the transaction as a whole was beneficial to the corporation, taking into

appropriate account whether it was (i) fair in terms of the director's dealings with the corporation, and (ii) comparable to what might have been obtainable in an arm's length transaction, given the consideration paid or received by the corporation.

(7) "Required disclosure" means disclosure of (i) the existence and nature of the director's conflicting interest, and (ii) all facts known to the director respecting the subject matter of the transaction that a director free of such conflicting interest would reasonably believe to be material in deciding whether to proceed with the transaction.

§ 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.

§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 is 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 to those qualified directors of information not already known by them, 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 of the conflicted director; and

(2) where the action is taken by a committee, all members of the committee are qualified directors, and either (i) the committee is composed of all the qualified directors on the board of directors or (ii) the members of the committee are appointed by the affirmative vote of a majority of the qualified directors on the board.

(b) Notwithstanding subsection (a), when a transaction is a director's conflicting interest transaction only because a related person described in clause (v) or clause (vi) of section 8.60(5) is a party to or has a material financial interest in the transaction, the conflicted director is not obligated to make required disclosure to the extent that the director reasonably believes that doing so would violate a duty imposed under law, a legally enforceable obligation of confidentiality, or a professional ethics rule, provided that the conflicted director discloses to the qualified directors voting on the transaction:
   (1) all information required to be disclosed that is not so violative,
   (2) the existence and nature of the director's conflicting interest, and
   (3) the nature of the conflicted director's duty not to disclose the confidential information.

(c) A majority (but no fewer than two) of all the qualified directors on the board of directors, or on the committee, constitutes a quorum for purposes of action that complies with this section.

(d) For purposes of this section, "qualified director" means, with respect to a director's conflicting interest transaction, any director who does not have either:
   (1) a conflicting interest respecting the transaction or
   (2) a familial, financial, professional, or employment relationship with another director who does have a conflicting interest respecting the transaction, where that relationship would reasonably be expected to influence the first director's judgment in any vote taken on the authorization of the transaction.

(e) Where directors' action under this section does not satisfy a quorum or voting requirement applicable to the authorization of the transaction by reason of the articles of incorporation, the bylaws or a provision of law, independent action to satisfy those authorization requirements must be taken by the board of directors or a committee, in which action directors who are not qualified directors may participate.

§8.63. SHAREHOLDERS' ACTION

(a) Shareholders' action respecting a director's conflicting interest transaction is effective for purposes of section 8.61(b)(2) if a majority of the votes cast by the holders of all qualified shares are in favor of the transaction after (1) notice to shareholders describing the action to be taken respecting the transaction, (2) provision to the corporation of the information referred to in subsection (b), and (3) communication to the shareholders entitled to vote on the transaction of the information that is the subject of required disclosure, to the extent the information is not known by them.

(b) A director who has a conflicting interest respecting the transaction shall, before the shareholders' vote, inform the secretary or other officer or agent of the corporation authorized to tabulate votes, in writing, of the

number of shares that the director knows are not qualified shares under subsection (c), and the identity of the holders of those shares.

(c) For purposes of this section: (1) "holder" means and "held by" refers to shares held by both a record shareholder (as defined in section 13.01(7)) and a beneficial shareholder (as defined in section 13.01(2)); and (2) "qualified shares" means all shares entitled to be voted with respect to the transaction except for shares that the secretary or other officer or agent of the corporation authorized to tabulate votes either knows, or under subsection (b) is notified, are held by (A) a director who has a conflicting interest respecting the transaction or (B) a related person of the director (excluding a person described in clause (vi) of Section 8.60(5)).

(d) A majority of the votes entitled to be cast by the holders of all qualified shares constitutes a quorum for purposes of compliance with this section. Subject to the provisions of subsection (e), shareholders' action that otherwise complies with this section is not affected by the presence of holders, or by the voting, of shares that are not qualified shares.

(e) If a shareholders' vote does not comply with subsection (a) solely because of a director's failure to comply with subsection (b), and if the director establishes that the failure was not intended to influence and did not in fact determine the outcome of the vote, the court may take such action respecting the transaction and the director, and may give such effect, if any, to the shareholders' vote, as the court considers appropriate in the circumstances.

(f) Where shareholders' action under this section does not satisfy a quorum or voting requirement applicable to the authorization of the transaction by reason of the articles of incorporation, the bylaws or a provision of law, independent action to satisfy those authorization requirements must be taken by the shareholders, in which action shares that are not qualified shares may participate.

§8.60. SUBCHAPTER DEFINITIONS

In this subchapter:

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

~~**(i) whether or not the transaction is brought before the board of directors of the corporation for action, the director knows at the time of commitment that he or a related person is a party to the transaction or has a beneficial financial interest in or so closely linked to the transaction and of such financial significance to the director or a related person that the interest would**~~

~~**reasonably be expected to exert an influence on the director's judgment if he were called upon to vote on the transaction; or**~~

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

(~~2~~1) "Director's conflicting interest transaction" ~~**with respect to a corporation**~~ means a transaction effected or proposed to be effected by the corporation (or by ~~**a subsidiary of**~~**an entity controlled by** the corporation ~~**or any other entity in which the corporation has a controlling interest) respecting which a director of the corporation has a conflicting interest.**~~

(i) **to which, at the relevant time, the director is a party; or**

(ii) **respecting which, at the relevant time, the director had knowledge and a material financial interest known to the director; or**

(iii) **respecting which, at the relevant time, the director knew that a related person was a party or had a material financial interest.**

(2) **"Control" (including the term "controlled by") means (i) having the power, directly or indirectly, to elect or remove a majority of the members of the board of directors or other governing body of an entity, whether through the ownership of voting shares or interests, by contract, or otherwise, or (ii) being subject to a majority of the risk of loss from the entity's activities or entitled to receive a majority of the entity's residual returns.**

(3) **"Relevant time" means (i) the time at which directors' action respecting the transaction is taken in compliance with section 8.62, or (ii) if the transaction is not brought before the board of directors of the corporation (or its committee) for action under section 8.62, at the time the corporation (or an entity controlled by the corporation) becomes legally obligated to consummate the transaction.**

(4) **"Material financial interest" means a financial interest in a transaction that would reasonably be expected to influence the director's judgment in any vote by the directors taken on the authorization of the transaction.**

(5) "Related person" means:

(iii) the director's spouse;

(iv) ~~(3) "Related person" of a director means (i) the spouse (or a parent or sibling thereof) of the director, or~~ a child, **stepchild**, grandchild, ~~sibling,~~ parent**, step parent, grandparent, sibling, ~~step sibling, half sibling, aunt, uncle, niece or nephew~~** (or spouse of any thereof) of the director~~,~~ or ~~an individual having the same home as the director, or a trust or estate~~ of ~~which an individual specified in this clause (i) is a substantial beneficiary~~**the director's spouse**; ~~or (ii) a trust, estate, incompetent, conservatee, or minor of which the director is a fiduciary.~~

(iii) an individual living in the same home as the director;

(iv) an entity (other than the corporation or an entity controlled by the corporation) controlled by the director or any person specified above in this subdivision (5);

(v) a domestic or foreign (A) business or nonprofit corporation (other than the corporation or an entity controlled by the corporation) of which the director is a director, (B) unincorporated entity of which the director is a general partner or a member of the governing body, or (C) individual, trust or estate for whom or of which the director is a trustee, guardian, personal representative or like fiduciary; or

(vi) a person that is, or an entity that is controlled by, an employer of the director.

(6) "Fair to the corporation" means, for purposes of section 8.61(b)(3), that the transaction as a whole was beneficial to the corporation, taking into appropriate account whether it was (i) fair in terms of the director's dealings with the corporation, and (ii) comparable to what might have been obtainable in an arm's length transaction, given the consideration paid or received by the corporation.

(4**7**) "Required disclosure" means disclosure ~~by the director who has a conflicting interest~~ of (i) the existence and nature of ~~his~~**the director's** conflicting interest, and (ii) all facts known to ~~him~~**the director** respecting the subject matter of the transaction that ~~an ordinarily prudent person~~**a director free of such conflicting interest** would reasonably believe to be material ~~to a judgment about~~**in deciding** whether ~~or not~~ to proceed with the transaction.

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

~~**transaction would entail significant loss, liability, or other damage.**~~

§ 8.61. JUDICIAL ACTION

(a) A transaction effected or proposed to be effected by ~~**a**~~**the** corporation (or by ~~**a subsidiary of the corporation or any other**~~**an** entity ~~**in**~~**controlled** ~~**which**~~**by** the corporation ~~**has a controlling interest**~~) ~~**that is not a director's conflicting interest transaction**~~ may not be ~~**enjoined, set aside**~~**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, ~~**because a**~~**on the ground that the** director ~~**of the corporation, or any person with whom or which he has a personal, economic, or other association**~~, has an interest ~~**in**~~**respecting** the transaction**, if it is not a director's conflicting interest transaction**.

(b) A director's conflicting interest transaction may not be ~~**enjoined, set aside**~~**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, ~~**because**~~**on the ground that** the director~~**, or any person with whom or which he has a personal, economic, or other association,**~~ has an interest ~~**in**~~**respecting** the transaction, if:

(1) directors' action respecting the transaction was ~~**at any time**~~ taken in compliance with section 8.62**; at any time; or**

(2) shareholders' action respecting the transaction was ~~**at any time**~~ taken in compliance with section 8.63 **at any time**; or

(3) the transaction, judged according to the circumstances at the **relevant** time ~~**of commitment**~~, is established to have been fair to the corporation.

§ 8.62. DIRECTORS' ACTION

(f) Directors' action respecting a **director's conflicting interest** transaction is effective for purposes of section 8.61(b)(1) if the transaction ~~**received**~~**is authorized by** the affirmative vote of a majority (but no fewer than two) of ~~**those qualified directors on**~~ the ~~**board of**~~**qualified** directors ~~**or on a duly empowered committee of the board**~~ who voted on the transaction**,** after ~~**either**~~ required disclosure to ~~**them (to the extent the**~~**those qualified directors** of information ~~**was**~~ not **already** known by them~~**),**~~ or **after modified disclosure in** compliance with subsection (b)~~;~~**,** provided that ~~**action by a committee is so effective only if:**~~

~~**(1) all its members are**~~

(1) **the** qualified directors~~,~~ **have deliberated** and **voted outside the presence of and without the participation of the conflicted director; and**

~~(2)~~ ~~**its**~~**(2) where the action is taken by a committee, all** members **of the committee** are **qualified directors, and** either **(i) the com-**

mittee is composed of all the qualified directors on the board **of directors** or **(ii) the members of the committee** are appointed by the affirmative vote of a majority of the qualified directors on the board.

(g) ~~If~~ **Notwithstanding subsection (a), when a transaction is** a director ~~has a~~**'s** conflicting interest ~~respecting a~~ transaction~~, but neither he nor~~ **only because** a related person ~~of the director specified~~**described** in **clause (v) or clause (vi) of** section 8.60(~~3)(i~~**5**) is a party to **or has a material financial interest in** the transaction, ~~and if~~ the **conflicted** director ~~has~~**is not obligated to make required disclosure to the extent that doing so would violate** a duty **imposed** under law ~~or professional canon, or~~ a ~~duty~~**legally enforceable obligation** of confidentiality ~~to another person, respecting information relating to the transaction such~~**or a professional ethics rule, provided** that the **conflicted** director ~~may not make the disclosure described in section 8.60(4)(ii), then disclosure is sufficient for purposes of subsection (a) if the director (1)~~ discloses to the **qualified** directors voting on the transaction ~~the existence and nature of his conflicting interest and informs them of the character and limitations imposed by that duty before their vote on the transaction, and (2) plays no part, directly or indirectly, in their deliberations or vote.~~**:**

- **(4) all information required to be disclosed that is not so violative,**
- **(5) the existence and nature of the director's conflicting interest, and**
- **(6) the nature of the conflicted director's duty or obligation not to disclose the confidential information.**

(h) A majority (but no fewer than two) of all the qualified directors on the board of directors, or on the committee, constitutes a quorum for purposes of action that complies with this section. ~~Directors' action that otherwise complies with this section is not affected by the presence or vote of a director who is not a qualified director.~~

(i) For purposes of this section, "qualified director" means, with respect to a director's conflicting interest transaction, any director who does not have either:

~~For purposes of this section, "qualified director" means, with respect to a director's conflicting interest transaction, any director who does not have either~~

- (1) a conflicting interest respecting the transaction, or
- (2) a familial, financial, professional, or employment relationship with ~~a second~~**another** director who does have a conflicting interest respecting the transaction, ~~which~~**where that** relationship would~~, in the circumstances,~~ reasonably be expected to ~~exert an~~ influence ~~on~~ the first director's judgment ~~when voting~~**in any vote taken** on the **authorization of the** transaction.

(e) Where directors' action under this section does not satisfy a quorum or voting requirement applicable to the authorization of the transaction by reason of the articles of incorporation, the bylaws or a provision of law, independent action to satisfy those authorization requirements must be taken by the board of directors or a committee, in which action directors who are not qualified directors may participate.

§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 ~~**entitled to be**~~ cast by the holders of all qualified shares ~~were~~ ~~**cast**~~ **are** in favor of the transaction after (1) notice to shareholders describing the ~~**director's conflicting interest**~~**action to be taken respecting the transaction,**(2) provision **to the corporation** of the information referred to in subsection (~~**d**~~**b**), and (3) **communication to the shareholders entitled to vote on the transaction of the information that is the subject of** required disclosure ~~**to the shareholders who voted on the transaction (**~~**,** to the extent the information ~~**was**~~**is** not known by them).

(b) A director who has a conflicting interest respecting the transaction shall, before the shareholders' vote, inform the secretary or other officer or agent of the corporation authorized to tabulate votes, in writing, of the number of shares that the director knows are not qualified shares under subsection (c), and the identity of the holders of those shares.

(~~**b**~~**c**) For purposes of this section~~,~~**: (1) "holder" means and "held by" refers to shares held by both a record shareholder (as defined in section 13.01(7)) and a beneficial shareholder (as defined in section 13.01(2)); and (2)** "qualified shares" means ~~**any**~~**all** shares entitled to ~~**vote**~~**be voted** with respect to the ~~**director's conflicting interest**~~ transaction except **for** shares that~~**, to the knowledge, before the vote, of**~~ the secretary (or other officer or agent of the corporation authorized to tabulate votes **either knows, or under subsection (b) is notified**, are ~~**beneficially owned (or the voting of which is controlled)**~~**held** by **(A)** a director who has a conflicting interest respecting the transaction or ~~**by**~~ **(B)** a related person of the director~~**, or both**~~ **(excluding a person described in clause (vi) of Section 8.60(5))**.

(~~**c**~~**d**) A majority of the votes entitled to be cast by the holders of all qualified shares constitutes a quorum for purposes of ~~**action that complies**~~**compliance** with this section. Subject to the provisions of ~~**subsections (d) and**~~**subsection** (e), shareholders' action that otherwise complies with this section is not affected by the presence of holders, or **by** the voting, of shares that are not qualified shares.

~~**(d) For purposes of compliance with subsection (a), a director who has a conflicting interest respecting the transaction shall, before the**~~

~~shareholders' vote, inform the secretary (or other office or agent of the corporation authorized to tabulate votes) of the number, and the identity of persons holding or controlling the vote, of all shares that the director knows are beneficially owned (or the voting of which is controlled) by the director or by a related person of the director, or both.~~

(e) If a shareholders' vote does not comply with subsection (a) solely because of ~~a failure of a~~ director **'s failure** to comply with subsection (~~d~~**b**), and if the director establishes that ~~his~~**the** failure ~~did not determine and~~ was not intended ~~by him~~ to influence **and did not in fact determine** the outcome of the vote, the court may~~, with or without further proceedings respecting section 8.61(b)(3),~~ take such action respecting the transaction and the director, and **may** give such effect, if any, to the shareholders' vote, as ~~it~~**the court** considers appropriate in the circumstances.

(f) Where shareholders' action under this section does not satisfy a quorum or voting requirement applicable to the authorization of the transaction by reason of the articles of incorporation, the bylaws or a provision of law, independent action to satisfy those authorization requirements must be taken by the shareholders, in which action shares that are not qualified shares may participate.

PART II. SUBCHAPTER G OF CHAPTER 8

8.70. BUSINESS OPPORTUNITIES

(a) A director's taking advantage, directly or indirectly, of a business opportunity may not be the subject of equitable relief, or give rise to an award of damages or other sanctions against the director, in a proceeding by or in the right of the corporation on the ground that such opportunity should have first been offered to the corporation, if before becoming legally obligated respecting the opportunity the director brings it to the attention of the corporation and:

(1) directors' action disclaiming the corporation's interest in the opportunity is taken in compliance with the procedures set forth in section 8.62, as if the decision being made concerned a director's conflicting interest transaction, or

(2) shareholders' action disclaiming the corporation's interest in the opportunity is taken in compliance with the procedures set forth in section 8.63, as if the decision being made concerned a director's conflicting interest transaction; except that, rather than making "required disclosure" as defined in section 8.60, in each case the director shall have made prior disclosure to those acting on behalf of the corporation of all material facts concerning the business opportunity that are then known to the director.

(b) In any proceeding seeking equitable relief or other remedies, based upon an alleged improper taking advantage of a business opportunity by a director, the fact that the director did not employ the procedure described in subsection (a) before taking advantage of the opportunity shall not create an inference that the opportunity should have been first presented to the corporation or alter the burden of proof otherwise applicable to establish that the director breached a duty to the corporation in the circumstances.

OFFICIAL COMMENT

Section 8.70 provides a safe harbor for a director weighing possible involvement with a prospective business opportunity that might constitute a "corporate opportunity." By action of the Board of Directors or shareholders of the corporation under section 8.70, the director can receive a disclaimer of the corporation's interest in the matter before proceeding with such involvement. In the alternative, the corporation may (i) decline to disclaim its interest, (ii) delay a decision respecting granting a disclaimer pending receipt from the director of additional information (or for any other reason), or (iii) attach conditions to the disclaimer it grants under section 8.70(a). The safe harbor granted to the director pertains only to the specific opportunity and does not have broader application, such as to a line of business or a geographic area.

The common law doctrine of "corporate opportunity" has long been recognized as a core part of the director's duty of loyalty. The doctrine stands for the proposition that the corporation has a right prior to that of its director to act on certain

business opportunities that come to the attention of the director. In such situations, a director who acts on the opportunity for the benefit of the director or another without having first presented it to the corporation can be held to have "usurped" or "intercepted" a right of the corporation. A defendant director who is found by a court to have violated the duty of loyalty in this regard is subject to damages or an array of equitable remedies, including injunction, disgorgement or the imposition of a constructive trust in favor of the corporation. While the doctrine's concept is easily described, whether it will be found to apply in a given case depends on the facts and circumstances of the particular situation and is thus frequently unpredictable. Ultimately, the doctrine requires the court to balance the corporation's legitimate expectations that its directors will faithfully promote its best interests against the legitimate right of individual directors to pursue their own economic interests in other contexts and venues.

In response to this difficult balancing task, courts have developed several (sometimes overlapping) principles to cabin the doctrine. Although the principles applied have varied from state to state, courts have sought to determine, for example, whether a disputed opportunity presented a business opportunity that was:

—the same as, or similar to, the corporation's current or planned business activities ("line of business" test);

—one that the corporation had already formulated plans or taken steps to acquire for its own use ("expectancy" test);

—developed by the director through the use of the corporation's property, personnel or proprietary information ("appropriation" test); or

—presented to the director with the explicit or implicit expectation that the director would present it to the corporation for its consideration—or—in contrast, one that initially came to the director's attention in the director's individual capacity unrelated to the director's corporate role ("capacity" test).

Finally, in recognition that the corporation need not pursue every business opportunity of which it becomes aware, an opportunity coming within the doctrine's criteria that has been properly presented to and declined by the corporation may then be pursued by the presenting director without breach of the director's duty of loyalty.

The fact intensive nature of the corporate opportunity doctrine resists statutory definition. Instead, subchapter G employs the broader notion of "business opportunity" that encompasses any opportunity, without regard to whether it would come within the judicial definition of a "corporate opportunity" as it may have been developed by courts in a jurisdiction. When properly employed, it provides a safe-harbor mechanism enabling a director to pursue an opportunity for his or her own account or for the benefit of another free of possible challenge claiming conflict with the director's duty of loyalty on the ground that the opportunity should first have been offered to the corporation. Section 8.70 is modeled on the safe-harbor and approval procedures of subchapter F pertaining to directors' conflicting interest transactions with, however, some modifications necessary to accommodate differences in the two topics.

1. Section 8.70(a)

Subsection (a) describes the safe harbor available to a director who elects to subject a business opportunity, regardless of whether the opportunity would be classified as a "corporate opportunity," to the disclosure and approval procedures set forth therein. The safe harbor provided is as broad as that provided for a director's conflicting interest transaction in section 8.61: if the director makes required disclosure of the facts specified and the corporation's interest in the opportunity is disclaimed by director action under subsection (a)(1) or shareholder action under subsection (a)(2), the director has foreclosed any claimed breach of the duty of loyalty and may not be subject to equitable relief, damages or other sanctions if the director thereafter takes the opportunity for his or her own account or for the benefit of another person. As a general proposition, disclaimer by director action under subsection (a)(1) must meet all of the requirements provided in section 8.62 with respect to a director's conflicting interest transaction and disclaimer by shareholder action under subsection (a)(2) must likewise comply with all of the requirements for shareholder action under section 8.63. Note, however, two important differences.

In contrast to director or shareholder action under sections 8.62 and 8.63, which may be taken at any time, section 8.70(a) requires that the director must present the opportunity and secure director or shareholder action disclaiming it *before* acting on the opportunity. The safe-harbor concept contemplates that the corporation's decision maker will have full freedom of action in deciding whether the corporation should take over a proferred opportunity or elect to disclaim the corporation's interest in it. If the interested director could seek ratification after acting on the opportunity, the option of taking over the opportunity would, in most cases, in reality be foreclosed and the corporation's decision maker would be limited to denying ratification or blessing the interested director's past conduct with a disclaimer. In sum, the safe harbor's benefit is available only when the corporation can entertain the opportunity in a fully objective way.

The second difference also involves procedure. Instead of employing section 8.60(7)'s definition of "required disclosure" that is incorporated in sections 8.62 and 8.63, section 8.70(a) requires the alternative disclosure to those acting for the corporation of "all material facts concerning the business opportunity that are then known to the director." As a technical matter, section 8.60(7) calls for, in part, disclosure of "the existence and nature of the director's conflicting interest"—that information is not only non-existent but irrelevant for purposes of subsection (a). But there is another consideration justifying replacement of the section 8.60(7) definition. In the case of the director's conflicting interest transaction, the director proposing to enter into a transaction with the corporation has presumably completed due diligence and made an informed judgment respecting the matter; accordingly, that interested director is in a position to disclose "all facts known to the director respecting the subject matter of the transaction that a director free of such conflicting interest would reasonably believe to be material in deciding whether to proceed with the transaction." The interested director, placing himself or herself in the independent director's position, should be able to deal comfort-

ably with the objective materiality standard. In contrast, the director proffering a business opportunity will often not have undertaken due diligence and made an informed judgment to pursue the opportunity following a corporate disclaimer. Thus, the disclosure obligation of subsection (a) requires only that the director reveal all material facts concerning the business opportunity that, at the time when disclosure is made, are known to the director. The safe-harbor procedure shields the director even if a material fact regarding the business opportunity is not disclosed, so long as the proffering director had no knowledge of such fact. In sum, the disclosure requirement for subsection (a) must be and should be different from that called for by subchapter F's provisions.

2. Section 8.70(b)

Subsection (b) reflects a fundamental difference between the coverage of subchapters F and G. Because subchapter F provides an exclusive definition of "director's conflicting interest transaction," any transaction meeting the definition that is not approved in accordance with the provisions of subchapter F is not entitled to its safe harbor. Unless the interested director can, upon challenge, establish the transaction's fairness, the director's conduct is presumptively actionable and subject to the full range of remedies that might otherwise be awarded by a court. In contrast, the concept of "business opportunity" under section 8.70 is not defined but is intended to be broader than what might be regarded as an actionable "corporate opportunity." This approach recognizes that, given the vagueness of the corporate opportunity doctrine, a director might be inclined to seek safe-harbor protection under section 8.70 before pursuing an opportunity that might or might not at a later point be subject to challenge as a "corporate opportunity." By the same token, a director might conclude that a business opportunity is not a "corporate opportunity" under applicable law and choose to pursue it without seeking a disclaimer by the corporation under section 8.70. Accordingly, subsection (b) provides that a director's decision not to employ the procedures of section 8.70(a) neither creates a negative inference nor alters the burden of proof in any subsequent proceeding seeking damages or equitable relief based upon an alleged improper taking of a "corporate opportunity."

PART III. ROLE AND RESPONSIBILITIES OF CORPORATE DIRECTORS

Add new section 1.40(18A):

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

Proposed addition to Official Comment to section 1.40:

6.1. Public Corporation
The term "public corporation" defined in section 1.40(18A) is used in sections 7.32, 8.01, 14.31 and 14.34 to distinguish publicly held corporations from other corporations. The definition establishes that distinction by reference to the existence of an organized trading market in the corporation's shares as an indication of broad share ownership. The reference to markets comes from the securities law governing regulation of securities trading markets.

Proposed new section 7.32:

(d) An agreement authorized by this section shall cease to be effective when the corporation becomes a public corporation. If the agreement ceases to be effective for any reason, the board of directors may, if the agreement is contained or referred to in the corporation's articles of incorporation or bylaws, adopt an amendment to the articles of incorporation or bylaws, without shareholder action, to delete the agreement and any references to it.

Proposed change to Official Comment to section 7.32:

4. Section 7.32(d)
Section 7.32(d) contains a self-executing termination provision for a shareholder agreement when the shares of the corporation become publicly traded, and the corporation thereby becomes a public corporation as defined in section 1.40(18A). The statutory norms in the Model Act become more appropriate as the number of shareholders increases, as there is greater opportunity to acquire or dispose of an investment in the corporation, and as there is less opportunity for negotiation over the terms under which the enterprise will be conducted. Given that section 7.32 requires unanimity, however, in most cases a practical limit will be reached before a public market develops. Subsection (d) rejects the use of an absolute number of shareholders in determining when the shelter of section 7.32 is lost.

Proposed section 14.31(d):

(d) Within 10 days of the commencement of a proceeding under section 14.30(2) to dissolve a corporation that is not a public corporation, the corporation must send to all shareholders, other than the petitioner, a notice stating that the shareholders are entitled to avoid the dissolution of the corporation by electing to

purchase the petitioner's shares under section 14.34 and accompanied by a copy of section 14.34.

Proposed section 14.34:

(a) In a proceeding under section 14.30(2) to dissolve a corporation that is not a public 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.

Proposed change to Official Comment to section 14.34:

1. AVAILABILITY

There are three prerequisites to filing an election to purchase under section 14.34. First, a proceeding to dissolve the corporation under section 14.30(2) must have been commenced. Second, the corporation must not be a public corporation as defined in section 1.40(18A). Finally, 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(2).

Proposed section 8.01 and its Official Comment

§ 8.01. REQUIREMENTS FOR AND FUNCTIONS OF BOARD OF DIRECTORS

(a) Except as provided in section 7.32, each corporation must have a board of directors.

(b) All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32.

(c) In the case of a public corporation, the board's oversight responsibilities include attention to:

- (i) business performance and plans;
- (ii) major risks to which the corporation is or may be exposed;
- (iii) the performance and compensation of senior officers;
- (iv) policies and practices to foster the corporation's compliance with law and ethical conduct;
- (v) preparation of the corporation's financial statements;
- (vi) the effectiveness of the corporation's internal controls;
- (vii) arrangements for providing adequate and timely information to directors; and
- (viii) the composition of the board and its committees, taking into account the important role of independent directors.

CROSS-REFERENCES

Amendment of articles of incorporation, see ch. 10A.
Articles of incorporation, see § 2.02.
Close corporations, see Model Statutory Corporation Supplement.
Director standards of conduct, see § 8.30.
Indemnification, see §§ 8.50-8.59.
Number of shareholders, see § 1.42.
Officers, see §§ 8.40 & 8.41.
Public corporation, see §1.40(18A).

OFFICIAL COMMENT

Section 8.01(a) requires that every corporation have a board of directors except that a shareholder agreement authorized by section 7.32 may dispense with the board of directors. Section 8.01(b) also recognizes that the powers of the board of directors may be limited by express provisions in the articles of incorporation or by an agreement among all shareholders under section 7.32.

Obviously, some form of governance is necessary for every corporation. The board of directors is the traditional form of governance but it need not be the exclusive form. Patterns of management may also be tailored to specific needs in connection with family-controlled enterprises, wholly or partially owned subsidiaries, or corporate joint ventures through a shareholder agreement under section 7.32.

Under section 7.32, an agreement among all shareholders can provide for a nontraditional form of governance until there is a regular market for the corporation's shares, a change from the 50 or fewer shareholder test in place in section 8.01 prior to 1990. As the number of shareholders increases and a market for the shares develops, there is (i) an opportunity for unhappy shareholders to dispose of shares(a "market out," (ii) a correlative opportunity for others to acquire shares with related expectations regarding the applicability of the statutory norms of governance, and (iii) no real opportunity to negotiate over the terms upon which the enterprise will be conducted. Moreover, tying the availability of nontraditional governance structures to an absolute number of shareholders at the time of adoption took no account of subsequent events, was overly mechanical, and was subject to circumvention. If a corporation does not have a shareholder agreement that satisfies the requirements of section 7.32 or if it is a public corporation, it must adopt the traditional board of directors as its governing body.

Section 8.01(b) states that if a corporation has a board of directors "its business and affairs shall be managed by or under the direction, and subject to the oversight, of its board of directors." The phrase "by or under the direction, and subject to the oversight, of," encompasses the varying functions of boards of directors of different corporations. In some closely held corporations, the board of directors may be involved in the day-to-day business and affairs and it may be reasonable to describe management as being "by" the board of directors. But in many other corporations, the business and affairs are managed "under the direction, and subject to the oversight, of" the board of directors, since operational management is delegated to executive officers and other professional managers.

While section 8.01(b), in providing for corporate powers to be exercised under the authority of the board of directors, allows the board of directors to delegate to appropriate officers, employees or agents of the corporation authority to exercise powers and perform functions not required by law to be exercised or performed by the board of directors itself, responsibility to oversee the exercise of that delegated authority nonetheless remains with the board of directors. The scope of that oversight responsibility will vary depending on the nature of the corporation's business. For public corporations, subsection (c) provides that the scope of the directors' oversight responsibility includes the matters identified in that subsection. For other corporations, that responsibility may, depending on the circumstances, include some or all of those matters as well. At least for public corporations, subsections (c)(iii) and (iv) encompass oversight of the corporation's dealings and relationships with its directors and officers, including processes designed to prevent improper related party transactions. See also, chapter 8, subchapter F, sections 8.60 *et seq.* Subsection (c)(v) encompasses the corporation's compliance with the requirements of sections 16.01 and 16.20, while subsection (c)(vi) extends also to the internal control processes in place to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Subsection (c)(vii) reflects that the board of directors should devote attention to whether the corporation has information and reporting systems in place to provide directors with appropriate information in a timely manner in order to permit them to discharge their responsibilities. *See In re Caremark Int'l Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

Subsection (c) (viii) calls for the board of a public corporation, in giving attention to the composition of the board and its committees, to take into account the important role of independent directors. It is commonly accepted that where ownership is separated from management, as is the case with public corporations, having non-management independent directors who participate actively in the board's oversight functions increases the likelihood that actions taken by the board will serve the best interests of the corporation and its shareholders and generally will be given deference in judicial proceedings. The listing standards of most public securities markets have requirements for independent directors to serve on boards; in many cases, they must constitute a majority of the board, and certain board committees must be composed entirely of independent directors. The listing standards have differing rules as to what constitutes an independent director. The Act does not attempt to define "independent director." Ordinarily, an independent director may not be a present or recent member of senior management. Also, to be considered independent, the individual usually must be free of significant professional, financial or similar relationships with the corporation—directly or as a partner, major shareholder or officer of an organization with such a relationship—and the director and members of the director's immediate family must be free of similar relationships with the corporation's senior management. Judgment is required to determine independence in light of the particular circumstances, subject to any specific requirements of a listing standard. The qualities

of disinterestedness required of directors under the Act for specific purposes are similar but not necessarily identical. For the requirements for a director to be eligible to act in those situations, see sections 7.40 and 7.44 (dismissal of shareholder derivative proceedings); sections 8.50 and 8.55 (b) (1) authorization of indemnification); and section 8.62 (approval of a director's conflicting interest transaction). An individual who is generally an independent director for purposes of subsection (c) may not be eligible to act in a particular case under those other provisions of the Act. Conversely, a director who is not independent for purposes of subsection (c) (for example, a member of management) may be so eligible in a particular case.

Although delegation does not relieve the board of directors from its responsibilities of oversight, directors should not be held personally responsible for actions or omissions of officers, employees, or agents of the corporation so long as the directors have relied reasonably and in good faith upon these officers, employees, or agents. See sections 8.30 and 8.31 and their Official Comments. Directors generally have the power to probe into day-to-day management to any depth they choose, but they have the obligation to do so only to the extent that the directors' oversight responsibilities may require, or, for example, when they become aware of matters which make reliance on management or other persons unwarranted.

§ 8.25. COMMITTEES

(a) Unless this Act, the articles of incorporation or the bylaws provide otherwise, a board of directors may create one or more committees and appoint one or more members of the board of directors to serve on any such committee.

(b) Unless this Act otherwise provides, the creation of a committee and appointment of members to it must be approved by the greater of (1) a majority of all the directors in office when the action is taken or (2) the number of directors required by the articles of incorporation or bylaws to take action under section 8.24.

(c) Sections 8.20 through 8.24 apply both to committees of the board and to their members.

(d) To the extent specified by the board of directors or in the articles of incorporation or bylaws, each committee may exercise the powers of the board of directors under section 8.01.

(e) A committee may not, however:

- (1) authorize or approve distributions, except according to a formula or method, or within limits, prescribed by the board of directors;
- (2) approve or propose to shareholders action that this Act requires be approved by shareholders;
- (3) fill vacancies on the board of directors or, subject to subsection (g), on any of its committees; or
- (4) adopt, amend, or repeal bylaws.

(f) The creation of, delegation of authority to, or action by a committee does not alone constitute compliance by a director with the standards of conduct described in section 8.30.

(g) The board of directors may appoint one or more directors as alternate members of any committee to replace any absent or disqualified member during the member's absence or disqualification. Unless the articles of incorporation or the bylaws or the resolution creating the committee provide otherwise, in the event of the absence or disqualification of a member of a committee, the member or members present at any meeting and not disqualified from voting, unanimously, may appoint another director to act in place of the absent or disqualified member.

CROSS-REFERENCES

Articles of incorporation, see § 2.02, ch. 10A.
Bylaws, see § 2.06, ch. 10B.
Derivative proceedings, see §§ 7.40-7.47.
Director standards of conduct, see § 8.30.
Dissolution, see ch. 14.
Distributions, see § 6.40.
Duties of board of directors, see § 8.01.
Indemnification determination, see § 8.55.
Issuance of shares, see §§ 6.01 & 6.02.
Mergers, see ch. 11.
Quorum and voting, see § 8.24.
Reacquisition of shares, see §§ 6.03 & 6.31.
Vacancies on board, see § 8.10.

OFFICIAL COMMENT

Section 8.25 makes explicit the common law power of a board of directors to act through committees of directors and specifies the powers of the board of directors that are nondelegable, that is, powers that only the full board of directors may exercise. Section 8.25 deals only with board committees exercising the powers or performing the functions of the board of directors; the board of directors or management, independently of section 8.25, may establish nonboard committees composed of directors, employees, or others to exercise corporate powers not required to be exercised by the board of directors.

Section 8.25(b) states that, unless this Act otherwise provides, a committee of the board of directors may be created only by the affirmative vote of a majority of the board of directors then in office, or, if greater, by the number of directors required to take action by the articles of incorporation or the bylaws. This supermajority requirement reflects the importance of the decision to invest board committees with power to act under section 8.25. Section 7.44(b) requires that a special litigation committee, to consider whether the maintenance of a derivative action is in the corporation's best interest, be appointed by a majority vote of independent directors present at a meeting of the board. Sections 8.55(b) and 8.62(a), respectively, contain a generally similar requirement with regard to the appointment of a committee to consider whether indemnification is permissible and the appointment of a committee to consider approval of a director conflicting interest transaction.

Committees of the board of directors are assuming increasingly important roles in the governance of public corporations. *See* THE COMMITTEE ON CORPORATE LAWS, CORPORATE DIRECTOR'S GUIDEBOOK, (4th ed. 2004). Nominating and compensation committees, composed primarily or entirely of independent directors, are widely used by public corporations and may be required by listing standards adopted by public securities markets. Such standards, including those mandated by law, also require the appointment of audit committees, composed entirely of independent directors, to perform important functions including the selection and retention of the corporation's external auditors.

Section 8.25(a) permits a committee to consist of a single director. This accommodates situations in which only one director may be present or available to make a decision on short notice, as well as situations in which it is unnecessary or inconvenient to have more than one member on a committee. Committees also are often employed to decide matters in which other members of the board have a conflict of interest; in such a case, a court will typically scrutinize with care the committee's decision when it is the product of a lone director. *See, e.g., Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985). Additionally, various sections of the Model Act require the participation or approval of at least two directors with no disqualifying relationship in order for the decision of the board or committee to have effect. These include a determination that maintenance of a derivative suit is not in the corporation's best interests (section 7.44(b)(3)), a determination that indemnification is permissible (section 8.55(b)(1)) and an approval of a director conflicting interest transaction (section 8.62(a)).

Section 8.25 limits the role of board committees in light of competing policies: on the one hand, it seems clear that appropriate committee action is not only desirable but is also likely to improve the functioning of larger and more diffuse boards of directors; on the other hand, wholesale delegation of authority to a board committee, to the point of abdication of director responsibility as a board of directors, is manifestly inappropriate and undesirable. Overbroad delegation also increases the potential, where the board of directors is divided, for usurpation of basic board functions by means of delegation to a committee dominated by one faction.

The statement of nondelegable functions set out in section 8.25(e) is based on the principle that prohibitions against delegation to board committees should be limited generally to actions that substantially affect the rights of shareholders or are fundamental to the governance of the corporation. As a result, delegation of authority to committees under section 8.25(e) may be broader than mere authority to act with respect to matters arising within the ordinary course of business.

Section 8.25(e) prohibits delegation of authority with respect to most mergers, sales of substantially all the assets, amendments to articles of incorporation and voluntary dissolution since these require shareholder action. In addition, section 8.25(e) prohibits delegation to a board committee of authority to fill board vacancies, subject to subsection (g), or to amend the bylaws. On the other hand, under section 8.25(e) many actions of a material nature, such as the authorization

of long-term debt and capital investment or the issuance of shares, may properly be made the subject of committee delegation. In fact, the list of nondelegable powers has been reduced from the prior formulation of section 8.25(e).

Although section 8.25(e)(1) generally makes nondelegable the decision whether to authorize or approve distributions, including dividends, it does permit the delegation to a committee of power to approve a distribution pursuant to a formula or method or within limits prescribed by the board of directors. Therefore, the board could set a dollar range and timeframe for a prospective dividend and delegate to a committee the authority to determine the exact amount and record and payment dates of the dividend. The board also could establish certain conditions to the payment of a distribution and delegate to a committee the power to determine whether the conditions have been satisfied.

The statutes of several states make nondelegable certain powers not listed in section 8.25(e)—for example, the power to change the principal corporate office, to appoint or remove officers, to fix director compensation, or to remove agents. These are not prohibited by section 8.25(e) since the whole board of directors may reverse or rescind the committee action taken, if it should wish to do so, without undue risk that implementation of the committee action might be irrevocable or irreversible.

Section 8.25(f) makes clear that although the board of directors may delegate to a committee the authority to take action, the designation of the committee, the delegation of authority to it, and action by the committee does not alone constitute compliance by a noncommittee board member with the director's responsibility under section 8.30. On the other hand, a noncommittee director also does not automatically incur personal risk should the action of the particular committee fail to meet the standard of conduct set out in section 8.30. The noncommittee member's liability in these cases will depend upon whether the director's conduct was actionable under section 8.31. Factors to be considered in this regard will include the care used in the delegation to and supervision over the committee, the extent to which the delegation was required by applicable law or listing standards, and the amount of knowledge regarding the actions being taken by the committee which is available to the noncommittee director. Care in delegation and supervision may be facilitated, in the usual case, by review of minutes and receipt of other reports concerning committee activities. The enumeration of these factors is intended to emphasize that directors may not abdicate their responsibilities and avoid liability simply by delegating authority to board committees. Rather, a director against whom liability is asserted based upon acts of a committee of which the director is not a member avoids liability under section 8.31 by an appropriate measure of monitoring—particularly if the director met the standards contained in section 8.30 with respect to the creation and supervision of the committee.

Section 8.25(f) has no application to a member of the committee itself. The standards of conduct applicable to a committee member are set forth in section 8.30.

Section 8.25(g) is a rule of convenience that permits the board or the other

committee members to replace an absent or disqualified member during the time that the member is absent or disqualified. Unless otherwise provided, replacement of an absent or disqualified member is not necessary to permit the other committee members to continue to perform their duties.

§ 8.30. STANDARDS OF CONDUCT FOR DIRECTORS

(a) Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.

(b) The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.

(c) In discharging board or committee duties a director shall disclose, or cause to be disclosed, to the other board or committee members information not already known by them but known by the director to be material to the discharge of their decision-making or oversight functions, except that disclosure is not required to the extent that the director reasonably believes that doing so would violate a duty imposed under law, a legally enforceable obligation of confidentiality, or a professional ethics rule.

(d) In discharging board or committee duties a director who does not have knowledge that makes reliance unwarranted is entitled to rely on the performance by any of the persons specified in subsection (f)(1) or subsection (f)(3) to whom the board may have delegated, formally or informally by course of conduct, the authority or duty to perform one or more of the board's functions that are delegable under applicable law.

(e) In discharging board or committee duties a director who does not have knowledge that makes reliance unwarranted is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, prepared or presented by any of the persons specified in subsection (f).

(f) A director is entitled to rely, in accordance with subsection (d) or (e), on:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports or statements provided;

(2) legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence; or

(3) a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.

CROSS-REFERENCES

Committees of board of directors, see § 8.25.
Conflict of interest, see ch. 8F.
Derivative proceedings, see §§ 7.40–7.47.
Duty of board of directors, see § 8.01.
Indemnification, see §§ 8.50–8.59.
Meetings of board of directors, see § 8.01.
Officer standards of conduct, see § 8.42.
Officers, see §§ 8.40 & 8.41.
Quorum of directors, see § 9.24.
Removal of directors, see §§ 8.08 & 8.09.
Standars of liability for directors, see § 8.31.
Unlawful distributions, see § 8.33

OFFICIAL COMMENT

Section 8.30 defines the general standards of conduct for directors. Under subsection (a), each board member must always perform a director's duties in good faith and in a manner reasonably believed to be in the best interests of the corporation. Although each director also has a duty to comply with its requirements, the focus of subsection (b) is on the discharge of those duties by the board as a collegial body. Under subsection (b), the members of the board or a board committee are to perform their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances. This standard of conduct is often characterized as a duty of care. Subsection (c) sets out the responsibility of each director, in discharging board or committee duties, to disclose or cause to be disclosed to the other members of the board or board committee information, of which they are unaware, known by the director to be material to their decision-making or oversight responsibilities, subject to countervailing confidentiality duties and appropriate action with respect thereto.

Section 8.30 sets forth the standards of conduct for directors by focusing on the manner in which directors perform their duties, not the correctness of the decisions made. These standards of conduct are based on former section 35 of the 1969 Model Act, a number of state statutes and on judicial formulations of the standards of conduct applicable to directors. Section 8.30 should be read in light of the basic role of directors set forth in section 8.01(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, as supplemented by various provisions of the Act assigning specific powers or responsibilities to the board. Relevant thereto, directors often act collegially in performing their functions and discharging their duties. If the observance of the directors' conduct is called into question, courts will typically evaluate the conduct of the entire board (or committee). Deficient performance of section 8.30 duties on the part of a particular director may be overcome, absent unusual circumstances, by acceptable conduct (meeting, for example, subsection (b)'s standard of care) on the part of other directors sufficient in number to perform the function or discharge the duty in question. While not thereby remedied, the deficient performance becomes irrelevant in any evaluation of the action taken. (This contrasts with a director's duties

of loyalty, fair dealing and disclosure which will be evaluated on an individual basis and will also implicate discharge of the director's duties under subsection (a).) Further relevant thereto, the board may delegate or assign to appropriate officers, employees or agents of the corporation the authority or duty to exercise powers that the law does not require it to retain. Since the directors are entitled to rely thereon absent knowledge making reliance unwarranted, deficient performance of the directors' section 8.30 duties will not result from their delegatees' actions or omissions so long as the board acted in good faith and complied with the other standards of conduct set forth in section 8.30 in delegating responsibility and, where appropriate, monitoring performance of the duties delegated.

In earlier versions of the Model Act the duty of care element was included in subsection (a), with the text reading: "[a] director shall discharge his duties—with the care an ordinarily prudent person in a like position would exercise under similar circumstances." The use of the phrase "ordinarily prudent person" in a basic guideline for director conduct, suggesting caution or circumspection vis-a-vis danger or risk, has long been problematic given the fact that risk-taking decisions are central to the directors' role. When coupled with the exercise of "care," the prior text had a familiar resonance long associated with the field of tort law. See the Official Comment to section 8.31. The further coupling with the phrasal verb "shall discharge" added to the inference that former section 8.30(a)'s standard of conduct involved a negligence standard, with resultant confusion. In order to facilitate its understanding, and analysis, independent of the other general standards of conduct for directors, the duty of care element has been set forth as a separate standard of conduct in subsection (b).

Long before statutory formulations of directors' standards of conduct, courts would invoke the business judgment rule in evaluating directors' conduct and determining whether to impose liability in a particular case. The elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts. Section 8.30 does not try to codify the business judgment rule or to delineate the differences between that defensive rule and the section's standards of director conduct. Section 8.30 deals only with standards of conduct(the level of performance expected of every director entering into the service of a corporation and undertaking the role and responsibilities of the office of director. The section does not deal directly with the liability of a director(although exposure to liability will usually result from a failure to honor the standards of conduct required to be observed by subsection (a). See section 8.31(a)(1) and clauses (i) and (ii)(A) of section 8.31(a)(2). The issue of directors' liability is addressed in sections 8.31 and 8.33 of this subchapter. Section 8.30 does, however, play an important role in evaluating a director's conduct and the effectiveness of board action. It has relevance in assessing, under section 8.31, the reasonableness of a director's belief. Similarly, it has relevance in assessing a director's timely attention to appropriate inquiry when particular facts and circumstances of significant concern materialize. It serves as a frame of reference for determining, under section 8.33(a), liability for an unlawful distribution. Finally, section 8.30 compliance may have a direct bearing on a court's analysis where transactional justification (*e.g.*, a suit to enjoin a pending merger) is at issue.

A director complying with the standard of care expressed in subsection (b) is entitled to rely (under subsection (d)) upon board functions performed pursuant to delegated authority by, and to rely (under subsection (e)) upon information, opinions, reports or statements, including financial statements and other financial data, provided by, the persons or committees specified in the relevant parts of subsection (f). Within this authorization, the right to rely applies to the entire range of matters for which the board of directors is responsible. However, a director so relying must be without knowledge that would cause that reliance to be unwarranted. Section 8.30 expressly prevents a director from "hiding his or her head in the sand" and relying on the delegation of board functions, or on information, opinions reports or statements, when the director has actual knowledge that makes (or has a measure of knowledge that would cause a person, in a like position under similar circumstances, to undertake reasonable inquiry that would lead to information making) reliance unwarranted. Subsection (a)'s standards of good faith and reasonable belief in the best interests of the corporation also apply to a director's reliance under subsections (d), (e) and (f).

1. Section 8.30(a)

Section 8.30(a) establishes the basic standards of conduct for all directors. Its command is to be understood as peremptory(its obligations are to be observed by every director(and at the core of the subsection's mandate is the requirement that, when performing directors' duties, a director shall act in good faith coupled with conduct reasonably believed to be in the best interests of the corporation. This mandate governs all aspects of directors' duties: the duty of care, the duty to become informed, the duty of inquiry, the duty of informed judgment, the duty of attention, the duty of disclosure, the duty of loyalty, the duty of fair dealing and, finally, the broad concept of fiduciary duty that the courts often use as a frame of reference when evaluating a director's conduct. These duties do not necessarily compartmentalize and, in fact, tend to overlap. For example, the duties of care, inquiry, becoming informed, attention, disclosure and informed judgment all relate to the board's decision-making function, whereas the duties of attention, disclosure, becoming informed and inquiry relate to the board's oversight function.

Two of the phrases chosen to specify the manner in which a director's duties are to be discharged deserve further comment:

(1) The phrase "reasonably believes" is both subjective and objective in character. Its first level of analysis is geared to what the particular director, acting in good faith, actually believes—not what objective analysis would lead another director (in a like position and acting in similar circumstances) to conclude. The second level of analysis is focused specifically on "reasonably." While a director has wide discretion in marshalling the evidence and reaching conclusions, whether a director's belief is reasonable (*i.e.*, could(not would(a reasonable person in a like position and acting in similar circumstances have arrived at that belief) ultimately involves an overview that is objective in character.

(2) The phrase "best interests of the corporation" is key to an explication of a director's duties. The term "corporation" is a surrogate for the business enterprise as well as a frame of reference encompassing the shareholder body. In determining the corporation's "best interests," the director has wide discretion in deciding how to weigh near-term opportunities versus long-term benefits as well as in making judgments where the interests of various groups within the shareholder body or having other cognizable interests in the enterprise may differ.

As a generalization, section 8.30 operates as a "baseline" principle governing director conduct "when discharging the [ongoing] duties of a director" in circumstances uncomplicated by self-interest taint. The Model Act recognizes, however, that directors' personal interests may not always align with the corporation's best interests and provides procedures by which interest-conflict transactions can be processed. See subchapter D (derivative proceedings) of chapter 7 and subchapter E (indemnification) and subchapter F (directors' conflicting interest transactions) of this chapter 8. Those procedures generally contemplate that the interested director will not be involved in taking action on the interest-conflict transaction. And the common law has recognized that other interest-conflict situations may arise which do not entail a "transaction" by or with the corporation. See subchapter G of this chapter 8 (discussing the corporate opportunity doctrine). The interested director is relieved of the duty to act in connection with the matter on behalf of the corporation (specifically, the traditional mandate to act in the corporation's best interests), given the inherent conflict. However, the interested director is still expected to act in good faith, and that duty is normally discharged by observing the obligation of fair dealing. In the case of interest-conflict transactions, where there is a conflicting interest with respect to the corporation under section 8.60(1), the interested director's conduct is governed by subchapter F of this chapter 8. The duty of fair dealing is embedded in the subsection 8.60(7) provision calling for the interested director to make the required disclosure as to the conflicting interest and the transaction and, if one of the two safe harbor procedures is not properly observed, the interested director must prove the fairness (*i.e.*, procedure, involving good faith among other aspects, as well as price) of the transaction to the corporation. In other cases, Section 8.30's standards of conduct are overlaid by various components of the duty to act fairly, the particular thrusts of which will depend upon the kind of interested director's conduct at issue and the circumstances of the case. As a general rule, the duty of fair dealing is normally discharged by the interested director through appropriate disclosure to the other directors considering the matter followed by abstention from participation in any decision-making relevant thereto. If and to the extent that the interested director's action respecting the matter goes further, the reasonableness of the director's belief as to the corporation's best interests, in respect of the action taken, should be evaluated on the basis of not only the director's honest and good faith belief but also on considerations bearing on the fairness of the transaction or conduct to the corporation.

2. Section 8.30(b)

Section 8.30(b) establishes a general standard of care for directors in the context of their dealing with the board's decision-making and oversight functions. While certain aspects will involve individual conduct (e.g., preparation for meetings), these functions are generally performed by the board through collegial action, as recognized by the reference in subsection (b) to board and committee "members" and "their duties." In contrast with subsection (a)'s individual conduct mandate, section 8.30(b) has a two-fold thrust: it provides a standard of conduct for individual action and, more broadly, it states a conduct obligation—"shall discharge their duties"—concerning the degree of care to be collegially used by the directors when performing those functions. It provides that directors have a duty to exercise "the care that a person in a like position would reasonably believe appropriate under similar circumstances."

The traditional formulation for a director's standard (or duty) of care has been geared to the "ordinarily prudent person." For example, the Model Act's prior formulation (in former section 8.30(a)(2)) referred to "the care an ordinarily prudent person in a like position would exercise under similar circumstances," and almost all state statutes that include a standard of care reflect parallel language. The phrase "ordinarily prudent person" constitutes a basic frame of reference grounded in the field of tort law and provides a primary benchmark for determining negligence. For this reason, its use in the standard of care for directors, suggesting that negligence is the proper determinant for measuring deficient (and thus actionable) conduct, has caused confusion and misunderstanding. Accordingly, the phrase "ordinarily prudent person" has been removed from the Model Act's standard of care and in its place "a person in a like position" has been substituted. The standard is not what care a particular director might believe appropriate in the circumstances but what a person(in a like position and acting under similar circumstances(would reasonably believe to be appropriate. Thus, the degree of care that directors should employ, under subsection (b), involves an objective standard.

Some state statutes have used the words "diligence," "care," and "skill" to define the duty of care. There is very little authority as to what "skill" and "diligence," as distinguished from "care," can be required or properly expected of corporate directors in the performance of their duties. "Skill," in the sense of technical competence in a particular field, should not be a qualification for the office of director. The concept of "diligence" is sufficiently subsumed within the concept of "care." Accordingly, the words "diligence" and "skill" are not used in section 8.30's standard of care.

The process by which a director becomes informed, in carrying out the decision-making and oversight functions, will vary. Relevant thereto, the directors' decision-making function is established in large part by various sections of the Act: the issuance of shares (6.21); distributions (6.40); dismissal of derivative proceedings (7.44); indemnification (8.55); interested-transaction authorization (8.62); articles of incorporation amendments (10.02 and 10.03); bylaw amendments (10.20); mergers (11.01); share exchanges (11.02); asset sales and mort-

gages (12.01 and 12.02); and dissolution (14.02). The directors' oversight function is established under section 8.01. In relying on the performance by management of delegated or assigned section 8.01 duties (including, for example, matters of law and legal compliance), as authorized by subsection (d), directors may depend upon the presumption of regularity absent knowledge or notice to the contrary. In discharging the section 8.01 duties associated with the board's oversight function, the standard of care entails primarily a duty of attention. In contrast with the board's decision-making function, which generally involves informed action at a point in time, the oversight function is concerned with a continuum and the duty of attention accordingly involves participatory performance over a period of time.

Several of the phrases chosen to define the standard of conduct in section 8.30(b) deserve specific mention:

(1) The phrase "becoming informed," in the context of the decision-making function, refers to the process of gaining sufficient familiarity with the background facts and circumstances in order to make an informed judgment. Unless the circumstances would permit a reasonable director to conclude that he or she is already sufficiently informed, the standard of care requires every director to take steps to become informed about the background facts and circumstances before taking action on the matter at hand. The process typically involves review of written materials provided before or at the meeting and attention to/participation in the deliberations leading up to a vote. It can involve consideration of information and data generated by persons other than legal counsel, public accountants, etc., retained by the corporation, as contemplated by subsection (f)(2); for example, review of industry studies or research articles prepared by unrelated parties could be very useful. It can also involve direct communications, outside of the boardroom, with members of management or other directors. There is no one way for "becoming informed," and both the method and measure—"how to" and "how much"—are matters of reasonable judgment for the director to exercise.

(2) The phrase "devoting attention," in the context of the oversight function, refers to concern with the corporation's information and reporting systems and not to proactive inquiry searching out system inadequacies or noncompliance. While directors typically give attention to future plans and trends as well as current activities, they should not be expected to anticipate the problems which the corporation may face except in those circumstances where something has occurred to make it obvious to the board that the corporation should be addressing a particular problem. The standard of care associated with the oversight function involves gaining assurances from management and advisers that systems believed appropriate have been established, coupled with ongoing monitoring of the systems in place, such as those concerned with legal compliance or internal controls(followed up with a proactive response when alerted to the need for inquiry.

(3) The reference to "person," without embellishment, is intended to avoid implying any qualifications, such as specialized expertise or experience requirements, beyond the basic director attributes of common sense, practical wisdom, and informed judgment.

(4) The phrase "reasonably believe appropriate" refers to the array of possible options that a person possessing the basic director attributes of common sense, practical wisdom and informed judgment would recognize to be available, in terms of the degree of care that might be appropriate, and from which a choice by such person would be made. The measure of care that such person might determine to be appropriate, in a given instance, would normally involve a selection from the range of options and any choice within the realm of reason would be an appropriate decision under the standard of care called for under subsection (b). However, a decision that is so removed from the realm of reason, or is so unreasonable, that it falls outside the permissible bounds of sound discretion, and thus an abuse of discretion, will not satisfy the standard.

(5) The phrase "in a like position" recognizes that the "care" under consideration is that which would be used by the "person" if he or she were a director of the particular corporation.

(6) The combined phrase "in a like position—under similar circumstances" is intended to recognize that (a) the nature and extent of responsibilities will vary, depending upon such factors as the size, complexity, urgency, and location of activities carried on by the particular corporation, (b) decisions must be made on the basis of the information known to the directors without the benefit of hindsight, and (c) the special background, qualifications, and management responsibilities of a particular director may be relevant in evaluating that director's compliance with the standard of care. Even though the combined phrase is intended to take into account the special background, qualifications and management responsibilities of a particular director, it does not excuse a director lacking business experience or particular expertise from exercising the basic director attributes of common sense, practical wisdom, and informed judgment.

3. Section 8.30(c)

A duty to disclose information that a director knows to be material to the oversight or decision-making functions of the board or committee has always been embraced in the standards of conduct set forth in subsections (a) and (b). Subsection (c) makes explicit this existing duty of disclosure among directors. Thus, for example, when a member of the board knows information that the director recognizes is material to a decision by the board to approve financial statements of the corporation, the director is obligated to see to it that such information is provided to the other members of the board. So long as that disclosure is accomplished, the action required of the director can occur through direct statements in meetings of the board, or by any other timely means, includ-

ing, for example, communicating the information to the chairman of the board or the chairman of a committee, or to the corporation's general counsel, and requesting that the recipient inform the other board or committee members of the disclosed information.

Subsection (c) recognizes that a duty of confidentiality can override a director's obligation to share with other directors information pertaining to a current corporate matter, and that a director is not required to make such disclosure to the extent the director reasonably believes that such a duty of confidentiality prohibits it. In some circumstances, a duty of confidentiality may even prohibit disclosure of the nature or the existence of the duty itself. Ordinarily, however, a director who withholds material information based on a reasonable belief that a duty of confidentiality prohibits disclosure should advise the other directors of the existence and nature of that duty. Under the standards of conduct set forth in section 8.30(a), the director may also be required to take other action in light of the confidentiality restraint. The precise nature of that action must, of necessity, depend on the specific circumstances. Depending on the nature of the material information and of the matter before the board of directors or committee of the board, such action may include abstention or absence from all or a portion of the other directors' deliberation or vote on the matter to which the undisclosed information is material, or even resignation as a director. See Official Comment to section 8.62. Finally, a duty of confidentiality may not form the basis for the limitation on disclosure unless it is entered into and relied upon in good faith.

The required disclosure (as defined in section 8.60(7)) that must be made under section 8.62(a) in connection with a director's conflicting interest transaction, and the exceptions to the required disclosure in that context under section 8.62(b), have elements that parallel the disclosure obligation of directors under section 8.30(c). The demands of section 8.62, however, are more detailed and specific. They apply to just one situation—a director's conflict of interest transaction—while the requirements of section 8.30(c) apply generally to all other decision-making and oversight functions. For example, the specific requirements of section 8.62(a)(1) for a deliberation and vote outside the presence of the conflicted director are not imposed universally for all decision-making matters or for oversight matters that do not involve a decision. To the extent they may be different from the generally applicable provisions of section 8.30(c), the specific provisions of subchapter F control and are exclusive with respect to director conflicting interest transactions.

4. Section 8.30(d)

The delegation of authority and responsibility under subsection (d) may take the form of (i) formal action through a board resolution, (ii) implicit action through the election of corporate officers (*e.g.*, chief financial officer or controller) or the appointment of corporate managers (e.g., credit manager), or (iii) informal action through a course of conduct (*e.g.*, involvement through corporate officers and managers in the management of a significant 50%-owned joint venture). A director may properly rely on those to whom authority has been delegated pursuant to subsection (d) respecting particular matters calling for specific action or

attention in connection with the directors' decision-making function as well as matters on the board's continuing agenda, such as legal compliance and internal control, in connection with the directors' oversight function. Delegation should be carried out in accordance with the standard of care set forth in section 8.30(b).

By identifying those upon whom a director may rely in connection with the discharge of duties, section 8.30(d) does not limit the ability of directors to delegate their powers under section 8.01(b) except where delegation is expressly prohibited by the Act or otherwise by applicable law (see, *e.g.*, section 8.25(e) and § 11 of the Securities Act of 1933). See section 8.25 and its Official Comment for detailed consideration of delegation to board committees of the authority of the board under section 8.01 and the duty to perform one or more of the board's functions. And by employing the concept of delegation, section 8.30(d) does not limit the ability of directors to establish baseline principles as to management responsibilities. Specifically, section 8.01(b) provides that "all corporate powers shall be exercised by or under the authority of" the board, and a basic board function involves the allocation of management responsibilities and the related assignment (or delegation) of corporate powers. For example, a board can properly decide to retain a third party to assume responsibility for the administration of designated aspects of risk management for the corporation (*e.g.*, health insurance or disability claims). This would involve the directors in the exercise of judgment in connection with the decision-making function pursuant to subsection (b) (*i.e.*, the assignment of authority to exercise corporate powers to an agent). See the Official Comment to section 8.01. It would not entail impermissible delegation-to a person specified in subsection (f)(2) pursuant to subsection (d)—of a board function for which the directors by law have a duty to perform. They have the corporate power (under section 8.01(b)) to perform the task but administration of risk management is not a board function coming within the ambit of directors' duties; together with many similar management responsibilities, they may assign the task in the context of the allocation of corporate powers exercised under the authority of the board. This illustration highlights the distinction between delegation of a board function and assignment of authority to exercise corporate powers.

Although the board may delegate the authority or duty to perform one or more of its functions, reliance on delegation under subsection (d) may not alone constitute compliance with section 8.30 and reliance on the action taken by the delegatee may not alone constitute compliance by the directors or a noncommittee board member with section 8.01 responsibilities. On the other hand, should the board committee or the corporate officer or employee performing the function delegated fail to meet section 8.30's standard of care, noncompliance by the board with section 8.01 will not automatically result. Factors to be considered, in this regard, will include the care used in the delegation to and supervision over the delegatee, and the amount of knowledge regarding the particular matter which is available to the particular director. Care in delegation and supervision includes appraisal of the capabilities and diligence of the delegatee in light of the subject and its relative importance and may be facilitated, in the usual case, by receipt of

reports concerning the delegatee's activities. The enumeration of these factors is intended to emphasize that directors may not abdicate their responsibilities and avoid accountability simply by delegating authority to others. Rather, a director charged with accountability based upon acts of others will fulfill the director's duties if the standards contained in section 8.30 are met.

5. Section 8.30(e)

Reliance under subsection (e) on a report, statement, opinion, or other information is permitted only if the director has read the information, opinion, report or statement in question, or was present at a meeting at which it was orally presented, or took other steps to become generally familiar with it. A director must comply with the general standard of care of section 8.30(b) in making a judgment as to the reliability and competence of the source of information upon which the director proposes to rely or, as appropriate, that it otherwise merits confidence.

6. Section 8.30(f)

Reliance on one or more of the corporation's officers or employees, pursuant to the intracorporate frame of reference of subsection (f)(1), is conditioned upon a reasonable belief as to the reliability and competence of those who have undertaken the functions performed or who prepared or communicated the information, opinions, reports or statements presented. In determining whether a person is "reliable," the director would typically consider (i) the individual's background experience and scope of responsibility within the corporation in gauging the individual's familiarity and knowledge respecting the subject matter and (ii) the individual's record and reputation for honesty, care and ability in discharging responsibilities which he or she undertakes. In determining whether a person is "competent," the director would normally take into account the same considerations and, if expertise should be relevant, the director would consider the individual's technical skills as well. Recognition in the statute of the right of one director to rely on the expertise and experience of another director, in the context of board or committee deliberations, is unnecessary, for the group's reliance on shared experience and wisdom is an implicit underpinning of director conduct. In relying on another member of the board, a director would quite properly take advantage of the colleague's knowledge and experience in becoming informed about the matter at hand before taking action; however, the director would be expected to exercise independent judgment when it comes time to vote.

Subsection (f)(2), which has an extracorporate frame of reference, permits reliance on outside advisers retained by the corporation, including persons specifically engaged to advise the board or a board committee. Possible advisers include not only those in the professional disciplines customarily supervised by state authorities, such as lawyers, accountants, and engineers, but also those in other fields involving special experience and skills, such as investment bankers, geologists, management consultants, actuaries, and real estate appraisers. The adviser could be an individual or an organization, such as a law firm. Reliance on a nonmanagement director, who is specifically engaged (and, normally, additionally

compensated) to undertake a special assignment or a particular consulting role, would fall within this outside adviser frame of reference. The concept of "expert competence" embraces a wide variety of qualifications and is not limited to the more precise and narrower recognition of experts under the Securities Act of 1933. In this respect, subsection (f)(2) goes beyond the reliance provision found in many existing state business corporation acts. In addition, a director may also rely on outside advisers where skills or expertise of a technical nature is not a prerequisite, or where the person's professional or expert competence has not been established, so long as the director reasonably believes the person merits confidence. For example, a board might choose to assign to a private investigator the duty of inquiry (*e.g.*, follow upon rumors about a senior executive's "grand lifestyle") and properly rely on the private investigator's report. And it would be entirely appropriate for a director to rely on advice concerning highly technical aspects of environmental compliance from a corporate lawyer in the corporation's outside law firm, without due inquiry concerning that particular lawyer's technical competence, where the director reasonably believes the lawyer giving the advice is appropriately informed (by reason of resources known to be available from that adviser's legal organization or through other means-and therefore merits confidence.

Subsection (f)(3) permits reliance on a board committee when it is submitting recommendations for action by the full board of directors as well as when it is performing supervisory or other functions in instances where neither the full board of directors nor the committee takes dispositive action. For example, the compensation committee typically reviews proposals and makes recommendations for action by the full board of directors. In contrast, there may be reliance upon an investigation undertaken by a board committee and reported to the full board, which form the basis for a decision by the board of directors not to take dispositive action. Another example is reliance on a committee of the board of directors, such as a corporate audit committee with respect to the board's ongoing role of oversight of the accounting and auditing functions of the corporation. In addition where reliance on information or materials prepared or presented by a board committee is not involved, in connection with board action, a director may properly rely on oversight monitoring or dispositive action by a board committee (of which the director is not a member) empowered to act pursuant to authority delegated under section 8.25 or acting with the acquiescence of the board of directors. See the Official Comment to section 8.25. A director may similarly rely on committees not created under section 8.25 which have nondirector members. In parallel with subsection (f)(2)(ii), the concept of "confidence" is substituted for "competence" in order to avoid any inference that technical skills are a prerequisite. In the usual case, the appointment of committee members or the reconstitution of the membership of a standing committee (*e.g.*, the audit committee), following an annual shareholders' meeting, would alone manifest the noncommittee members' belief that the committee "merits confidence." However, the reliance contemplated by subsection (f)(3) is geared to the point in time when the board takes action or the period of time over which a committee is engaged

in an oversight function; consequently, the judgment to be made (*i.e.*, whether a committee "merits confidence") will arise at varying points in time. After making an initial judgment that a committee (of which a director is not a member) merits confidence, the director may depend upon the presumption of regularity absent knowledge or notice to the contrary.

7. APPLICATION TO OFFICERS

Section 8.30 generally deals only with directors. Section 8.42 and its Official Comment explain the extent to which the provisions of section 8.30 apply to officers.

Proposed changes to section 8.01 (and related changes) are shown below with additions underlined and deletions in strikethrough.

Add new section 1.40(18A):

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

Proposed addition to Official Comment to section 1.40:
6.1. Public Corporation
The term "public corporation" defined in section 1.40(18A) is used in sections 7.32, 8.01, 14.31 and 14.34 to distinguish publicly held corporations from other corporations. The definition establishes that distinction by reference to the existence of an organized trading market in the corporation's shares as an indication of broad share ownership. The reference to markets comes from the securities law governing regulation of securities trading markets.

Proposed change to section 7.32:

(d) An agreement authorized by this section shall cease to be effective when the corporation becomes a public corporation ~~shares of the corporation are listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national or affiliated securities association~~. If the agreement ceases to be effective for any reason, 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.

Proposed change to Official Comment to section 7.32:

4. Section 7.32(d)

Section 7.32(d) contains a self-executing termination provision for a shareholder agreement when the shares of the corporation become publicly ~~held~~ traded, and the corporation thereby becomes a public corporation as defined in section 1.40(18A). The statutory norms in the Model Act become more appropriate as the number of shareholders increases, as there is greater opportunity to acquire or dispose of an investment in the corporation, and as there is less opportunity for negotiation over the terms under which the enterprise will be conducted. Given that section 7.32 requires unanimity, however, in most cases a practical limit will be reached before a public market develops. Subsection (d)~~, coupled with a parallel change in section 8.01,~~ rejects the use of an absolute number of shareholders in determining when the shelter of section 7.32 is lost.

Proposed change to section 14.31(d):

(d) Within 10 days of the commencement of a proceeding under section 14.30(2) to dissolve a corporation that is not a public corporation ~~that~~

~~has no shares listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national or affiliated securities association~~, the corporation must send to all shareholders, other than the petitioner, a notice stating that the shareholders are entitled to avoid the dissolution of the corporation by electing to purchase the petitioner's shares under section 14.34 and accompanied by a copy of section 14.34

[no change to the Official Comment is necessary]

Proposed change to section 14.34:

(b) In a proceeding under section 14.30(2) to dissolve a corporation that is not a public corporation ~~has no shares listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national or affiliated securities association~~, 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.

Proposed change to Official Comment to section 14.34:

1. AVAILABILITY

There are three prerequisites to filing an election to purchase under section 14.34. First, a proceeding to dissolve the corporation under section 14.30(2) must have been commenced. Second, the corporation must not be a public corporation as defined in section 1.40(18A) ~~must have no shares of any class listed on a national securities exchange or regularly traded over the counter~~. Finally, 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(2).

Proposed changes to section 8.01 and its Official Comment

§ 8.01. REQUIREMENTS FOR AND ~~DUTIES~~ FUNCTIONS OF BOARD OF DIRECTORS

(a) Except as provided in section 7.32, each corporation must have a board of directors.

(b) All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32.

(c) In the case of a public corporation, the board's oversight responsibilities include attention to:

(i) business performance and plans;
(ii) major risks to which the corporation is or may be exposed;
(iii) the performance and compensation of senior officers;
(iv) policies and practices to foster the corporation's compliance with law and ethical conduct;
(v) preparation of the corporation's financial statements;
(vi) the effectiveness of the corporation's internal controls;
(vii) arrangements for providing adequate and timely information to directors; and
(viii) the composition of the board and its committees, taking into account the important role of independent directors.

CROSS-REFERENCES

Amendment of articles of incorporation, see ch. 10A.
Articles of incorporation, see § 2.02.
Close corporations, see Model Statutory Corporation Supplement.
Director standards of conduct, see § 8.30.
Indemnification, see §§ 8.50-8.59.
Number of shareholders, see § 1.42.
Officers, see §§ 8.40 & 8.41.
Public corporation, see §1.40(18A).

OFFICIAL COMMENT

Section 8.01(a) requires that every corporation have a board of directors except that a shareholder agreement authorized by section 7.32 may dispense with ~~or limit the authority of~~ the board of directors. Section 8.01(b) also recognizes that the powers of the board of directors may be limited by express provisions in the articles of incorporation or by an agreement among all shareholders under section 7.32.

Obviously, some form of governance is necessary for every corporation. The board of directors is the traditional form of governance but it need not be the exclusive form. Patterns of management may also be tailored to specific needs in connection with family-controlled enterprises, wholly or partially owned subsidiaries, or corporate joint ventures through a shareholder agreement under section 7.32.

Under section 7.32, an agreement among all shareholders can provide for a nontraditional form of governance until there is a regular market for the corporation's shares, a change from the 50 or fewer shareholder test in place in section 8.01 prior to 1990. As the number of shareholders increases and a market for the shares develops, there is (i) an opportunity for unhappy shareholders to dispose of shares(a "market out," (ii) a correlative opportunity for others to acquire shares with related expectations regarding the applicability of the statutory norms of governance, and (iii) no real opportunity to negotiate over the terms upon which the enterprise will be conducted. Moreover, tying the availability of nontraditional governance structures to an absolute number of shareholders at the time of adoption took no account of subsequent events, was overly mechanical, and was sub-

ject to circumvention. If a corporation does not have a shareholder agreement that satisfies the requirements of section 7.32 or if it is a public corporation, ~~a market exists for its shares as specified in section 7.32~~, it must adopt the traditional board of directors as its governing body.

Section 8.01(b) states that if a corporation has a board of directors "its business and affairs shall be managed by or under the direction, and subject to the oversight, of its board of directors." The phrase "by or under the direction, and subject to the oversight, of," ~~was chosen to~~ encompass~~es~~ the varying functions of boards of directors of different corporations. In some closely held corporations, the board of directors may be involved in the day-to-day business and affairs and it may be reasonable to describe management as being "by" the board of directors. But in many other ~~most~~ corporations, the business and affairs are managed "under the direction, and subject to the oversight, of" the board of directors, since ~~the role of the board of directors consists principally of the formulation of policy, the selection of the chief executive officer and other key officers, and the approval of major actions or transactions~~ operational management is delegated to executive officers and other professional managers.

~~It is generally recognized that~~ While section 8.01(b), in providing for corporate powers to be exercised under the authority of the board of directors, allows the board of directors ~~may~~ to delegate to appropriate officers, employees or agents of the corporation authority to exercise powers and perform functions not required by law to be exercised or performed by the board of directors itself, responsibility to oversee the exercise of that delegated authority nonetheless remains with the board of directors. The scope of that oversight responsibility will vary depending on the nature of the corporation's business. For public corporations, subsection (c) provides that the scope of the directors' oversight responsibility includes the matters identified in that subsection. For other corporations, that responsibility may, depending on the circumstances, include some or all of those matters as well. At least for public corporations, subsections (c)(iii) and (iv) encompass oversight of the corporation's dealings and relationships with its directors and officers, including processes designed to prevent improper related party transactions. See also, chapter 8, subchapter F, sections 8.60 *et seq.* Subsection (c)(v) encompasses the corporation's compliance with the requirements of sections 16.01 and 16.20, while subsection (c)(vi) extends also to the internal control processes in place to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Subsection (c)(vii) reflects that the board of directors should devote attention to whether the corporation has information and reporting systems in place to provide directors with appropriate information in a timely manner in order to permit them to discharge their responsibilities. *See In re Caremark Int'l Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

Subsection (c) (viii) calls for the board of a public corporation, in giving attention to the composition of the board and its committees, to take into account the important role of independent directors. It is commonly accepted that where ownership is separated from management, as is the case with public corporations,

having non-management independent directors who participate actively in the board's oversight functions increases the likelihood that actions taken by the board will serve the best interests of the corporation and its shareholders and generally will be given deference in judicial proceedings. The listing standards of most public securities markets have requirements for independent directors to serve on boards; in many cases, they must constitute a majority of the board, and certain board committees must be composed entirely of independent directors. The listing standards have differing rules as to what constitutes an independent director. The Act does not attempt to define "independent director." Ordinarily, an independent director may not be a present or recent member of senior management. Also, to be considered independent, the individual usually must be free of significant professional, financial or similar relationships with the corporation—directly or as a partner, major shareholder or officer of an organization with such a relationship—and the director and members of the director's immediate family must be free of similar relationships with the corporation's senior management. Judgment is required to determine independence in light of the particular circumstances, subject to any specific requirements of a listing standard. The qualities of disinterestedness required of directors under the Act for specific purposes are similar but not necessarily identical. For the requirements for a director to be eligible to act in those situations, see sections 7.40 and 7.44 (dismissal of shareholder derivative proceedings); sections 8.50 and 8.55 (b) (1) authorization of indemnification); and section 8.62 (approval of a director's conflicting interest transaction). An individual who is generally an independent director for purposes of subsection (c) may not be eligible to act in a particular case under those other provisions of the Act. Conversely, a director who is not independent for purposes of subsection (c) (for example, a member of management) may be so eligible in a particular case.

Although delegation does not relieve the board of directors from its responsibilities of oversight, directors should not be held personally responsible for actions or omissions of officers, employees, or agents of the corporation so long as the directors have relied reasonably and in good faith upon these officers, employees, or agents. See sections 8.30 and 8.31 and ~~its~~ their Official Comments. ~~The board of~~ Directors generally have the power to probe into day-to-day management to any depth they choose, but they have the obligation to do so only to the extent that the directors' oversight responsibilities may require, or, for example, when they become aware of matters which make reliance on management or other persons unwarranted.

~~Section 8.01(b) also recognizes that the powers of the board of directors may be limited by express provisions in the articles of incorporation.~~

§ 8.25. COMMITTEES

(a) Unless this Act, the articles of incorporation or the bylaws provide otherwise, a board of directors may create one or more committees and appoint one or more members of the board of directors to serve on any such committee.

(b) Unless this Act otherwise provides, the creation of a committee and appointment of members to it must be approved by the greater of (1) a majority of all the directors in office when the action is taken or (2) the number of directors required by the articles of incorporation or bylaws to take action under section 8.24.

(c) Sections 8.20 through 8.24 apply both to committees of the board and to their members.

(d) To the extent specified by the board of directors or in the articles of incorporation or bylaws, each committee may exercise the powers of the board of directors under section 8.01.

(e) A committee may not, however:

(1) authorize or approve distributions, except according to a formula or method, or within limits, prescribed by the board of directors;

(2) approve or propose to shareholders action that this Act requires be approved by shareholders;

(3) fill vacancies on the board of directors or, subject to subsection (g), on any of its committees; or

(4) adopt, amend, or repeal bylaws.

(f) The creation of, delegation of authority to, or action by a committee does not alone constitute compliance by a director with the standards of conduct described in section 8.30.

(g) The board of directors may appoint one or more directors as alternate members of any committee to replace any absent or disqualified member during the member's absence or disqualification. Unless the articles of incorporation or the bylaws or the resolution creating the committee provide otherwise, in the event of the absence or disqualification of a member of a committee, the member or members present at any meeting and not disqualified from voting, unanimously, may appoint another director to act in place of the absent or disqualified member.

CROSS-REFERENCES

Articles of incorporation, see § 2.02, ch. 10A.

Bylaws, see § 2.06, ch. 10B.

Derivative proceedings, see §§ 7.40-7.47.

Director standards of conduct, see § 8.30.

Dissolution, see ch. 14.

Distributions, see § 6.40.

Duties of board of directors, see § 8.01.

Indemnification determination, see § 8.55.

Issuance of shares, see §§ 6.01 & 6.02.

Mergers, see ch. 11.

Quorum and voting, see § 8.24.

Reacquisition of shares, see §§ 6.03 & 6.31.

Vacancies on board, see § 8.10.

OFFICIAL COMMENT

Section 8.25 makes explicit the common law power of a board of directors to act through committees of directors and specifies the powers of the board of directors that are nondelegable, that is, powers that only the full board of directors may exercise. Section 8.25 deals only with board committees exercising the powers or performing the functions of the board of directors; the board of directors or management, independently of section 8.25, may establish nonboard committees composed of directors, employees, or others to exercise corporate powers not required to be exercised by the board of directors.

Section 8.25(b) states that, unless this Act otherwise provides, a committee of the board of directors may be created only by the affirmative vote of a majority of the board of directors then in office, or, if greater, by the number of directors required to take action by the articles of incorporation or the bylaws. This supermajority requirement reflects the importance of the decision to invest board committees with power to act under section 8.25. Section 7.44(b) requires that a special litigation committee, to consider whether the maintenance of a derivative action is in the corporation's best interest, be appointed by a majority vote of independent directors present at a meeting of the board. Sections 8.55(b) and 8.62(a), respectively, contain a *generally* similar requirement with regard to the appointment of a committee to consider whether indemnification is permissible and the appointment of a committee to consider approval of a director conflicting interest transaction.

Committees of the board of directors are assuming increasingly important roles in the governance of public~~ly held~~ corporations. *See* The Committee on Corporate Laws, Corporate Director's Guidebook, (4th ed. 2004). Nominating and compensation committees, composed primarily or entirely of ~~nonmanagement or~~ independent directors, are widely used by public~~ly held~~ corporations and may be required by listing standards adopted by public securities markets. Such standards, including those mandated by law, also require the appointment of ~~. A~~ audit committees, ***composed entirely*** of ~~nonmanagement or~~ independent directors, to perform important ~~review~~ functions including the selection and retention of the corporation's external auditors. ~~assigned to them by the board of directors~~.

Section 8.25(a) permits a committee to consist of a single director. This accommodates situations in which only one director may be present or available to make a decision on short notice, as well as situations in which it is unnecessary or inconvenient to have more than one member on a committee. Committees also are often employed to decide matters in which other members of the board have a conflict of interest; in such a case, a court will typically scrutinize with care the committee's decision when it is the product of a lone director. See, e.g., *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985). Additionally, various sections of the Model Act require the participation or approval of at least two ~~independent~~ directors *with no disqualifying relationship* in order for the decision of the board or committee to have effect. These include a determination that maintenance of a derivative suit is not in the corporation's best interests (section 7.44(b)(3)), a

determination that indemnification is permissible (section 8.55(b)(1)) and an approval of a director conflicting interest transaction (section 8.62(a)).

Section 8.25 limits the role of board committees in light of competing policies: on the one hand, it seems clear that appropriate committee action is not only desirable but is also likely to improve the functioning of larger and more diffuse boards of directors; on the other hand, wholesale delegation of authority to a board committee, to the point of abdication of director responsibility as a board of directors, is manifestly inappropriate and undesirable. Overbroad delegation also increases the potential, where the board of directors is divided, for usurpation of basic board functions by means of delegation to a committee dominated by one faction.

The statement of nondelegable functions set out in section 8.25(e) is based on the principle that prohibitions against delegation to board committees should be limited generally to actions that substantially affect the rights of shareholders or are fundamental to the governance of the corporation. As a result, delegation of authority to committees under section 8.25(e) may be broader than mere authority to act with respect to matters arising within the ordinary course of business.

Section 8.25(e) prohibits delegation of authority with respect to most mergers, sales of substantially all the assets, amendments to articles of incorporation and voluntary dissolution since these require shareholder action. In addition, section 8.25(e) prohibits delegation to a board committee of authority to fill board vacancies, subject to subsection (g), or to amend the bylaws. On the other hand, under section 8.25(e) many actions of a material nature, such as the authorization of long-term debt and capital investment or the issuance of shares, may properly be made the subject of committee delegation. In fact, the list of nondelegable powers has been reduced from the prior formulation of section 8.25(e).

Although section 8.25(e)(1) generally makes nondelegable the decision whether to authorize or approve distributions, including dividends, it does permit the delegation to a committee of power to approve a distribution pursuant to a formula or method or within limits prescribed by the board of directors. Therefore, the board could set a dollar range and timeframe for a prospective dividend and delegate to a committee the authority to determine the exact amount and record and payment dates of the dividend. The board also could establish certain conditions to the payment of a distribution and delegate to a committee the power to determine whether the conditions have been satisfied.

The statutes of several states make nondelegable certain powers not listed in section 8.25(e)—for example, the power to change the principal corporate office, to appoint or remove officers, to fix director compensation, or to remove agents. These are not prohibited by section 8.25(e) since the whole board of directors may reverse or rescind the committee action taken, if it should wish to do so, without undue risk that implementation of the committee action might be irrevocable or irreversible.

Section 8.25(f) makes clear that although the board of directors may delegate to a committee the authority to take action, the designation of the committee, the

delegation of authority to it, and action by the committee does not alone constitute compliance by a noncommittee board member with the director's responsibility under section 8.30. On the other hand, a noncommittee director also does not automatically incur personal risk should the action of the particular committee fail to meet the standard of conduct set out in section 8.30. The noncommittee member's liability in these cases will depend upon whether the director's conduct was actionable under section 8.31. Factors to be considered in this regard will include the care used in the delegation to and supervision over the committee, the extent to which the delegation was required by applicable law or listing standards, and the amount of knowledge regarding the actions being taken by the committee which is available to the noncommittee director. Care in delegation and supervision may be facilitated, in the usual case, by review of minutes and receipt of other reports concerning committee activities. The enumeration of these factors is intended to emphasize that directors may not abdicate their responsibilities and avoid liability simply by delegating authority to board committees. Rather, a director against whom liability is asserted based upon acts of a committee of which the director is not a member avoids liability under section 8.31 by an appropriate measure of monitoring— particularly if the director met the standards contained in section 8.30 with respect to the creation and supervision of the committee.

Section 8.25(f) has no application to a member of the committee itself. The standards of conduct applicable to a committee member are set forth in section 8.30.

Section 8.25(g) is a rule of convenience that permits the board or the other committee members to replace an absent or disqualified member during the time that the member is absent or disqualified. Unless otherwise provided, replacement of an absent or disqualified member is not necessary to permit the other committee members to continue to perform their duties.

§ 8.30. STANDARDS OF CONDUCT FOR DIRECTORS

(a) Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.

(b) The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.

(c) In discharging board or committee duties a director shall disclose, or cause to be disclosed, to the other board or committee members information not already known by them but known by the director to be material to the discharge of their decision-making or oversight functions, except that disclosure is not required to the extent that the director reasonably believes that doing so would violate a duty imposed under law, a legally enforceable obligation of confidentiality, or a professional ethics rule.

(d) In discharging board or committee duties a director[] who does not have knowledge that makes reliance unwarranted[] is entitled to rely on the performance by any of the persons specified in subsection (f)(1) or subsection (f)(3) to whom the board may have delegated, formally or informally by course of conduct, the authority or duty to perform one or more of the board's functions that are delegable under applicable law.

(e) In discharging board or committee duties a director[] who does not have knowledge that makes reliance unwarranted[] is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, prepared or presented by any of the persons specified in subsection (f).

(f) A director is entitled to rely, in accordance with subsection (d) or (e), on:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports or statements provided;

(2) legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence; or

(3) a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.

CROSS-REFERENCES

Committees of board of directors, see § 8.25
Conflict of interest, see ch. 8F
Derivative proceedings, see §§ 7.40–7.47.
Duty of board of directors, see § 8.01
Indemnification, see §§ 8.50–8.59
Meetings of board of directors, see § 8.20 & 8.21
Officer standards of conduct, see § 8.42.
Officers, see §§ 8.40 & 8.42
Quorum of directors, see § 8.24.
Removal of directors, see §§ 8.09 & 8.09.
Standards of liability for directors, see § 8.31.
Unlawful distributions, see § 8.33.

OFFICIAL COMMENT

Section 8.30 defines the general standards of conduct for directors. Under subsection (a), each board member must always perform a director's duties in good faith and in a manner reasonably believed to be in the best interests of the corporation. Although each director also has a duty to comply with its requirements, the focus of subsection (b) is on the discharge of those duties by the board as a collegial body. Under subsection (b), the members of the board or a board

committee are to perform their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances. This standard of conduct is often characterized as a duty of care. Subsection (c) sets out the responsibility of each director, in discharging board or committee duties, to disclose or cause to be disclosed to the other members of the board or board committee information, of which they are unaware, known by the director to be material to their decision-making or oversight responsibilities, *subject to countervailing confidentiality duties and appropriate action with respect thereto.*

Section 8.30 sets forth the standards of conduct for directors by focusing on the manner in which directors perform their duties, not the correctness of the decisions made. These standards of conduct are based on former section 35 of the 1969 Model Act, a number of state statutes and on judicial formulations of the standards of conduct applicable to directors. Section 8.30 should be read in light of the basic role of directors set forth in section 8.01(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, as supplemented by various provisions of the Act assigning specific powers or responsibilities to the board. Relevant thereto, directors often act collegially in performing their functions and discharging their duties. If the observance of the directors' conduct is called into question, courts will typically evaluate the conduct of the entire board (or committee). Deficient performance of section 8.30 duties on the part of a particular director may be overcome, absent unusual circumstances, by acceptable conduct (meeting, for example, subsection (b)'s standard of care) on the part of other directors sufficient in number to perform the function or discharge the duty in question. While not thereby remedied, the deficient performance becomes irrelevant in any evaluation of the action taken. (This contrasts with a director's duties of loyalty ~~and~~, fair dealing and disclosure which will be evaluated on an individual basis and will also implicate discharge of the director's duties under subsection (a).) Further relevant thereto, the board may delegate or assign to appropriate officers, employees or agents of the corporation the authority or duty to exercise powers that the law does not require it to retain. Since the directors are entitled to rely thereon absent knowledge making reliance unwarranted, deficient performance of the directors' section 8.30 duties will not result from their delegatees' actions or omissions so long as the board acted in good faith and complied with the other standards of conduct set forth in section 8.30 in delegating responsibility and, where appropriate, monitoring performance of the duties delegated.

In earlier versions of the Model Act the duty of care element was included in subsection (a), with the text reading: "[a] director shall discharge his duties—with the care an ordinarily prudent person in a like position would exercise under similar circumstances." The use of the phrase "ordinarily prudent person" in a basic guideline for director conduct, suggesting caution or circumspection vis-a-vis danger or risk, has long been problematic given the fact that risk-taking decisions are central to the directors' role. When coupled with the exercise of "care," the prior text had a familiar resonance long associated with the field of tort law. See the Official Comment to section 8.31. The further coupling with the phrasal

verb "shall discharge" added to the inference that former section 8.30(a)'s standard of conduct involved a negligence standard, with resultant confusion. In order to facilitate its understanding, and analysis, independent of the other general standards of conduct for directors, the duty of care element has been set forth as a separate standard of conduct in subsection (b).

Long before statutory formulations of directors' standards of conduct, courts would invoke the business judgment rule in evaluating directors' conduct and determining whether to impose liability in a particular case. The elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts. Section 8.30 does not try to codify the business judgment rule or to delineate the differences between that defensive rule and the section's standards of director conduct. Section 8.30 deals only with standards of conduct—the level of performance expected of every director entering into the service of a corporation and undertaking the role and responsibilities of the office of director. The section does not deal directly with the liability of a director—although exposure to liability will usually result from a failure to honor the standards of conduct required to be observed by subsection (a). See section 8.31(a)(1) and clauses (i) and (ii)(A) of section 8.31(a)(2). The issue of directors' liability is addressed in sections 8.31 and 8.33 of this subchapter. Section 8.30 does, however, play an important role in evaluating a director's conduct and the effectiveness of board action. It has relevance in assessing, under section 8.31, the reasonableness of a director's belief. Similarly, it has relevance in assessing a director's timely attention to appropriate inquiry when particular facts and circumstances of significant concern materialize. It serves as a frame of reference for determining, under section 8.33(a), liability for an unlawful distribution. ~~Further, compliance with the section is important under section 8.62 for board action to be effective, under section 8.61(b)(1), to protect (i) a director's conflicting interest transaction, and (ii) the director(s) interested in the transaction.~~ Finally, section 8.30 compliance may have a direct bearing on a court's analysis where transactional justification (*e.g.*, a suit to enjoin a pending merger) is at issue.

A director complying with the standard of care expressed in subsection (b) is entitled to rely (under subsection (d)) upon board functions performed pursuant to delegated authority by, and to rely (under subsection (e)) upon information, opinions, reports or statements, including financial statements and other financial data, provided by, the persons or committees specified in the relevant parts of subsection (f). Within this authorization, the right to rely applies to the entire range of matters for which the board of directors is responsible. However, a director so relying must be without knowledge that would cause that reliance to be unwarranted. Section 8.30 expressly prevents a director from "hiding his or her head in the sand" and relying on the delegation of board functions, or on information, opinions reports or statements, when the director has actual knowledge that makes (or has a measure of knowledge that would cause a person, in a like position under similar circumstances, to undertake reasonable inquiry that would lead to information making) reliance unwarranted. Subsection (a)'s standards of

good faith and reasonable belief in the best interests of the corporation also apply to a director's reliance under subsections (d), (e) and (f).

1. Section 8.30(a)

Section 8.30(a) establishes the basic standards of conduct for all directors. Its command is to be understood as peremptory(its obligations are to be observed by every director(and at the core of the subsection's mandate is the requirement that, when performing directors' duties, a director shall act in good faith coupled with conduct reasonably believed to be in the best interests of the corporation. This mandate governs all aspects of directors' duties: the duty of care, the duty to become informed, the duty of inquiry, the duty of informed judgment, the duty of attention, the duty of disclosure, the duty of loyalty, the duty of fair dealing and, finally, the broad concept of fiduciary duty that the courts often use as a frame of reference when evaluating a director's conduct. These duties do not necessarily compartmentalize and, in fact, tend to overlap. For example, the duties of care, inquiry, becoming informed, attention, disclosure and informed judgment all relate to the board's decision-making function, whereas the duties of attention, disclosure, becoming informed and inquiry relate to the board's oversight function.

Two of the phrases chosen to specify the manner in which a director's duties are to be discharged deserve further comment:

(1) The phrase "reasonably believes" is both subjective and objective in character. Its first level of analysis is geared to what the particular director, acting in good faith, actually believes—not what objective analysis would lead another director (in a like position and acting in similar circumstances) to conclude. The second level of analysis is focused specifically on "reasonably." While a director has wide discretion in marshalling the evidence and reaching conclusions, whether a director's belief is reasonable (*i.e.*, could(not would(a reasonable person in a like position and acting in similar circumstances have arrived at that belief) ultimately involves an overview that is objective in character.

(2) The phrase "best interests of the corporation" is key to an explication of a director's duties. The term "corporation" is a surrogate for the business enterprise as well as a frame of reference encompassing the shareholder body. In determining the corporation's "best interests," the director has wide discretion in deciding how to weigh near-term opportunities versus long-term benefits as well as in making judgments where the interests of various groups within the shareholder body or having other cognizable interests in the enterprise may differ.

As a generalization, section 8.30 operates as a "baseline" principle governing director conduct "when discharging the [ongoing] duties of a director" in circumstances uncomplicated by self-interest taint. The Model Act recognizes, however, that directors' personal interests may not always align with the corporation's best interests and provides procedures by which interest-conflict transactions can be processed. See subchapter D (derivative proceedings) of chapter 7 and

subchapter E (indemnification) and subchapter F (directors' conflicting interest transactions) of this chapter 8. Those procedures generally contemplate that the interested director will not be involved in taking action on the interest-conflict transaction. And the common law has recognized that other interest-conflict situations may arise which do not entail a "transaction" by or with the corporation. See subchapter G of this chapter 8 (discussing the corporate opportunity doctrine). The interested director is relieved of the duty to act in connection with the matter on behalf of the corporation (specifically, the traditional mandate to act in the corporation's best interests), given the inherent conflict. However, the interested director is still expected to act in good faith, and that duty is normally discharged by observing the obligation of fair dealing. In the case of interest-conflict transactions, where there is a conflicting interest with respect to the corporation under section 8.60(1), the interested director's conduct is governed by subchapter F of this chapter 8. The duty of fair dealing is embedded in the subsection 8.60(7) provision calling for the interested director to make the required disclosure as to the conflicting interest and the transaction and, if one of the two safe harbor procedures is not properly observed, the interested director must prove the fairness (*i.e.*, procedure, involving good faith among other aspects, as well as price) of the transaction to the corporation. In other cases, Section 8.30's standards of conduct are overlaid by various components of the duty to act fairly, the particular thrusts of which will depend upon the kind of interested director's conduct at issue and the circumstances of the case. As a general rule, the duty of fair dealing is normally discharged by the interested director through appropriate disclosure to the other directors considering the matter followed by abstention from participation in any decision-making relevant thereto. If and to the extent that the interested director's action respecting the matter goes further, the reasonableness of the director's belief as to the corporation's best interests, in respect of the action taken, should be evaluated on the basis of not only the director's honest and good faith belief but also on considerations bearing on the fairness of the transaction or conduct to the corporation.

2. Section 8.30(b)

Section 8.30(b) establishes a general standard of care for directors in the context of their dealing with the board's decision-making and oversight functions. While certain aspects will involve individual conduct (e.g., preparation for meetings), these functions are generally performed by the board through collegial action, as recognized by the reference in subsection (b) to board and committee "members" and "their duties." In contrast with subsection (a)'s individual conduct mandate, section 8.30(b) has a two-fold thrust: it provides a standard of conduct for individual action and, more broadly, it states a conduct obligation—"shall discharge their duties"—concerning the degree of care to be collegially used by the directors when performing those functions. It provides that directors have a duty to exercise "the care that a person in a like position would reasonably believe appropriate under similar circumstances."

The traditional formulation for a director's standard (or duty) of care has been geared to the "ordinarily prudent person." For example, the Model Act's prior

formulation (in former section 8.30(a)(2)) referred to "the care an ordinarily prudent person in a like position would exercise under similar circumstances," and almost all state statutes that include a standard of care reflect parallel language. The phrase "ordinarily prudent person" constitutes a basic frame of reference grounded in the field of tort law and provides a primary benchmark for determining negligence. For this reason, its use in the standard of care for directors, suggesting that negligence is the proper determinant for measuring deficient (and thus actionable) conduct, has caused confusion and misunderstanding. Accordingly, the phrase "ordinarily prudent person" has been removed from the Model Act's standard of care and in its place "a person in a like position" has been substituted. The standard is not what care a particular director might believe appropriate in the circumstances but what a person(in a like position and acting under similar circumstances(would reasonably believe to be appropriate. Thus, the degree of care that directors should employ, under subsection (b), involves an objective standard.

Some state statutes have used the words "diligence," "care," and "skill" to define the duty of care. There is very little authority as to what "skill" and "diligence," as distinguished from "care," can be required or properly expected of corporate directors in the performance of their duties. "Skill," in the sense of technical competence in a particular field, should not be a qualification for the office of director. The concept of "diligence" is sufficiently subsumed within the concept of "care." Accordingly, the words "diligence" and "skill" are not used in section 8.30's standard of care.

The process by which a director becomes informed, in carrying out the decision-making and oversight functions, will vary. Relevant thereto, the directors' decision-making function is established in large part by various sections of the Act: the issuance of shares (6.21); distributions (6.40); dismissal of derivative proceedings (7.44); indemnification (8.55); interested-transaction authorization (8.62); articles of incorporation amendments (10.02 and 10.03); bylaw amendments (10.20); mergers (11.01); share exchanges (11.02); asset sales and mortgages (12.01 and 12.02); and dissolution (14.02). ~~In contrast, the Act does not deal directly with the~~ The directors' oversight function ~~That function~~ is established ~~indirectly by~~ under section 8.01~~(b)'s broad provision making the board responsible for the exercise of corporate powers and the direction of how the corporation's business and affairs are managed.~~ In relying on the performance by management of delegated or assigned section 8.01 duties (including, for example, matters of law and legal compliance), as authorized by subsection (d), directors may depend upon the presumption of regularity absent knowledge or notice to the contrary. In discharging the section 8.01 duties associated with the board's oversight function, the standard of care entails primarily a duty of attention. In contrast with the board's decision-making function, which generally involves informed action at a point in time, the oversight function is concerned with a continuum and the duty of attention accordingly involves participatory performance over a period of time.

Several of the phrases chosen to define the standard of conduct in section 8.30(b) deserve specific mention:

(1) The phrase "becoming informed," in the context of the decision-making function, refers to the process of gaining sufficient familiarity with the background facts and circumstances in order to make an informed judgment. Unless the circumstances would permit a reasonable director to conclude that he or she is already sufficiently informed, the standard of care requires every director to take steps to become informed about the background facts and circumstances before taking action on the matter at hand. The process typically involves review of written materials provided before or at the meeting and attention to/participation in the deliberations leading up to a vote. It can involve consideration of information and data generated by persons other than legal counsel, public accountants, etc., retained by the corporation, as contemplated by subsection (f)(2); for example, review of industry studies or research articles prepared by unrelated parties could be very useful. It can also involve direct communications, outside of the boardroom, with members of management or other directors. There is no one way for "becoming informed," and both the method and measure—"how to" and "how much"—are matters of reasonable judgment for the director to exercise.

(2) The phrase "devoting attention," in the context of the oversight function, refers to concern with the corporation's information and reporting systems and not to proactive inquiry searching out system inadequacies or noncompliance. While directors typically give attention to future plans and trends as well as current activities, they should not be expected to anticipate the problems which the corporation may face except in those circumstances where something has occurred to make it obvious to the board that the corporation should be addressing a particular problem. The standard of care associated with the oversight function involves gaining assurances from management and advisers that systems believed appropriate have been established, coupled with ongoing monitoring of the systems in place, such as those concerned with legal compliance or internal controls(followed up with a proactive response when alerted to the need for inquiry.

(3) The reference to "person," without embellishment, is intended to avoid implying any qualifications, such as specialized expertise or experience requirements, beyond the basic director attributes of common sense, practical wisdom, and informed judgment.

(4) The phrase "reasonably believe appropriate" refers to the array of possible options that a person possessing the basic director attributes of common sense, practical wisdom and informed judgment would recognize to be available, in terms of the degree of care that might be appropriate, and from which a choice by such person would be made. The measure of

care that such person might determine to be appropriate, in a given instance, would normally involve a selection from the range of options and any choice within the realm of reason would be an appropriate decision under the standard of care called for under subsection (b). However, a decision that is so removed from the realm of reason, or is so unreasonable, that it falls outside the permissible bounds of sound discretion, and thus an abuse of discretion, will not satisfy the standard.

(5) The phrase "in a like position" recognizes that the "care" under consideration is that which would be used by the "person" if he or she were a director of the particular corporation.

(6) The combined phrase "in a like position . . . under similar circumstances" is intended to recognize that (a) the nature and extent of responsibilities will vary, depending upon such factors as the size, complexity, urgency, and location of activities carried on by the particular corporation, (b) decisions must be made on the basis of the information known to the directors without the benefit of hindsight, and (c) the special background, qualifications, and management responsibilities of a particular director may be relevant in evaluating that director's compliance with the standard of care. Even though the combined phrase is intended to take into account the special background, qualifications and management responsibilities of a particular director, it does not excuse a director lacking business experience or particular expertise from exercising the basic director attributes of common sense, practical wisdom, and informed judgment.

3. Section 8.30(c)

A duty to disclose information that a director knows to be material to the oversight or decision-making functions of the board or committee has always been embraced in the standards of conduct set forth in subsections (a) and (b). Subsection (c) makes explicit this existing duty of disclosure among directors. Thus, for example, when a member of the board knows information that the director recognizes is material to a decision by the board to approve financial statements of the corporation, the director is obligated to see to it that such information is provided to the other members of the board. So long as that disclosure is accomplished, the action required of the director can occur through direct statements in meetings of the board, or by any other timely means, including, for example, communicating the information to the chairman of the board or the chairman of a committee, or to the corporation's general counsel, and requesting that the recipient inform the other board or committee members of the disclosed information.

Subsection (c) recognizes that a duty of confidentiality can override a director's obligation to share with other directors information pertaining to a current corporate matter, and that a director is not required to make such disclosure to the extent the director reasonably believes that such a duty of confidentiality prohibits it. In some circumstances, a duty of confidentiality may even prohibit disclosure

of the nature or the existence of the duty itself. Ordinarily, however, a director who withholds material information based on a reasonable belief that a duty of confidentiality prohibits disclosure should advise the other directors of the existence and nature of that duty. Under the standards of conduct set forth in section 8.30(a), the director may also be required to take other action in light of the confidentiality restraint. The precise nature of that action must, of necessity, depend on the specific circumstances. Depending on the nature of the material information and of the matter before the board of directors or committee of the board, such action may include abstention or absence from all or a portion of the other directors' deliberation or vote on the matter to which the undisclosed information is material, or even resignation as a director. See Official Comment to section 8.62. Finally, a duty of confidentiality may not form the basis for the limitation on disclosure unless it is entered into and relied upon in good faith.

The required disclosure (as defined in section 8.60(7)) that must be made under section 8.62(a) in connection with a director's conflicting interest transaction, and the exceptions to the required disclosure in that context under section 8.62(b), have elements that parallel the disclosure obligation of directors under section 8.30(c). The demands of section 8.62, however, are more detailed and specific. They apply to just one situation—a director's conflict of interest transaction—while the requirements of section 8.30(c) apply generally to all other decision-making and oversight functions. For example, the specific requirements of section 8.62(a)(1) for a deliberation and vote outside the presence of the conflicted director are not imposed universally for all decision-making matters or for oversight matters that do not involve a decision. To the extent they may be different from the generally applicable provisions of section 8.30(c), the specific provisions of subchapter F control and are exclusive with respect to director conflicting interest transactions.

4. Section 8.30(d)

The delegation of authority and responsibility under subsection (d) may take the form of (i) formal action through a board resolution, (ii) implicit action through the election of corporate officers (*e.g.*, chief financial officer or controller) or the appointment of corporate managers (e.g., credit manager), or (iii) informal action through a course of conduct (*e.g.*, involvement through corporate officers and managers in the management of a significant 50%-owned joint venture). A director may properly rely on those to whom authority has been delegated pursuant to subsection (d) respecting particular matters calling for specific action or attention in connection with the directors' decision-making function as well as matters on the board's continuing agenda, such as legal compliance and internal control, in connection with the directors' oversight function. Delegation should be carried out in accordance with the standard of care set forth in section 8.30(b).

By identifying those upon whom a director may rely in connection with the discharge of duties, section 8.30(d) does not limit the ability of directors to delegate their powers under section 8.01(b) except where delegation is expressly prohibited by the Act or otherwise by applicable law (see, e.g., section 8.25(e) and § 11 of the Securities Act of 1933). See section 8.25 and its Official Comment

for detailed consideration of delegation to board committees of the authority of the board under section 8.01 and the duty to perform one or more of the board's functions. And by employing the concept of delegation, section 8.30(d) does not limit the ability of directors to establish baseline principles as to management responsibilities. Specifically, section 8.01(b) provides that "all corporate powers shall be exercised by or under the authority of" the board, and a basic board function involves the allocation of management responsibilities and the related assignment (or delegation) of corporate powers. For example, a board can properly decide to retain a third party to assume responsibility for the administration of designated aspects of risk management for the corporation (*e.g.*, health insurance or disability claims). This would involve the directors in the exercise of judgment in connection with the decision-making function pursuant to subsection (b) (*i.e.*, the assignment of authority to exercise corporate powers to an agent). See the Official Comment to section 8.01. It would not entail impermissible delegation-to a person specified in subsection (f)(2) pursuant to subsection (d)—of a board function for which the directors by law have a duty to perform. They have the corporate power (under section 8.01(b)) to perform the task but administration of risk management is not a board function coming within the ambit of directors' duties; together with many similar management responsibilities, they may assign the task in the context of the allocation of corporate powers exercised under the authority of the board. This illustration highlights the distinction between delegation of a board function and assignment of authority to exercise corporate powers.

Although the board may delegate the authority or duty to perform one or more of its functions, reliance on delegation under subsection (d) may not alone constitute compliance with section 8.30 and reliance on the action taken by the delegatee may not alone constitute compliance by the directors or a noncommittee board member with section 8.01 responsibilities. On the other hand, should the board committee or the corporate officer or employee performing the function delegated fail to meet section 8.30's standard of care, noncompliance by the board with section 8.01 will not automatically result. Factors to be considered, in this regard, will include the care used in the delegation to and supervision over the delegatee, and the amount of knowledge regarding the particular matter which is available to the particular director. Care in delegation and supervision includes appraisal of the capabilities and diligence of the delegatee in light of the subject and its relative importance and may be facilitated, in the usual case, by receipt of reports concerning the delegatee's activities. The enumeration of these factors is intended to emphasize that directors may not abdicate their responsibilities and avoid accountability simply by delegating authority to others. Rather, a director charged with accountability based upon acts of others will fulfill the director's duties if the standards contained in section 8.30 are met.

5. Section 8.30(e)

Reliance under subsection (e) on a report, statement, opinion, or other information is permitted only if the director has read the information, opinion, report

or statement in question, or was present at a meeting at which it was orally presented, or took other steps to become generally familiar with it. A director must comply with the general standard of care of section 8.30(b) in making a judgment as to the reliability and competence of the source of information upon which the director proposes to rely or, as appropriate, that it otherwise merits confidence.

6. Section 8.30(f)

Reliance on one or more of the corporation's officers or employees, pursuant to the intracorporate frame of reference of subsection (f)(1), is conditioned upon a reasonable belief as to the reliability and competence of those who have undertaken the functions performed or who prepared or communicated the information, opinions, reports or statements presented. In determining whether a person is "reliable," the director would typically consider (i) the individual's background experience and scope of responsibility within the corporation in gauging the individual's familiarity and knowledge respecting the subject matter and (ii) the individual's record and reputation for honesty, care and ability in discharging responsibilities which he or she undertakes. In determining whether a person is "competent," the director would normally take into account the same considerations and, if expertise should be relevant, the director would consider the individual's technical skills as well. Recognition in the statute of the right of one director to rely on the expertise and experience of another director, in the context of board or committee deliberations, is unnecessary, for the group's reliance on shared experience and wisdom is an implicit underpinning of director conduct. In relying on another member of the board, a director would quite properly take advantage of the colleague's knowledge and experience in becoming informed about the matter at hand before taking action; however, the director would be expected to exercise independent judgment when it comes time to vote.

Subsection (f)(2), which has an extracorporate frame of reference, permits reliance on outside advisers retained by the corporation, including persons specifically engaged to advise the board or a board committee. Possible advisers include not only those in the professional disciplines customarily supervised by state authorities, such as lawyers, accountants, and engineers, but also those in other fields involving special experience and skills, such as investment bankers, geologists, management consultants, actuaries, and real estate appraisers. The adviser could be an individual or an organization, such as a law firm. Reliance on a nonmanagement director, who is specifically engaged (and, normally, additionally compensated) to undertake a special assignment or a particular consulting role, would fall within this outside adviser frame of reference. The concept of "expert competence" embraces a wide variety of qualifications and is not limited to the more precise and narrower recognition of experts under the Securities Act of 1933. In this respect, subsection (f)(2) goes beyond the reliance provision found in many existing state business corporation acts. In addition, a director may also rely on outside advisers where skills or expertise of a technical nature is not a prerequisite, or where the person's professional or expert competence has not been established, so long as the director reasonably believes the person merits confidence. For

example, a board might choose to assign to a private investigator the duty of inquiry (*e.g.*, follow upon rumors about a senior executive's "grand lifestyle") and properly rely on the private investigator's report. And it would be entirely appropriate for a director to rely on advice concerning highly technical aspects of environmental compliance from a corporate lawyer in the corporation's outside law firm, without due inquiry concerning that particular lawyer's technical competence, where the director reasonably believes the lawyer giving the advice is appropriately informed(by reason of resources known to be available from that adviser's legal organization or through other means-and therefore merits confidence.

Subsection (f)(3) permits reliance on a board committee when it is submitting recommendations for action by the full board of directors as well as when it is performing supervisory or other functions in instances where neither the full board of directors nor the committee takes dispositive action. For example, the compensation committee typically reviews proposals and makes recommendations for action by the full board of directors. In contrast, there may be reliance upon an investigation undertaken by a board committee and reported to the full board, which form the basis for a decision by the board of directors not to take dispositive action. Another example is reliance on a committee of the board of directors, such as a corporate audit committee with respect to the board's ongoing role of oversight of the accounting and auditing functions of the corporation. In addition where reliance on information or materials prepared or presented by a board committee is not involved, in connection with board action, a director may properly rely on oversight monitoring or dispositive action by a board committee (of which the director is not a member) empowered to act pursuant to authority delegated under section 8.25 or acting with the acquiescence of the board of directors. See the Official Comment to section 8.25. A director may similarly rely on committees not created under section 8.25 which have nondirector members. In parallel with subsection (f)(2)(ii), the concept of "confidence" is substituted for "competence" in order to avoid any inference that technical skills are a prerequisite. In the usual case, the appointment of committee members or the reconstitution of the membership of a standing committee (*e.g.*, the audit committee), following an annual shareholders' meeting, would alone manifest the noncommittee members' belief that the committee "merits confidence." However, the reliance contemplated by subsection (f)(3) is geared to the point in time when the board takes action or the period of time over which a committee is engaged in an oversight function; consequently, the judgment to be made (*i.e.*, whether a committee "merits confidence") will arise at varying points in time. After making an initial judgment that a committee (of which a director is not a member) merits confidence, the director may depend upon the presumption of regularity absent knowledge or notice to the contrary.

7. APPLICATION TO OFFICERS

Section 8.30 generally deals only with directors. Section 8.42 and its Official Comment explain the extent to which the provisions of section 8.30 apply to officers.

PART IV. FUNCTIONS OF OFFICERS

§ 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.

OFFICIAL COMMENT

Section 8.41 recognizes that persons designated as officers have the formal authority set forth for that position (1) by its description in the bylaws, (2) by specific resolution of the board of directors, or (3) by direction of another officer authorized by the board of directors to prescribe the functions of other officers.

These methods of investing officers with formal authority do not exhaust the sources of an officer's actual or apparent authority. Many cases state that specific corporate officers, particularly the chief executive officer, may have implied authority merely by virtue of their positions. This authority, which may overlap the express authority granted by the bylaws, generally has been viewed as extending only to ordinary business transactions, though some cases have recognized unusually broad implied authority of the chief executive officer or have created a presumption that corporate officers have broad authority, thereby placing on the corporation the burden of showing lack of authority. Corporate officers may also be vested with apparent (or ostensible) authority by reason of corporate conduct on which third persons reasonably rely.

In addition to express, implied, or apparent authority, a corporation is normally bound by unauthorized acts of officers if they are ratified by the board of directors. Generally, ratification extends only to acts that could have been authorized as an original matter. Ratification may itself be express or implied and may in some cases serve as the basis of apparent (or ostensible) authority.

§ 8.42. STANDARDS OF CONDUCT FOR OFFICERS

(a) An officer, when performing in such capacity, has the duty to act:
- (1) in good faith;
- (2) with the care that a person in a like position would reasonably exercise under similar circumstances; and
- (3) in a manner the officer reasonably believes to be in the best interests of the corporation.

(b) The duty of an officer includes the obligation:
- (1) to inform the superior officer to whom, or the board of directors or the committee thereof to which, the officer reports of information about the affairs of the corporation known to the officer, within the scope of the officer's functions, and known to the officer to be material to such superior officer, board or committee; and
- (2) to inform his or her superior officer, or another appropriate person within the corporation, or the board of directors, or a committee thereof, of any actual or probable material violation of law involving the corporation or material breach of duty to the corporation by

an officer, employee, or agent of the corporation, that the officer believes has occurred or is about 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.

OFFICIAL COMMENT

Subsection (a) provides that an officer, when performing in such officer's official capacity, shall meet standards of conduct generally similar to those expected of directors under section 8.30. Consistent with the principles of agency, which generally govern the conduct of corporate employees, an officer is expected to observe the duties of obedience and loyalty and to act with the care that a person in a like position would reasonably exercise under similar circumstances. *See* RESTATEMENT (SECOND) OF AGENCY § 379(1) (1958) ("Unless otherwise agreed, a paid agent is subject to a duty to the principal to act with standard care and with the skill which is standard in the locality for the kind of work which he is employed to perform and, in addition, to exercise any special skill that he has"). This section is not intended to modify, diminish or qualify the duties or standards of conduct that may be imposed upon specific officers by other law or regulation.

The common law, including the law of agency, has recognized a duty on the part of officers and key employees to disclose to their superiors material information relevant to the affairs of the agency entrusted to them. *See* RESTATEMENT (SECOND) OF AGENCY §381; A. Gilchrist Sparks, III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 BUS. LAW. 215, 226—29 (1992). This duty is implicit in, and embraced under, the broader standard of subsection (a). New subsection (b) sets forth explicitly this disclosure obligation by confirming that the officer's duty includes the obligation (i) to keep superior

corporate authorities informed of material information within the officer's sphere of functional responsibilities, and (ii) to inform the relevant superior authority, or other appropriate person within the corporation, of violations of law or breaches of duty that the officer believes have occurred or are about to occur (i.e., more likely than not to occur) and are or would be material to the corporation. Subsection (b)(1) specifies that business information shall be transmitted through the officer's regular reporting channels. Subsection (b)(2) specifies the reporting responsibility differently with respect to actual or probable material violations of law or material breaches of duty. The use of the term "appropriate" in subsection (b)(2) is intended to accommodate both the normative standard that may have been set up by the corporation for reporting potential violations of law or duty to a specified person, such as an ombudsperson, ethics officer, internal auditor, general counsel or the like, and situations where there is no designated person but the officer's immediate superior is not appropriate (for example, because the officer believes that individual is complicit in the unlawful activity or breach of duty).

Subsection (b)(1) should not be interpreted so broadly as to discourage efficient delegation of functions. It addresses the flow of information to the board of directors and to superior officers necessary to enable them to perform their decision-making and oversight functions. See the Official Comment to section 8.31. The officer's duties under subsection (b) may not be negated by agreement; however, their scope under subsection (b)(1) may be shaped by prescribing the scope of an officer's functional responsibilities.

With respect to the duties under subsection (b)(2), codes of conduct or codes of ethics, such as those adopted by many large corporations, may prescribe the circumstances in which and mechanisms by which officers and employees may discharge their duty to report material information to superior officers or the board of directors, or to other designated persons.

The term "material" modifying violations of law or breaches of duty in subsection (b) (2) denotes a qualitative as well as quantitative standard. It relates not only to the potential direct financial impact on the corporation, but also to the nature of the violation or breach. For example, an embezzlement of $10,000, or even less, would be material because of the seriousness of the offense, even though the amount involved would not be material to the financial position or results of operations of the corporation.

The duty under subsection (b)(2) is triggered by an officer's subjective belief that a material violation of law or breach of duty actually or probably has occurred or is about to occur. This duty is not triggered by objective knowledge concepts, such as whether the officer should have concluded that such misconduct was occurring. The subjectivity of the trigger under subsection (b)(2), however, does not excuse officers from their obligations under subsection (a) to act in good faith and with due care in the performance of the functions assigned to them, including oversight duties within their respective areas of responsibility.

An officer's ability to rely on others in meeting the standards prescribed in section 8.42 may be more limited, depending upon the circumstances of the

particular case, than the measure and scope of reliance permitted a director under section 8.30, in view of the greater obligation the officer may have to be familiar with the affairs of the corporation. The proper delegation of responsibilities by an officer, separate and apart from the exercise of judgment as to the delegatee's reliability and competence, is concerned with the procedure employed. This will involve, in the usual case, sufficient communication to the end that the delegatee understands the scope of the assignment and, in turn, manifests to the officer a willingness and commitment to undertake its performance. The entitlement to rely upon employees assumes that a delegating officer will maintain a sufficient level of communication with the officer's subordinates to fulfill his or her supervisory responsibilities. The definition of "employee" in section 1.40(8) includes an officer; accordingly, section 8.42 contemplates the delegation of responsibilities to other officers as well as to non-officer employees.

It is made clear, in subsection (d), that performance meeting the section's standards of conduct will eliminate an officer's exposure to any liability to the corporation or its shareholders. In contrast, an officer failing to meet its standards will not automatically face liability. Deficient performance of duties by an officer, depending upon the facts and circumstances, will normally be dealt with through intracorporate disciplinary procedures, such as reprimand, compensation adjustment, delayed promotion, demotion or discharge. These procedures may be subject to (and limited by) the terms of an officer's employment agreement. See section 8.44.

In some cases, failure to observe relevant standards of conduct can give rise to an officer's liability to the corporation or its shareholders. A court review of challenged conduct will involve an evaluation of the particular facts and circumstances in light of applicable law. In this connection, subsection (d) recognizes that relevant principles of section 8.31, such as duties to deal fairly with the corporation and its shareholders and the challenger's burden of establishing proximately caused harm, should be taken into account. In addition, the business judgment rule will normally apply to decisions within an officer's discretionary authority. Liability to others can also arise from an officer's own acts or omissions (e.g., violations of law or tort claims) and, in some cases, an 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.

Proposed changes to sections 8.41 and 8.42 and Official Comments are shown below with additions in italics and deletions in strikethrough.

§ 8.41. *FUNCTIONS* ~~DUTIES~~ OF OFFICERS

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

OFFICIAL COMMENT

Section 8.41 recognizes that persons designated as officers have the formal authority set forth for that position (1) by its description in the bylaws, (2) by specific resolution of the board of directors, or (3) by direction of another officer authorized by the board of directors to prescribe the *functions* ~~duties~~ of other officers.

These methods of investing officers with formal authority do not exhaust the sources of an officer's actual or apparent authority. Many cases state that specific corporate officers, particularly the chief executive officer, may have implied authority merely by virtue of their positions. This authority, which may overlap the express authority granted by the bylaws, generally has been viewed as extending only to ordinary business transactions, though some cases have recognized unusually broad implied authority of the chief executive officer or have created a presumption that corporate officers have broad authority, thereby placing on the corporation the burden of showing lack of authority. Corporate officers may also be vested with apparent (or ostensible) authority by reason of corporate conduct on which third persons reasonably rely.

In addition to express, implied, or apparent authority, a corporation is normally bound by unauthorized acts of officers if they are ratified by the board of directors. Generally, ratification extends only to acts that could have been authorized as an original matter. Ratification may itself be express or implied and may in some cases serve as the basis of apparent (or ostensible) authority.

§ 8.42. STANDARDS OF CONDUCT FOR OFFICERS

(a) An officer, when performing in such capacity, *has the duty to* ~~shall~~ act:

  (1) in good faith;

  (2) with the care that a person in a like position would reasonably exercise under similar circumstances; and

  (3) in a manner the officer reasonably believes to be in the best interests of the corporation.

(b) The duty of an officer includes the obligation:

  (1) to inform the superior officer to whom, or the board of directors or the committee thereof to which, the officer reports of information about the affairs of the corporation known to the officer, within the scope of the officer's functions, and known to the officer to be material to such superior officer, board or committee; and

  (2) to inform his or her superior officer, or another appropriate person within the corporation, or the board of directors, or a committee thereof, of any actual or probable material violation of law involving the corporation or material breach of duty to the corporation by an officer, employee, or agent of the corporation, that the officer believes has occurred or is about to occur.

(c~~b~~) In discharging *his or her* ~~those~~ 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*~~c~~) 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.

OFFICIAL COMMENT

Subsection (a) ~~This section~~ provides that an officer, when performing in such officer's official capacity, shall meet standards of conduct generally similar to those expected of directors under section 8.30. Consistent with the principles of agency, which generally govern the conduct of corporate employees, an officer is expected to observe the duties of obedience and loyalty and to act with the care that a person in a like position would reasonably exercise under similar circumstances. See RESTATEMENT (SECOND) OF AGENCY §379(1) (1958) ("Unless otherwise agreed, a paid agent is subject to a duty to the principal to act with standard care and with the skill which is standard in the locality for the kind of work which he is employed to perform and, in addition, to exercise any special skill that he has"). *This section is not intended to modify, diminish or qualify the duties or standards of conduct that may be imposed upon specific officers by other law or regulation.*

The common law, including the law of agency, has recognized a duty on the part of officers and key employees to disclose to their superiors material information relevant to the affairs of the agency entrusted to them. See (SECOND) OF AGENCY §381; A. Gilchrist Sparks, III & Lawrence A. Hamermesh, Common Law Duties of Non-Director Corporate Officers, 48 BUS. LAW. 215, 226—29 (1992). This duty is implicit in, and embraced under, the broader standard of subsection (a). New subsection (b) sets forth explicitly this disclosure obligation by confirming that the officer's duty includes the obligation (i) to keep superior corporate authorities informed of material information within the officer's sphere of functional responsibilities, and (ii) to inform the relevant superior authority, or other appropriate person within the corporation, of violations of law or breaches of duty that the officer believes have occurred or are about to occur (i.e., more likely than not to occur) and are or would be material to the corporation. Subsection (b)(1) specifies that business information shall be transmitted through the

officer's regular reporting channels. Subsection (b)(2) specifies the reporting responsibility differently with respect to actual or probable material violations of law or material breaches of duty. The use of the term "appropriate" in subsection (b)(2) is intended to accommodate both the normative standard that may have been set up by the corporation for reporting potential violations of law or duty to a specified person, such as an ombudsperson, ethics officer, internal auditor, general counsel or the like, and situations where there is no designated person but the officer's immediate superior is not appropriate (for example, because the officer believes that individual is complicit in the unlawful activity or breach of duty).

Subsection (b)(1) should not be interpreted so broadly as to discourage efficient delegation of functions. It addresses the flow of information to the board of directors and to superior officers necessary to enable them to perform their decision-making and oversight functions. See the Official Comment to section 8.31. The officer's duties under subsection (b) may not be negated by agreement; however, their scope under subsection (b)(1) may be shaped by prescribing the scope of an officer's functional responsibilities.

With respect to the duties under subsection (b)(2), codes of conduct or codes of ethics, such as those adopted by many large corporations, may prescribe the circumstances in which and mechanisms by which officers and employees may discharge their duty to report material information to superior officers or the board of directors, or to other designated persons.

The term "material" modifying violations of law or breaches of duty in subsection (b)(2) denotes a qualitative as well as quantitative standard. It relates not only to the potential direct financial impact on the corporation, but also to the nature of the violation or breach. For example, an embezzlement of $10,000, or even less, would be material because of the seriousness of the offense, even though the amount involved would not be material to the financial position or results of operations of the corporation.

The duty under subsection (b)(2) is triggered by an officer's subjective belief that a material violation of law or breach of duty actually or probably has occurred or is about to occur. This duty is not triggered by objective knowledge concepts, such as whether the officer should have concluded that such misconduct was occurring. The subjectivity of the trigger under subsection (b)(2), however, does not excuse officers from their obligations under subsection (a) to act in good faith and with due care in the performance of the functions assigned to them, including oversight duties within their respective areas of responsibility.

An officer's ability to rely on others *in meeting the standards prescribed in section 8.42* may be more limited, depending upon the circumstances of the particular case, than the measure and scope of reliance permitted a director under section 8.30, in view of the greater obligation the officer may have to be familiar with the affairs of the corporation. The proper delegation of responsibilities by an officer, separate and apart from the exercise of judgment as to the delegatee's reliability and competence, is concerned with the procedure employed. This will involve, in the usual case, sufficient communication to the end that the delegatee understands the scope of the assignment and, in turn, manifests to the officer a willingness and commitment to undertake its performance. *The entitlement to rely upon employees assumes that a delegating officer will maintain a sufficient level of*

communication with the officer's subordinates to fulfill his or her supervisory responsibilities. The definition of "employee" in section 1.40(8) includes an officer; accordingly, section 8.42 contemplates the delegation of responsibilities to other officers as well as to non-officer employees.

It is made clear, in subsection (*d*~~e~~), that performance meeting the section's standards of conduct will eliminate an officer's exposure to any liability to the corporation or its shareholders. In contrast, an officer failing to meet its standards will not automatically face liability. Deficient performance of duties by an officer, depending upon the facts and circumstances, will normally be dealt with through intracorporate disciplinary procedures, such as reprimand, compensation adjustment, delayed promotion, demotion or discharge. ~~Such a procedure would be subject to any employment agreement between the corporation and the officer.~~ *These procedures may be subject to (and limited by) the terms of an officer's employment agreement. See section 8.44*~~3~~.

In some cases, failure to observe relevant standards of conduct can give rise to an officer's liability to the corporation or its shareholders. A court review of challenged conduct will involve an evaluation of the particular facts and circumstances in light of applicable law. In this connection, subsection (*d*~~e~~) 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.