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## The Revised Model Business Corporation Act and Corporate Law Reform in Mississippi: Part One

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# THE REVISED MODEL BUSINESS CORPORATION ACT AND CORPORATE LAW REFORM IN MISSISSIPPI: PART ONE

*Wendell H. Holmes\**

In 1987, the Mississippi Business Corporation Act<sup>1</sup> (hereinafter MBCA) will mark the first quarter-century of its existence.<sup>2</sup> The age of twenty-five years might seem mere infancy for a major business statute, particularly one that comprehensively supplanted the disconnected corporate statutes that preceded it. Moreover, most corporate practitioners in this state would probably agree that in commonplace transactions the MBCA presents a workable set of rules with which to deal. Thus, one might initially question the necessity (not to say the wisdom) of the notion of corporate law reform which the title of this article advances.

In a sense, however, the MBCA may be considered to be at least thirty-six years old as of the writing of this article. The MBCA was based upon the Model Business Corporation Act, which in 1950 assumed the basic form with which the Mississippi Legislature worked.<sup>3</sup> In turn, the Model Act itself was

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<sup>1</sup> Miss. CODE ANN. §§ 79-3-3 to -293 (Supp. 1985).

<sup>2</sup> For a discussion of the history of the adoption of the MBCA see Hodge & Perry, *The Model Business Corporation Act: Does the Mississippi Version Lime the Bushes?*, 46 Miss. L.J. 371 (1975) [hereinafter cited as Hodge & Perry]

<sup>3</sup> Eisenberg, *The Model Business Corporation Act and the Model Business Corporation Act Annotated*, 29 Bus. LAW. 1407, 1407-08 (1974) [hereinafter cited as Eisenberg, *Model Act*]. Professor Melvin Eisenberg has noted that the first preliminary draft of the Model Act appeared in 1943; in 1946, the Corporation Law Committee of the American Bar Association promulgated the "Model for State Business Corporation

largely adapted from the Illinois Business Corporation Act of 1933.<sup>4</sup> In some ways, then, the MBCA may have been dated from its very inception.

Since its adoption, however, developments in corporate thinking have rendered the MBCA outmoded in many significant respects. In the areas of formation,<sup>5</sup> corporate management and governance,<sup>6</sup> capitalization and distribution policy, organic changes, and problems of the close corporation,<sup>7</sup> dramatic changes in both statutory and case law have occurred. The significance of those developments alone would suggest the need for a re-examination of the MBCA.

The most significant signpost to a re-evaluation of our statute is, however, the promulgation of the Revised Model Business Corporation Act (hereinafter RMA) in 1984. The RMA represents the culmination of some five years of work by the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the American Bar Association. It is the first complete revision of the Model Act for more than thirty years.<sup>8</sup>

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Acts"; other revisions followed in 1950, 1953, 1959, and 1969. *Id.* It is noteworthy that by 1969, seven years after the adoption of the MBCA, a new edition of the Model Act had been published which substantially differed from the MBCA in several important respects. See generally MODEL BUSINESS CORP. ACT ANN. (2d ed. 1971). Furthermore, substantive revisions continued throughout the next decade, with major changes occurring in 1975, 1976, 1977, 1979, and 1980. 1 MODEL BUSINESS CORP. ACT ANN. xxvi-xxix (3d ed. 1985). This process of revision, coupled with the need for either a new edition or recodification, led ultimately to the adoption of the 1984 Revised Model Business Corporation Act. See *infra* note 8 and accompanying text. For further background of the history of the Model Act see Campbell, *The Model Business Corporation Act*, 11 BUS. LAW. 98 (1956); Garrett, *History, Purpose and Summary of the Model Business Corporation Act*, 6 BUS. LAW. 1 (1950) [hereinafter cited as Garrett].

<sup>4</sup> 1 MODEL BUSINESS CORP. ACT ANN. § 1 (2d ed. 1971). It should be noted that in 1983, Illinois adopted a completely revised business corporation act. Illinois Business Corporation Act of 1983, ILL. REV. STAT. ch. 32, §§ 1.01-17.05 (Supp. 1983), *repealing* ILL. REV. STAT. ch. 32, §§ 157.1-167 (1933). For analyses of the new Illinois legislation see Van Vliet, Jr., *The New Illinois Business Corporation Act Needs More Work*, 61 CHI.-KENT L. REV. 1 (1985); *Symposium on the 1983 Illinois Business Corporation Act*, 1985 U. ILL. L. REV. 635.

<sup>5</sup> See *infra* notes 17-66 and accompanying text.

<sup>6</sup> See *infra* notes 67-318 and accompanying text.

<sup>7</sup> These latter topics will be the subject of Part Two of this article.

<sup>8</sup> REVISED MODEL BUSINESS CORP. ACT ANN. xxiv-xxvi (3d ed. 1985). Several reasons underlie the adoption of the RMA rather than another revision to the 1969 Model Act. First, the Committee on Corporate Laws was considering updating the Model Business

Since the source of Mississippi's general corporate law has now been completely revamped and modernized, the implications of the RMA for the future of Mississippi's corporate law should surely be explored.

Finally, the history of the MBCA since its adoption demonstrates the need for critical re-analysis. Since 1962, only a handful of amendments have occurred, almost all of them technical in nature.<sup>9</sup> Thus, substantive innovations in corporate law since

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Corporation Act Annotated to incorporate changes made since the 1971 edition and its 1973 and 1977 supplements. A third supplement, however, was deemed less practicable than a new edition. *Id.* at xxv. Concurrently, a 1979 study of portions of the Model Act which had not been substantially revised since 1950 suggested numerous areas where the experience of various states indicated that significant simplifications and innovations could be made. *Id.* Among these would be a complete reorganization and renumbering of the Model Act. *Id.* Finally, the process of substantive amendments which had transpired since 1950 had resulted in a document internally inconsistent in format and drafting style. *Id.* Coupled with the need to incorporate post-1977 amendments and the Committee's determination to make further substantive amendments to the Model Act during the drafting process, the decision was made to develop the RMA. *Id.*

An exposure draft of the RMA was circulated for comment in 1983. As will be further discussed herein, the draft differs in many significant respects from the final product. See REVISED MODEL BUSINESS CORP. ACT (Exposure Draft March 1983). After the receipt of extensive commentary and a re-analysis and substantial revision of the draft, the final draft was published in 1984. 1 REVISED MODEL BUSINESS CORP. ACT ANN. xxxii-xxxiii (3d ed. 1985). For further background on the RMA see Goldstein, *Revision of the Model Business Corporation Act*, 63 TEX. L. REV. 1471 (1985) [hereinafter cited as Goldstein]; Goldstein & Hamilton, *The Revised Model Business Corporation Act*, 38 BUS. LAW. 1019 (1983); Hamilton, *Reflections of a Reporter*, 63 TEX. L. REV. 1455 (1985) [hereinafter cited as Hamilton, *Reflections*].

\* The following sections of the Act have been amended: §§ 79-3-15 (reservation of name increased to 180 days); 79-3-25 (increasing fee for service of process on Secretary of State); 79-3-37 (decreasing vote necessary to approve stock options to insiders and not to shareholders generally); 79-3-43 (dealing with facsimile signatures); 79-3-55 (60 days notice of shareholders' meeting); 79-3-57 (closing of transfer books and record date increased to 60 days before meeting); 79-3-67 (directors must be 18); 79-3-103 (single incorporator for professional corporation); 79-3-107 (eliminated publication requirement for certificate of incorporation); 79-3-119 (exempted regulated utilities); 79-3-123 (eliminated publication requirement for articles of amendment); 79-3-141 (allows conversion of shares of merging corporations into shares of corporation other than survivor); 79-3-142 (merger of domestic corporations and business trusts); 79-3-147 (eliminated publication requirement for articles of merger or consolidation); 79-3-149 (eliminated publication requirement for merger of subsidiary corporation); 79-3-159 (broadened dissenters' rights to include business combination as defined in 79-25-3(e)); 79-3-163 (eliminated publication requirement for articles of dissolution); 79-3-189 (various amendments involving administrative suspension and dissolution); 79-3-209 (various amendments dealing with survival of remedies); 79-3-249 (technical amendments dealing with annual reports); 79-

1962 have gone largely ignored. Moreover, a cursory glance at the *Mississippi Digest* and the Annotations to the Mississippi Code of 1972 illustrate dramatically the paucity of judicial interpretation of the MBCA. As a result, significant ambiguities in the Model Act which have been identified and extensively litigated in other jurisdictions still plague Mississippi practitioners, who have no authoritative precedent to guide them.<sup>10</sup> Moreover, Mississippi has little precedent on many common-law corporate issues which have in recent years been increasingly dealt with by statute.<sup>11</sup> Finally, the only article critically analyzing the MBCA previously published in this *Journal* was of limited scope and is now more than ten years old.<sup>12</sup> The purpose of this article, then,

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3-251 (technical amendments involving filing of annual reports); 79-3-253 (minor wording change regarding fee collection); 79-3-255 (changing filing fees); 79-3-257 (changing miscellaneous charges); 79-3-259 (deleted penalty for failure to file annual report); 79-3-269 (changed disposition of fees, charges and penalties).

<sup>10</sup> See, e.g., *infra* notes 55-66 and accompanying text. Of course, an important goal of the drafters of the RMA was to respond to and clarify those ambiguities.

<sup>11</sup> See, e.g., *infra* notes 99-173 and accompanying text. In addition, that authority which does exist is, in some instances, confusing and outdated. The notorious example is *Knox Glass Bottle Co. v. Underwood*, 228 Miss. 699, 89 So. 2d 799 (1956), *cert. denied*, 353 U.S. 97 (1957), the leading Mississippi opinion on director conflicts of interest. See *Hodge & Perry*, *supra* note 2, at 386-90 (strict interpretation of opinion does not coincide with commercial practices or practicalities); Comment, *Transactions Between a Corporation and its Directors: Where Does Mississippi Stand?*, 52 Miss. L.J. 877, 889-95 (1982) (decision leaves many questions unanswered) [hereinafter cited as Comment, *Transactions*]. *Knox Glass* and general questions of director conflicts of interest are discussed more fully at *infra* notes 141-73 and accompanying text.

<sup>12</sup> See *supra* note 2. The authors of that article eschewed any effort at a comprehensive re-appraisal, focusing instead on four subjects: provisions designed to protect creditors; provisions designed for the protection of shareholders; provisions designed for the regulation of transactions with officers and directors; and provisions dealing with the protection of officers and directors. *Hodge & Perry*, *supra* note 2, at 373-75.

As of the writing of this article, the only other published article dealing primarily with the MBCA is McLendon, *Formation, Operation and Dissolution of Business Corporations*, 39 Miss. L.J. 281 (1963), a summary of provisions of the then newly-adopted MBCA. Other works dealing with the MBCA in some context include Dunn-Cooper, *An Analysis of Mississippi's Treatment of Foreign Corporations*, 55 Miss. L.J. 259 (1985); O'Neal, *Preventative Law: Tailoring the Corporate Form of Business to Ensure Fair Treatment of All*, 49 Miss. L.J. 529 (1978) [hereinafter cited as O'Neal, *Preventative Law*]; Comment, *Appreciated Property as a Source of Dividends: Its Use and Effects in Mississippi*, 48 Miss. L.J. 309 (1977); Comment, *Valuation of Shares in a Closely-Held Corporation*, 47 Miss. L.J. 715 (1976); Comment, *Oppression of Minority Shareholders: A Proposed Model and Suggested Remedies*, 47 Miss. L.J. 476 (1976). Other works dealing with prior Mississippi corporate laws include Roberds, *The New Corporation Act*, 2

is to examine selected portions of the RMA with a view towards suggested revisions to the Mississippi Act. One point should be made at the outset: this article does not advocate the wholesale adoption of the RMA in Mississippi. Specific reasons for this will be discussed in the context of the provisions of the RMA, but some philosophical rationales can be noted here. By admission of its authors, the RMA is meant to synthesize the recent experience of corporate drafters in "important commercial states."<sup>13</sup> It may be fairly characterized as perpetuating the trend towards "permissiveness" that has been the dominant theme in corporate legislation following the adoption of the 1950 Model Act.<sup>14</sup> I would not presume to resolve conclusively the ac-

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Miss. L.J. 179 (1929) [hereinafter cited as Roberds]; Comment, *The Power of an Equity Court in Mississippi to Dissolve a Corporation*, 15 Miss. L.J. 150 (1943).

<sup>13</sup> 1 REVISED MODEL BUSINESS CORP. ACT ANN. xxiv (3d ed. 1985).

<sup>14</sup> See, e.g., Branson, *Countertrends in Corporate Law: Model Business Corporation Act Revision, British Company Law Reform, and Principles of Corporate Governance and Structure*, 68 MINN. L. REV. 53, 62 (1983) (arguing that in large part due to the Model Act, the enabling philosophy of corporate law has become dominant and the protection of shareholders abandoned as a major goal of corporation act drafters) [hereinafter cited as Branson, *Countertrends*]. Professor William Cary has noted that the original Model Act was intended to serve as an alternative to the "permissive" Delaware approach, which the Model Act drafters believed to afford insufficient protection to investors. Cary, *Federalism and Corporate Law: Reflections on Delaware*, 83 YALE L.J. 663, 665 (1974) [hereinafter cited as Cary, *Federalism*]. Cary believed that the process of amendment to the Model Act over the years represented a conscious effort to "out-Delaware Delaware." *Id.*; cf. Garrett, *supra* note 3, at 7 (stating that the 1950 Model Act may not appeal to states soliciting corporate business). Professor Eisenberg has noted that the committee responsible for the Model Act was composed overwhelmingly of management lawyers, and that management-oriented changes to the Act took place for many years with little or no comment from its drafters, e.g., the change from mandatory to permissive cumulative voting in 1955. Eisenberg, *Model Act*, *supra* note 3, at 1410, 1414-15.

In general, criticism of the trend towards permissive, or management-oriented statutes, as opposed to regulatory, or investor-protective statutes, has been thematic in recent corporate scholarship. See, e.g., Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1081 (1968) (practice of protecting corporate executives against litigation and liability has been carried as far as it should be and perhaps further) [hereinafter cited as Bishop, *Sitting Ducks*]; Branson, *Countertrends*, *supra* note 14, at 53-62 (corporate law no longer has protection of shareholders at heart); Bulbulia & Pinto, *Statutory Responses to Interested Director Transactions: A Watering Down of Fiduciary Standards?*, 53 NOTRE DAME L. REV. 201, 220-22 (1977) (statutory changes may work to disadvantage of minority shareholders) [hereinafter cited as Bulbulia & Pinto]; Cary, *Federalism*, *supra*, at 665-66 (shareholders rights watered down to thin gruel); Eisenberg, *Model Act*, *supra*

ademic debate as to the desirability of permissive rather than regulatory statutes; at a minimum the RMA displays a large corporation orientation which in some instances would be clearly inappropriate, or at least unnecessary, in Mississippi, where the vast majority of domestically chartered corporations are closely-held.<sup>15</sup>

Thus, the methodology of this article is to compare the treatment of selected issues under the RMA and the MBCA in an effort to identify those areas of Mississippi's law in need of revision. This process, however, does not inevitably lead to the conclusion that the RMA should be adopted. Rather, the purpose of this article is to suggest the most desirable approach to specific issues, whether the approach is that taken by the RMA, the current MBCA, or the statutes of other states.

The potential scope of such an undertaking would, of course, be vast, since many of the myriad issues discussed herein would individually merit article-length treatment. This article, which will appear in two parts, is in the nature of an overview, suggesting subjects for further exploration and refinement. With the caveat that attempts at categorization may be arbitrary and of necessity overlap, Part 1 of this article will address the question of corporate law reform in Mississippi in the areas of corporate formation and organization and corporate management and governance. Part 2, to be published in a subsequent issue, will

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note 3, at 1410, 1427-28 (severe imbalance of management lawyers in committee composition); Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 872-75 (1969) (three-way arrangement of corporate structures has led to increased management power at expense of public shareholder). Of course, this view has itself been questioned and criticized. See, e.g., Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U.L. REV. 913, 916-21 (1982) (theoretical and empirical evidence does not support attack on separation of ownership and control) [hereinafter cited as Fischel, *Reflections*]; Hetherington, *Redefining the Task of Corporation Law*, 19 U.S.F.L. REV. 229, 235-248 (1985) (assumptions regarding traditional corporate model were largely mistaken).

A related but broader issue is that of the respective roles of management and shareholders in corporate governance and the necessity *vel non* of stricter standards of conduct for managers. This will be further developed at *infra* notes 67-173 and accompanying text.

<sup>15</sup> Indeed, Professor O'Neal has noted the possible "big business bias" of the MBCA, based as it is on the Model Act and made applicable to both large and small corporations. O'Neal, *Preventative Law*, *supra* note 12, at 534 n.24.

discuss the areas of capitalization, organic changes, and issues of particular concern to close corporations.

## I. FORMATION AND ORGANIZATION

### A. *Process of Incorporation*

Among the most salutary changes which would be effected by the RMA are those in the area of corporate formation. In general, the RMA would effectively accomplish three objectives: (1) streamlining and simplifying a procedure that is currently unjustifiably cumbersome; (2) responding to interpretative issues that arose under the Model Act; and (3) clearly defining the legal role of the Secretary of State in the incorporation process.

The MBCA follows a very traditional statutory scheme of incorporation: articles of incorporation including prescribed information<sup>16</sup> must be signed and verified by two incorporators<sup>17</sup> and duplicate originals delivered to the Secretary of State.<sup>18</sup> Assuming that the Secretary determines that the articles "conform to law," the certificate of incorporation is issued and returned together with a duplicate original of the articles.<sup>19</sup> Although the publication requirement was eliminated in 1983,<sup>20</sup> the certificate must be recorded in the chancery clerk's office in the county of the corporation's principal place of business.<sup>21</sup> Upon issuance of the certificate, the corporation is deemed to exist.<sup>22</sup>

The thrust of Chapter 1 of the RMA is twofold: to eliminate much of what is unnecessary under traditional statutes such as the MBCA, and to provide needed clarification and definition to much that previously was unstated or ambiguous. For example, under the RMA only one incorporator is required, and the incor-

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<sup>16</sup> MISS. CODE ANN. § 79-3-105 (1972).

<sup>17</sup> MISS. CODE ANN. § 79-3-103 (1972). The incorporators must be natural persons of the age of 21. *Id.*

<sup>18</sup> MISS. CODE ANN. § 79-3-107 (1972).

<sup>19</sup> *Id.*

<sup>20</sup> 1983 Miss. Laws 403, § 2, amending MISS. CODE ANN. § 79-3-107 (1972).

<sup>21</sup> MISS. CODE ANN. § 79-3-01 (1972).

<sup>22</sup> MISS. CODE ANN. § 79-3-109. As to the relationship of this section to common law doctrines of de jure and de facto corporations and corporation by estoppel see *infra* notes 53-66 and accompanying text.



porator can be either a person or an entity.<sup>23</sup> Only one original and one conformed copy need be filed,<sup>24</sup> and the articles need not be verified.<sup>25</sup> The prescribed information in the articles is greatly reduced,<sup>26</sup> and the corporate existence made perpetual unless otherwise provided.<sup>27</sup> There is no necessity to include a purpose clause unless a more limited purpose than the transac-

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<sup>23</sup> REVISED MODEL BUSINESS CORP. ACT §§ 1.40, 2.02 (1984). Given the purely formal and limited nature of the incorporator's role under modern statutes, and the pervasive use of corporation service companies in interstate incorporation transactions, there appears no need to have a natural person as incorporator, and certainly no rationale to require more than one. The Model Act's historical justification for requiring multiple incorporators (the 1950 Model Act required three) appears to have been a somewhat irrational prejudice against "one-person" corporations. See Garrett, *supra* note 3, at 3 (requirement of multiple incorporators is firmly established in most states although regarded as fictional in many cases).

Curiously, the RMA is ambiguous in one respect: it sets no minimum age for an individual to be either an incorporator or a director. REVISED MODEL BUSINESS CORP. ACT §§ 2.01, 8.03 (1984). While the RMA permits corporations to prescribe qualifications for members of the board, it is unclear whether this contemplates a minimum age limitation. See *id.* § 8.02 & official comment. Under present Mississippi law, incorporators must be 21 and directors 18. MISS. CODE ANN. §§ 79-3-67, -103 (1972 and Supp. 1985). *Quaere* whether the common law age of capacity, 21, would impliedly prohibit a younger person from serving in these capacities.

<sup>24</sup> REVISED MODEL BUSINESS CORP. ACT § 1.20(i)(1984). A duplicate original can, of course, suffice as a conformed copy. *Id.* official comment.

<sup>25</sup> *Id.* § 1.20(g). The RMA makes verification or acknowledgement optional for all documents filed pursuant thereto. *Id.*

<sup>26</sup> The articles need state only the corporate name, number (but not par value) of authorized shares, street address of the initial registered office and initial registered agent, and name and address of each incorporator. *Id.* § 2.02(a). All other information and provisions are optional. Of course, certain provisions must appear in the articles if they are to apply. Provisions which are mandatory are those regarding a limited purpose; managing the business and affairs of the corporation; defining, limiting, and regulating the powers of the corporation, board, or shareholders; par value of shares; and imposition of personal liability on shareholders. *Id.* § 2.02(b)(2)(i)-(u).

<sup>27</sup> *Id.* § 3.02. Like the MBCA, the RMA contains an extensive grant of general powers; these need not be repeated in the articles. *Id.* § 2.02(c); see MISS. CODE ANN. § 79-3-7 (1972). The broad powers of § 3.02, coupled with the adoption of an "any lawful business" purpose provision, should virtually eliminate the possibility of an ultra vires attack on a transaction, unless of course the corporation has elected to limit its purpose. REVISED MODEL BUSINESS CORP. ACT § 3.02 official comment (1984); see *infra* note 28 (general powers of corporation). Nonetheless, the RMA retains a provision defining the scope of the ultra vires doctrine. REVISED MODEL BUSINESS CORP. ACT § 3.04 (1984). The Mississippi provision is substantially the same. MISS. CODE ANN. § 79-3-11 (1972).

It should be noted that the adoption of the RMA in this regard would require constitutional amendment, since "private corporation[s] for pecuniary gain" are constitutionally limited in Mississippi to a duration of 99 years. MISS. CONST. art. 7, § 178.

tion of "any lawful business" is desired.<sup>28</sup> The Secretary of State's duty of filing is ministerial in nature; no longer is he required to determine if the articles conform to law.<sup>29</sup> In addition, the Secretary is not required to issue a certificate of incorporation, but rather only to return the document copy to the corporation.<sup>30</sup> The articles are effective and the corporate existence begins upon filing, unless a delayed effective time and date are

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<sup>28</sup> REVISED MODEL BUSINESS CORP. ACT § 3.01(a) (1984). The RMA deems a corporation to be organized for any lawful purpose unless a more restricted purpose is stated in the articles. *Id.* § 2.02(b)(1).

While restrictive purpose clauses may sometimes be used to protect the interests of minority shareholders, the mandate for the specific purpose clause under the MBCA may serve no rational function, other than to test the ingenuity of drafters to phrase the purpose for which the corporation is organized in sufficiently broad terms to permit the transaction of any lawful business. *See* MISS. CODE ANN. § 79-3-105(c) (1972)(specific purpose or purposes for which corporation is organized shall be set forth, stated in general terms). Any supposed informational function to shareholders is negated by the fact that few, if any, shareholders of any corporation, whatever its size, ever examine its articles. Moreover, elimination of any requirement of specificity removes the possibility of a drafter unwittingly creating a potential ultra vires challenge.

Currently at least 34 states permit the use of "any lawful purpose" or similar clauses. ALA CODE § 10-2A-91 (1980); ARIZ. REV. STAT. ANN. § 10-054 (1977); CAL. CORP. CODE § 202 (West 1977); COLO. REV. STAT. § 7-2-102 (Supp. 1985); CONN. GEN. STAT. ANN., §§ 33-290 (West Supp. 1986); DEL. CODE ANN. tit. 8, § 102 (1983); FLA. STAT. ANN. § 607.164 (West 1977); HAWAII REV. STAT. § 416-11 (Supp. 1984); IDAHO CODE § 30-1-54 (1980); ILL. ANN. STAT. ch. 32, ¶ 2.10 (Smith-Hurd 1985); IND. CODE ANN. § 23-1-22-1(a) (Burns Supp. 1986); IOWA CODE ANN. § 496A.49 (West Supp. 1986); KAN. STAT. ANN. § 17-6002 (1981); KY. REV. STAT. ANN. § 271A.270 (Baldwin 1983); LA. REV. STAT. ANN. § 12.24 (West 1969); MICH. COMP. LAWS ANN. § 450.1202 (West 1973); MONT. CODE ANN. § 35-1-202 (1985); NEB. REV. STAT. § 21-2052 (1983); NEV. REV. STAT. § 78.035 (1985); N.H. REV. STAT. ANN. § 293-A:54 (Supp. 1985); N.J. STAT. ANN. §§ 14A:2-7, 14A:3-1(2) (West 1969); N.M. STAT. ANN. § 53-12-2 (1983); N.Y. BUS. CORP. LAW § 402 (McKinney 1986); N.C. GEN. STAT. § 55-7 (1982); OHIO REV. CODE ANN. § 1701.04 (Page 1985); OR. REV. STAT. § 57-311 (1984); PA. STAT. ANN. tit. 15, §§ 1204, 1302 (Purdon 1967); R.I. GEN. LAWS § 7-1.1-48 (1985); TEX. BUS. CORP. ACT ANN. art. 3.02 (Vernon 1980); VA. CODE § 13.1-626 (Repl. Vol. 1985); WASH. REV. CODE ANN. § 23A:12.020 (Supp. 1986); WISC. STAT. ANN. § 180.45 (West 1957); WYO. STAT. § 17-1-202 (1977). The new Tennessee Business Corporation Act, effective October 1, 1987, enacts the RMA provision. 1986 Tenn. Pub. Acts 887, § 3.01.

<sup>29</sup> REVISED MODEL BUSINESS CORP. ACT § 1.25(d) & official comment 1 (1984); *see infra* notes 33-49 and accompanying text.

<sup>30</sup> The need for formal certificates of corporate acts is unclear, and the RMA wisely eliminates the requirement that the Secretary issue certificates of incorporation, merger, or similar documents. REVISED MODEL BUSINESS CORP. ACT. § 1.25(b) & official comment 3 (1984).

specified in the articles.<sup>31</sup> The RMA does not require either publication of notice or recording in any public office other than that of the Secretary of State. The provisions of the RMA and MBCA dealing with the organizational meeting and adoption of bylaws are substantively similar.<sup>32</sup>

### B. Secretary of State

In addition to miscellaneous simplifying provisions,<sup>33</sup> a second major contribution of the RMA is the clarification of the role of the Secretary of State. Early corporate statutes commonly provided for substantive review of articles of incorporation by a state official.<sup>34</sup> As previously noted, the MBCA charges the Secretary of State with the responsibility of determining that articles of incorporation "conform to law" before issuance

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<sup>31</sup> *Id.* §§ 1.23, 2.03(a). The RMA requires the Secretary to maintain a date and time stamp that will eliminate any ambiguities as to effective time. *Id.* § 1.23(a) & official comment. Filing is made conclusive proof that all conditions precedent to incorporation have been met, except in proceedings brought by the state. *Id.* § 2.03(b). As to the effect of the RMA on the issue of preincorporation transactions, see *infra* notes 53-66 and accompanying text.

<sup>32</sup> Compare REVISED MODEL BUSINESS CORP. ACT §§ 2.05-2.06 (1984) (where initial directors are named they shall hold organizational meeting of majority of directors; incorporators on board of directors shall adopt initial bylaws) with MISS. CODE ANN. §§ 79-3-51, -113 (1972) (bylaws adopted by board which also has power to amend or repeal unless power is reserved to shareholders; organizational meeting shall be called by majority of incorporators and three days notice thereof shall be given by mail). In addition, the RMA includes a provision dealing with emergency bylaws which does not appear in the MBCA but which has been adopted in a number of states. REVISED MODEL BUSINESS CORP. ACT § 2.07 (1984).

<sup>33</sup> *E.g.*, the RMA allows a document containing an "incorrect statement" or one defectively executed to be corrected by filing "articles of correction," thus eliminating the necessity of either refileing or submitting formal articles of amendment to correct minor errors. REVISED MODEL BUSINESS CORP. ACT § 1.24(a) (1984). The correction relates back to the date of the original filing except as to persons who detrimentally rely upon the original document before correction. *Id.* § 1.24(c). In addition, the RMA permits a corporation to change its registered office or agent simply by filing a statement of change without any shareholder or formal board action. *Id.* § 5.02. Under the MBCA, this seemingly mechanical act can be accomplished only by formal resolution of the board and subsequent filing with the Secretary of State. MISS. CODE ANN. § 79-3-23 (1972). There appears to be no reason for formal documentation of board approval for this to be effected.

<sup>34</sup> See, *e.g.*, Roberds, *supra* note 12, at 179-80 (noting authority of governor to regulate amount of paid-in capital before approving charter under 1928 Mississippi Corporation Act).

of the charter.<sup>35</sup> The scope of the Secretary of State's duties under such provisions is somewhat unclear: is he merely to review the charter for technical compliance with the minimum standards of the Act, or is he also charged with determining the substantive legality or relevance of provisions which may go beyond the bare statutory requirements? If the latter is the statute's meaning, one may then question whether the Secretary of State's office is adequately staffed to render a competent judgment on such matters, as well as the appropriateness of granting the Secretary broad substantive discretion in such areas. Existing case law on these issues, unsurprisingly, has yielded sometimes contradictory results.<sup>36</sup>

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<sup>35</sup> MISS. CODE ANN. § 79-3-107 (Supp. 1986). Similar language is employed regarding articles of amendment, restated articles of incorporation, amendment of articles of incorporation in reorganization, statements of reduction in capital, articles of merger or consolidation, articles of merger of a 95% subsidiary, articles of dissolution by act of the incorporators, shareholders or corporation, revocation of dissolution proceedings, application for certificate of authority of a foreign corporation, application for withdrawal of a foreign corporation, and annual reports. *Id.* §§ 79-3-121, -127, -129, -137, -147, -149, -163, -165, -169, -179, -185, -221, -234, -251 (1972 and Supp. 1986).

Currently at least 21 states have adopted comprehensive provisions dealing with the Secretary of State's duty in filing documents. ALA. CODE § 10-2A-93 (1980); ARK. STAT. ANN. § 64-117 (1980); CAL. CORP. CODE § 110 (West 1977); CONN. GEN. STAT. ANN. § 33-285 (West 1960); DEL. CODE ANN. tit. 8, § 103 (1983); GA. CODE ANN. § 14-2-5 (1982); IOWA CODE ANN. § 496A.53 (West 1962); KAN. STAT. ANN. § 17-6003 (1981); MD. CORPS. & ASS'NS CODE ANN. §§ 1-201, -202, -204 (1985); MASS. GEN. LAWS ANN. ch 156B, § 6 (West 1970); MICH. COMP. LAWS ANN. § 450.1131 (West 1973); MINN. STAT. ANN. § 302A.011(11) (West 1985); N.Y. BUS. CORP. LAW § 104 (McKinney 1986); N.C. GEN. STAT. § 54-4 (1982); OHIO REV. CODE ANN. § 1701.08 (Page 1985); PA. STAT. ANN. tit. 15, § 1010 (Purden 1967); S.C. CODE ANN. § 33-1-60 (Law. Co-op 1977); 1986 TENN. PUB. ACTS 887, § 1.35 (effective Oct. 1, 1987); WASH. REV. CODE ANN. § 23A.04.010(9)(17)(Supp. 1986); WIS. STAT. ANN. § 180.86 (West 1957). The standards expressed defining the scope of the secretary's discretion varies somewhat from state to state; in some, no standard whatsoever is defined.

<sup>36</sup> *E.g.*, compare State *ex rel.* Grant v. Brown, 39 Ohio St. 2d 112, 313 N.E.2d 847, 848 (1974)(upholding authority of secretary to refuse articles of incorporation of nonprofit corporation whose purpose was the promotion of homosexuality on grounds that this was unlawful and contravened public policy) with Gay Activists Alliance v. Lomenzo, 31 N.Y.2d 965, 293 N.E.2d 255, 256 (1973)(secretary wrongfully refused articles of incorporation of nonprofit corporation with purpose of seeking repeal of laws discriminating against homosexuals; secretary lacked authority to determine that certain purposes violate public policy or that proposed names are inappropriate).

For other examples, see Smith v. Director, Corporate & Sec. Bureau, 79 Mich. App. 107, 261 N.W.2d 228, 230-31 (1977)(state official had authority to reject article stating purpose of lending money at interest rates in excess of seven percent, then maximum rate permitted under Michigan's usury law); Coal Harbor Stock Farm, Inc. v. Meier, 191

The RMA provides that the Secretary has an express duty to file all documents which satisfy the requirements of the Act,<sup>37</sup> and that this duty is "ministerial."<sup>38</sup> By so doing, the RMA limits the Secretary's discretion to matters of technical compliance. Thus, he would have no authority to reject a document because he believes that it contains provisions that are irrelevant or that violate legal principles not contained in the Act.<sup>39</sup> The RMA properly recognizes that the Secretary's office is not the appropriate forum for such challenges to corporate documents.

Another area in which the proper role of the Secretary has engendered controversy is that of corporate names. As is true of the vast majority of state statutes,<sup>40</sup> the MBCA requires that a corporation's name include words denoting corporateness, *i.e.*, corporation, company, incorporated, or limited, or an abbreviation thereof.<sup>41</sup> The RMA maintains this requirement.<sup>42</sup> By far the most common problem in the area of corporate names, however, is that of similarity to that of an existing corporation currently registered in the state. The MBCA provides that a corporate name must not be "the same as, or deceptively similar to," that of an existing domestic corporation or a previously qualified

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N.W.2d 583, 588 (N.D. 1971)(articles of corporation with purpose of farming properly rejected where statutes prohibited all but qualified cooperative corporations from engaging in farming and limited power to own rural real estate); *LeForce v. Bullard*, 454 P.2d 297, 304 (Okla. 1969)(secretary wrongfully refused to file articles of farming corporation on ground that state constitution and statutes prohibited a corporation from farming since they prohibited corporate ownership of land; corporation can be formed in Oklahoma for general purpose of engaging in farming with power of owning real estate); *State ex rel. Church v. Brown*, 165 Ohio St. 31, 133 N.E.2d 333, 335-36 (1956)(secretary properly rejected articles of corporation whose purpose was to provide private facilities for the practice of nudism; formation of corporation would violate indecent exposure statute).

<sup>37</sup> REVISED MODEL BUSINESS CORP. ACT § 1.25(a) (1984). In order to be eligible for filing, all documents must contain the information required by the RMA and conform to technical requirements of form and execution. *Id.* § 1.20.

<sup>38</sup> *Id.* § 1.25(d).

<sup>39</sup> *Id.* § 1.25 official comment 1.

<sup>40</sup> Only Maine, Massachusetts, Utah, and Wyoming have no such general requirement. ME. REV. STAT. ANN. tit. 13A, § 301 (1981); MASS. GEN. LAWS ANN. ch. 156B, § 11 (West 1970); UTAH CODE ANN. § 16-10-7 (1973); WYO. STAT. § 17-1-107 (1977).

<sup>41</sup> MISS. CODE ANN. § 79-3-13(a)(1972).

<sup>42</sup> REVISED MODEL BUSINESS CORP. ACT § 4.01(a).

foreign corporation.<sup>43</sup> The use of a “deceptive similarity” standard, however, may suggest an inappropriate overlap with the law of unfair competition. Under both the federal and Mississippi trademark statutes, the general test for registrability of a trademark is that it not “be likely . . . to cause confusion, or to cause mistake, or to deceive.”<sup>44</sup> Inherent in the “likelihood of confusion” test applied under trademark law, however, is not only similarity in name but also the competitive nature of the businesses pursued by competing claimants.<sup>45</sup>

In some instances courts have held that unfair competition standards govern the results under corporate name statutes as well.<sup>46</sup> The resources of the Secretary of State may, however, be inadequate to make such a judgment, and the possibility of inconsistency is evident.<sup>47</sup> The RMA adopts the test “distinguishable upon the records of the Secretary of State” for determining the right to use a corporate name. This formulation makes it clear that similarity in an absolute or linguistic sense, and not confusion, is the appropriate test since the function of requiring

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<sup>43</sup> MISS. CODE ANN. § 79-3-13(c)(1972).

<sup>44</sup> 15 U.S.C. § 1052(d)(1980); MISS. CODE ANN. § 75-25-3(f)(1972). Unlike many states, Mississippi has no statute dealing with the registration of trade or assumed names. *See, e.g.*, CAL. BUS. & PROF. CODE §§ 14411-417 (West Supp. 1986)(filing of fictitious name raises rebuttable presumption of exclusive right to use as trade name); CONN. GEN. STAT. ANN. § 35-1 (West Supp. 1986)(assumed name under which business is to be conducted must be filed); MICH. COMP. LAWS ANN. §§ 445.1-445.5 (West Supp. 1986)(same); N.Y. GEN. BUS. LAW § 130 (McKinney Supp. 1986)(same); VA. CODE ANN. §§ 59.1-69 to 59.1-76 (1982 & Supp. 1986)(same).

<sup>45</sup> *See, e.g.*, Kentucky Fried Chicken v. Diversified Packaging, 549 F.2d 368, 388 (5th Cir. 1977)(confusion with respect to product's source, its indorsement by plaintiff, or its connection with plaintiff).

<sup>46</sup> *See, e.g.*, Couhig's Restaway Co. v. Pestaway, Inc., 278 So. 2d 519, 521 (La. App. 1973)(substantially same test as applied in determining infringement of proprietary right to trade name).

<sup>47</sup> An interesting case illustrating this point is Ergon, Inc. v. Dean, 649 S.W.2d 772 (Tex. Ct. App. 1983). Ergon, Inc., a Mississippi corporation, qualified to do business in Texas in 1973. *Id.* at 774. In 1978, the Secretary of State of Texas issued a charter to Nova Energy Corporation, which shortly thereafter changed its name to Ergon Energy Corporation. *Id.* Both Ergon and Ergon Energy were engaged in similar businesses. *Id.* at 775. Ergon sought to compel the Secretary to revoke approval of Ergon Energy's corporate name and also relief under the Federal Trademark Act. *Id.* at 773. The court, relying heavily upon regulations promulgated by the Secretary, upheld his decision to allow Ergon Energy to use its corporate name, but further held that Ergon Energy had infringed upon Ergon's federal trademark. *Id.* at 776-80.

distinguishable names in a corporate statute is to prevent confusion by the Secretary and taxing authorities, and to permit accurate service of process.<sup>48</sup> Under the RMA, no issues of the appropriate relationship between corporate law and unfair competition standards should arise.<sup>49</sup>

The RMA contains a number of clarifying features not present in earlier versions of the Model Act. One is an extensive set of definitions.<sup>50</sup> Perhaps even more helpful is a prescribed procedure for giving notice and rules defining when notice becomes effective.<sup>51</sup> The RMA also relieves the Secretary of State of an unnecessary responsibility by providing that in the event that service of process cannot be made on a corporation's registered agent, the corporation can be served by registered or certified mail addressed to the secretary of the corporation at its principal office shown in its most recent annual report.<sup>52</sup>

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<sup>48</sup> REVISED MODEL BUSINESS CORP. ACT. § 4.01 & official comment 2 (1984).

<sup>49</sup> The RMA carries forward other provisions from the 1969 Model Act relating to corporate names which would be desirable additions to Mississippi law. The first is a consent procedure to permit the use of similar names. The 1969 Model Act allowed a corporation to use a name that would be otherwise unavailable if it could obtain the written consent of the holder of the conflicting name and, if necessary, add one or more words to the new name to make it distinguishable. MODEL BUSINESS CORPORATION ACT § 8(c)(1969). A majority of states have adopted this or similar provisions. 1 REVISED MODEL BUSINESS CORP. ACT ANN. 252 (1985). While the Secretary of State of Mississippi has followed this practice on an informal basis, a codified procedure is preferable. The substance of the 1969 amendment is incorporated in REVISED MODEL BUSINESS CORP. ACT § 4.01(c)(1)(1984). In addition, the RMA authorizes the use of an indistinguishable name if the applicant can produce a judgment of a court of final jurisdiction establishing its right to the name. *Id.* § 4.01(c)(2).

The provisions of the MBCA and RMA dealing with reserved and registered names are substantially the same; the primary difference is that the RMA makes the reservation of a corporate name nonrenewable. Compare MISS. CODE ANN. §§ 79-3-15, -17 (1972 & Supp. 1985)(name reserved for period of 180 days) with REVISED MODEL BUSINESS CORP. ACT §§ 4.02, 4.03 (1984)(only single, one time reservation of 120 days is provided). Nothing in the RMA, however, prohibits an applicant from reapplying for reservation upon lapse, nor from forming an inactive corporation to maintain perpetual rights to a name. REVISED MODEL BUSINESS CORP. ACT § 4.02 official comment (1984).

<sup>50</sup> See REVISED MODEL BUSINESS CORP. ACT § 1.40 (1984)(definitions of terms used throughout Model Act collected in single section).

<sup>51</sup> *Id.* § 1.41. Notice provisions included in a corporation's articles or bylaws are effective to the extent that they are not inconsistent with the Act. *Id.* § 1.41(g).

<sup>52</sup> *Id.* § 5.04(b) & official comment. Under the MBCA the Secretary of State is deemed to be a corporation's agent when a registered agent is not appointed or cannot be found. MISS. CODE ANN. § 79-3-25 (1972). Service must therefore be made on the Secre-

### C. Liability for Preincorporation Obligations

One of the most troublesome interpretative questions arising under earlier versions of the Model Act was its impact on the problems falling within the general rubric of defective incorporation. The classic case involved liabilities incurred before all formal conditions precedent to incorporation were met. The common law addressed the question of the potential liability of individuals acting on the corporation's behalf by the doctrines of de jure corporation, de facto corporation, or corporation by estoppel. So long as substantial compliance with the necessary steps to incorporation was effected, a de jure corporation would exist which was generally immune from either direct or collateral attack by the state or any other party.<sup>53</sup> Conversely, although the substantial compliance standard was not met, courts would recognize a de facto corporation where (1) there was a statute under which the corporation might have been validly organized, (2) a colorable attempt was made to comply with the statute, and (3) there was some exercise of corporate powers. A de facto corporation was safe from collateral challenge but could be attacked directly by the state in a *quo warranto* or similar

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tary, who forwards it to the corporation at its registered office. *Id.* No reason for the Secretary's intervention appears to exist.

A related technical problem exists concerning the resignation of a registered agent. Under the MBCA a resigning agent is to notify the Secretary, who then sends a copy of the notice to the corporation "at its registered office." MISS. CODE ANN. § 79-3-23 (1972). In many instances, however, that will be the address of the resigning agent, with the anomalous result that the resigning agent receives the notice of its resignation. Thus, the RMA provides for the Secretary to forward the notice to the corporation's registered office, if not discontinued, and to its principal office as shown on its annual report. REVISED MODEL BUSINESS CORP. ACT § 5.03(b)(1984).

<sup>53</sup> 8 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 3799 (rev. perm. ed. 1982) [hereinafter cited as W. FLETCHER]; A. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 139, at 327-28 (3d ed. 1983) [hereinafter cited as HENN & ALEXANDER]. Of course, this begs the question somewhat as to what constitutes "substantial compliance." One standard sometimes articulated is that the noncompliance be "slight." A. FREY, J. CHOPER, N. LEECH & C. MORRIS, CASES AND MATERIALS ON CORPORATIONS 34 (2d ed. 1977). A distinction is sometimes drawn between "directory" and "mandatory" provisions, a directory provision being an inconsequential one, noncompliance with which does not prejudice any public interest. W. FLETCHER, *supra*, § 3800; HENN & ALEXANDER, *supra*, at 328. An example would be the incorrect street address of an incorporator. For examples of other directory provisions see 1A W. FLETCHER, *supra*, § 132.



action.<sup>54</sup> Finally, regardless of the degree of compliance with incorporation procedures, one dealing with a purported corporation could, under the principle of corporation by estoppel, be precluded from denying its existence.<sup>55</sup>

The former Model Act contained two provisions relating to these issues. Section 56 provided:

Upon the issuance of the certificate of incorporation, the corporate existence shall begin, and such certificate of incorporation shall be conclusive evidence that all conditions precedent required to be performed by the incorporators have been complied with and that the corporation has been incorporated under this Act, except as against this State in a proceeding to cancel or revoke the certificate of incorporation or for involuntary dissolution of the corporation.<sup>56</sup>

Section 146 of the Model Act provided that “[a]ll persons who assume to act as a corporation without authority so to do shall be jointly and severally liable for all debts and liabilities incurred or arising as a result thereof.”<sup>57</sup>

The drafters of the Model Act took the position that these sections abrogated the de facto corporation concept and that nothing less than full compliance with the statute could create a corporation.<sup>58</sup> Given the simplicity of the incorporation proce-

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<sup>54</sup> 8 W. FLETCHER, *supra* note 53, § 3761; HENN & ALEXANDER, *supra* note 53, § 140, at 329-330. The doctrine of de facto corporation has also been applied where a condition precedent to doing business, as opposed to incorporation, has not been met. *See, e.g., In re Estate of Hardin*, 218 So. 2d 889, 891 (Miss. 1969) (failure to comply with minimum paid-in capital did not deprive corporation of de facto status).

<sup>55</sup> W. FLETCHER, *supra* note 53, §§ 3889, 3910; HENN & ALEXANDER, *supra* note 53, § 141, at 335. In addition, those acting as a corporation may be estopped from denying the corporation's existence. W. FLETCHER, *supra* note 53, § 3930; HENN & ALEXANDER, *supra* note 53, § 141; *see, e.g., Taylor v. Aldridge*, 180 Miss. 635, 643, 178 So. 331, 332-33 (1938) (Tennessee corporation doing business in Mississippi without qualifying as foreign corporation estopped from denying its existence).

<sup>56</sup> MODEL BUSINESS CORP. ACT § 56 (1969). Mississippi adopted this provision with the substitution of the word “chapter” for “Act.” MISS. CODE ANN. § 79-3-109 (1972).

<sup>57</sup> MODEL BUSINESS CORP. ACT § 146 (1969). Mississippi adopted this provision without change. MISS. CODE ANN. § 79-3-285 (1972).

<sup>58</sup> The comment to § 56 stated that “a de facto corporation cannot exist under the Model Act.” MODEL BUSINESS CORP. ACT § 56 comment (1969). Moreover, the drafters stated that the purpose of § 146 was “to prohibit the application of any theory of de facto corporation.” *Id.* § 146 comment. Other authorities have commonly agreed. *See,*

ture under the Model Act, the logic of this argument seems sound. Nonetheless, not all courts have accepted the dictum of the drafters, the Supreme Court of Mississippi being an example.<sup>59</sup>

By far the more troublesome question is whether the doctrine of corporation by estoppel was affected by the Model Act and similar state statutes. Since the doctrine is equitable in nature and is based on a course of conduct rather than any question of statutory compliance, a convincing argument could be made that it was not abrogated by the Model Act. Two well-known cases, decided in the same year, reached opposite conclusions on the issue. In *Robertson v. Levy*,<sup>60</sup> the Court of Appeals for the District of Columbia held that the Model Act abrogated both the doctrines of de facto corporation and corporation by estoppel. Noteworthy in that case, however, was that the person acting on behalf of the purported corporation was aware that the charter had not been issued at the time that the obligation was incurred. Conversely, in *Cranson v. International Business Machines Corp.*,<sup>61</sup> the Supreme Court of Maryland applied the doctrine of corporation by estoppel despite the presence of a statute substantively identical to Section 56 of the Model Act. In that case, however, the individual defendant was unaware of the non-existence of the corporation, the party at fault being his lawyer who had failed for seven months to file the articles. Subsequent cases have split on the issue,<sup>62</sup> although some states have ex-

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*e.g.*, 8 W. FLETCHER, *supra* note 53, § 3762.1.

<sup>59</sup> See *In re Estate of Hardin*, 218 So. 2d 889, 891 (Miss. 1969)(failure to comply with minimum paid-in capital did not deprive corporation of de facto status); *Gulf Land & Dev. Co. v. McRaney*, 197 So. 2d 212, 217 (Miss. 1967)(de facto corporation exists where good faith attempt made under existing laws to organize corporation for specific purpose and corporation has exercised corporate functions for indefinite time).

<sup>60</sup> 197 A.2d 443 (D.C.C. App. 1964), noted in 43 N.C.L. REV. 206 (1964). *But see* *Namerdy v. Generalcar*, 217 A.2d 109, 112 (D.C. App. 1966)(corporation by estoppel applied).

<sup>61</sup> 234 Md. 477, 200 A.2d 33 (1964), noted in 10 VILL. L. REV. 166 (1964).

<sup>62</sup> *E.g.*, compare *Thompson & Green Mach. v. Music City Lumber Co.*, 683 S.W.2d 340, 344 (Tenn. App. 1984)(both de facto corporation and corporation by estoppel eliminated in Tennessee) with *Harris v. Stephens Wholesale Bldg. Supply Co.*, 54 Ala. App. 405, 309 So. 2d 115, 117-18 (1975) and *Cantor v. Sunshine Greenery, Inc.*, 165 N.J. Super. 411, 398 A.2d 571, 573 (1979)(both applying corporation by estoppel).

pressly preserved the estoppel doctrine by statute.<sup>63</sup>

The RMA clarifies the intent of former section 146 by now providing that "[a]ll persons purporting to act as or on behalf of a corporation, *knowing there was no incorporation under this Act*, are jointly and severally liable for all liabilities created while so acting."<sup>64</sup> The drafters of the RMA concluded as a policy matter that in certain situations the recognition of limited liability would be appropriate notwithstanding the failure to comply with statutory formalities, with the overriding consideration being the good faith of the persons so acting.<sup>65</sup> The RMA, then, strikes an appropriate balance between the interests of participants in the corporate enterprise and third parties dealing with it, and is consistent with recent decisions of the Mississippi Supreme Court dealing with liability of persons who conduct business after the suspension of a corporation's charter.<sup>66</sup>

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<sup>63</sup> An earlier Minnesota statute preserved both de facto corporation and corporation by estoppel. MINN. STAT. ANN. § 301.08 (West 1980), *repealed by* 1981 MINN. LAWS 270, § 142. The comments to its present act take the position that the de facto corporation doctrine has been eliminated, but that the estoppel doctrine is unaffected. Reporter's Notes to MINN. STAT. ANN. § 302A.153 (West 1985). The Georgia Corporation Code provides that "[t]he existence of a corporation claiming a charter under color of law cannot be collaterally attacked by persons who have dealt with it as a corporation. Such persons are estopped from denying its corporate existence." GA. CODE ANN. § 14-5-4 (1982). In *Cahoon v. Ward*, 231 Ga. 872, 204 S.E.2d 622, 624-25 (1974), the Supreme Court of Georgia construed this as preserving the doctrine of corporation by estoppel which would otherwise have been eliminated by adoption of provisions identical to Model Act Sections 56 and 146. *But see* *Don Swann Sales Corp. v. Echols*, 160 Ga. App. 539, 287 S.E.2d 577, 580 (1981)(corporation by estoppel should not be applied to protect individual purporting to act for non-existent corporation from liability on contract executed in corporation's name).

<sup>64</sup> REVISED MODEL BUSINESS CORP. ACT § 2.04 (1984)(emphasis added).

<sup>65</sup> *Id.* official comment. As the comment notes, equivalent protection is accorded to limited partners who contribute capital in the erroneous belief that the certificate of limited partnership has been filed. *See, e.g.*, Miss. CODE ANN. § 79-13-23 (1972)(contributor to capital of business erroneously believing he has become limited partner is not bound by partnership provided he renounces his interest in profits of business).

Moreover, the comments state that, despite the lack of specific language to this effect, § 2.04 is not intended to foreclose the application of estoppel in instances where the defendants are urged to execute contracts in the corporate name by persons who are aware that no corporation exists. REVISED MODEL BUSINESS CORP. ACT § 2.04 official comment (1984).

<sup>66</sup> *Compare* *Carolina Transformer Co. v. Anderson*, 341 So. 2d 1327, 1329-30 (Miss. 1977)(owner and officer of corporation suspended for failure to file annual report liable under § 79-3-285 on contracts made in corporation's name after suspension) *with* *Flana-*

In summary, the provisions of Chapters 1 through 5 of the RMA provide a desirable basis for revision of the Mississippi Act. The RMA effectively accomplishes the dual goals of simplification and clarification of traditional laws dealing with the incorporation process.

## II. CORPORATE MANAGEMENT AND GOVERNANCE

### A. *Composition and Structure of Board of Directors*

The provisions of the RMA dealing with directors reflect not only widespread statutory developments but, in some instances, innovations not yet commonly found in state general corporation statutes. A striking example of the latter is the ability, under some circumstances, to eliminate the board of directors entirely or limit its authority by provisions in the articles describing who is to perform all or part of the board's duties. This election is limited to corporations with fifty or fewer shareholders.<sup>67</sup> While this is obviously practicable only for a close corporation, the RMA would permit such action even in a state like Mississippi with no separate close corporation statute.<sup>68</sup>

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gan v. Jackson Wholesale Bldg. Supply Co., 461 So. 2d 761, 764-65 (Miss. 1984)(wife of deceased owner of suspended corporation, though director, not liable since she was not actively involved in the control and management of corporation, notwithstanding that corporation and its finances were intertwined with her household).

<sup>67</sup> REVISED MODEL BUSINESS CORP. ACT § 8.01(c)(1984). Such provisions are not, of course, uncommon in states with separate close corporation statutes. *See, e.g.*, DEL. CODE ANN. tit. 8, § 351 (1983)(permitting management by shareholders). Related issues will be discussed in greater depth in Part 2 of this article.

A more radical approach is taken in Minnesota, where any business corporation can be managed by its shareholders. MINN. STAT. ANN. §§ 302A.201, 302A.457 (West 1985). The limitation in the RMA is consistent with the Close Corporation Supplement to the Model Act, which authorizes the elimination of the board in a statutory close corporation but would allow only existing corporations with 50 or fewer shareholders to amend its articles to elect close corporation status. MODEL STATUTORY CLOSE CORP. SUPPLEMENT §§ 3(b), 21 (1983). An unusual feature of the supplement is that it would permit a new corporation to elect such status without regard to the number of shareholders. *Id.* § 3(a).

<sup>68</sup> The avowed purpose of the drafters of the RMA is to avoid the necessity of manipulating a corporation's capital structure in order to achieve a similar result. The classic case is *Lehrmann v. Cohen*, 43 Del. Ch. 222, 222 A.2d 800 (1966), which upheld the issuance to the corporation's attorney of a class of voting common stock without a significant equity interest in order to create a tie-breaking vote on the board. The RMA would permit the same result by express provision in the articles, without the necessity of creating a special class of stock. REVISED MODEL BUSINESS CORP. ACT § 8.01 official

While relatively few corporations might avail themselves of this option, a provision of much wider appeal in the RMA is the elimination of the mandatory three member board. Surely no corporate practitioner in Mississippi has escaped the problems posed by the MBCA's insistence on three directors.<sup>69</sup> In many instances, particularly where the corporation has fewer than three shareholders, this requirement forces the inclusion on the board of persons with no equity interest and possibly no other financial interest in the corporation. Attorneys particularly are often put in the awkward position of declining a client's request to serve. The potential liability of the inactive director is clear,<sup>70</sup> but this is not always an easy matter to explain to clients. A figurehead director in general serves no purpose and the requirement of multiple directors appears purely historical in nature.<sup>71</sup> Thus, the RMA wisely mandates only one director unless the articles or bylaws provide to the contrary.<sup>72</sup>

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comment (1984); *cf. id.* § 7.31 (dealing with voting agreements among shareholders).

For a general discussion of the necessity *vel non* for a board of directors see Kessler, *Statutory Requirement of a Board of Directors: A Corporate Anachronism*, 27 U. CHI. L. REV. 696 (1960). Arguably, the mandate for cumulative voting in § 194 of the Mississippi Constitution could prevent outright abolition of the board. MISS. CONST. art. VII, § 194. Part 2 of this article will consider the desirability of separate close corporation treatment in Mississippi, as well as related issues involving shareholder control devices.

<sup>69</sup> MISS. CODE ANN. § 79-3-69 (1972).

<sup>70</sup> See, e.g., *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814, 829 (1981) (estate of inactive director held liable to bankruptcy trustees of corporation for over \$10,000,000 stolen from corporation by other directors). This is not to say, of course, that attorneys do not often play a useful role as directors of many companies. For a summary of arguments both supporting and criticizing this practice see Comment, *Corporate Counsel on the Board of Directors: An Overview*, 10 CUM. L. REV. 791 (1980).

<sup>71</sup> 2 MODEL BUSINESS CORP. ACT ANN. § 8.03, at 805 (1985).

<sup>72</sup> REVISED MODEL BUSINESS CORP. ACT § 8.03(a)(1984). The Model Act first eliminated the three-director requirement in 1969. MODEL BUSINESS CORP. ACT § 36 (1969). At least half the states now permit a one member board. 2 MODEL BUSINESS CORP. ACT ANN. § 8.03, at 808 (1985). For general background on the issue see Rudolph, *Further Thoughts on the One and Two Director Statutes*, 20 BUS. LAW. 781 (1965).

The RMA contains two other provisions concerning board size that would be beneficial additions to Mississippi's law. Under the MBCA, the number of directors is fixed in the bylaws, which may be amended by the board unless that power is reserved by the articles to the shareholders. MISS. CODE ANN. §§ 79-3-51, -69 (1972). In order to prevent the board from utilizing this power in a way which would fundamentally alter the board's composition, the RMA prohibits the board from increasing or decreasing the number of directors by more than 30% of the number of directors last approved by the shareholders. REVISED MODEL BUSINESS CORP. ACT § 8.03(b)(1984). In addition, the RMA

The RMA contains numerous other provisions which would effect other desirable changes in the MBCA. For example, the RMA specifically sanctions the common practice in many states of allocating among different classes of stock the right to elect all or a specified number of directors.<sup>73</sup> This is presently impermissible under the MBCA, which prohibits the issuance of common stock with no or limited voting rights, and mandates that all stock regardless of class (except preferred stock) have one vote per share on each matter submitted to shareholders.<sup>74</sup> This provision of the RMA might, however, run afoul of the constitutional mandate of cumulative voting in Mississippi.<sup>75</sup> For reasons which will be more fully explained later, this article recommends the elimination of mandatory cumulative voting,<sup>76</sup> which would make available this potentially valuable structural device.

Under the MBCA, the power to remove directors<sup>77</sup> and to fill vacancies<sup>78</sup> on the board is vested solely in the shareholders. The RMA would change this in two respects. First, the RMA provides a machinery for the judicial removal of a director. The standard for removal is that "(1) the director engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion, with respect to the corporation and (2) removal is in the best interest of the corporation."<sup>79</sup> The suit may be brought either by the corporation or by a shareholder suing derivatively on its behalf, or directly by the holders of ten percent or more of

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specifically sanctions the widely used device of providing for a variable size board in the bylaws. As a matter of shareholder protection, however, once shares are issued only the shareholders can change the range or change from a fixed to a variable size board, or vice versa. The specific number of directors within the range would then be determined by either the shareholders or directors as provided in the articles or bylaws. *Id.* § 8.03(c).

<sup>73</sup> REVISED MODEL BUSINESS CORP. ACT § 8.04 (1984). This, of course, is a commonly used control device in close corporations.

<sup>74</sup> See MISS. CODE ANN. §§ 79-3-27, -63 (1972). This is apparently an outmoded vestige of the common law's resistance to severing proprietary rights and control rights. See FREY, CHOPER, LEECH & MORRIS, *supra* note 53, at 541.

<sup>75</sup> MISS. CONST. art. 7, § 194; see HENN & ALEXANDER, *supra* note 53, § 189, at 499 n.33.

<sup>76</sup> See *infra* notes 258-68 and accompanying text.

<sup>77</sup> MISS. CODE ANN. § 79-3-75 (1972).

<sup>78</sup> *Id.* § 79-3-73.

<sup>79</sup> REVISED MODEL BUSINESS CORP. ACT § 8.09(a)(1984).

any class of stock.<sup>80</sup> The existence of this power could be significant, for example, in removing a director elected by cumulative voting. Under both the RMA<sup>81</sup> and the MBCA<sup>82</sup>, such a director cannot be removed if votes sufficient for his election under cumulative voting are cast against his removal. While there is authority that a majority of shareholders have inherent power to remove a director for cause notwithstanding cumulative voting rights,<sup>83</sup> sufficient uncertainty exists on the issue to make an explicit judicial alternative desirable.<sup>84</sup>

The RMA also permits either the shareholders or directors to fill a vacancy on the board, unless otherwise provided in the articles.<sup>85</sup> In light of the logistical difficulties encountered by larger corporations in holding shareholders' meetings, this change in the MBCA<sup>86</sup> is recommended, particularly since the term of the new director is limited to the next shareholders' meeting at which directors are elected,<sup>87</sup> and in all events the power can be reserved to the shareholders exclusively if appropriate.<sup>88</sup>

The RMA also streamlines some functional aspects of board

<sup>80</sup> Any such derivative action would be subject to the procedural restrictions of the RMA. *Id.* § 7.40.

<sup>81</sup> REVISED MODEL BUSINESS CORP. ACT § 8.08(c)(1984).

<sup>82</sup> MISS. CODE ANN. § 79-3-75 (1972). In all material respects, the RMA and MBCA are substantively identical on the issue of shareholder removal.

<sup>83</sup> See *Campbell v. Loew's, Inc.*, 36 Del. Ch. 563, 134 A.2d 852, 857-58 (1957) (stockholders have power to remove director for cause). There is a division of authority on the question of a court's general equity power to remove a director. *E.g.*, compare *Brown v. North Ventura Road Dev. Co.*, 216 Cal. App. 2d 227, 233, 30 Cal. Rptr. 568, 571 (1963) (such power exists independent of statute) with *Markovitz v. Markovitz*, 336 Pa. 145, 8 A.2d 46, 48 (1939) (no such inherent powers).

<sup>84</sup> As the comments to the RMA point out, the procedure may also be practicably necessary in a public corporation due to the logistical difficulties in effecting a special shareholders' meeting. REVISED MODEL BUSINESS CORP. ACT § 8.09 official comment (1984). Moreover, even absent cumulative voting, super-majority provisions requiring a higher than majority vote for shareholder action may preclude removal for cause by less than the required percentage. HENN & ALEXANDER, *supra* note 53, § 205, at 559.

<sup>85</sup> REVISED MODEL BUSINESS CORP. ACT § 8.10(a). If the remaining directors constitute less than a quorum, a majority of those remaining have power to fill the vacancy.

<sup>86</sup> In Mississippi only shareholders can fill a vacancy. MISS. CODE ANN. § 79-3-73 (1972). Again, adoption of the RMA in this respect might necessitate constitutional amendment. See MISS. CONST. art. 7, § 194.

<sup>87</sup> REVISED MODEL BUSINESS CORP. ACT § 8.05(d)(1984).

<sup>88</sup> *E.g.* in a closely-held corporation where shareholder action poses no real obstacle.

operation. For example, the RMA follows the widely-adopted trend of permitting the directors to meet by conference telephone call, with each participating director deemed to be present as if physically in attendance.<sup>89</sup> In addition, while the RMA, like the MBCA,<sup>90</sup> permits directors to act by unanimous written consent, the RMA specifically recognizes the common practice of using separate consent forms for all or some directors, and expressly provides that such action is effective upon the signature of the last director.<sup>91</sup>

The formalities of director action would also be affected by the RMA provisions on the quorum. The MBCA,<sup>92</sup> like the RMA, permits super-majority provisions in the articles or bylaws increasing the quorum up to and including unanimity.<sup>93</sup> Unlike the MBCA, however, the RMA would allow the articles or bylaws to *decrease* the quorum to not less than one-third of the directors.<sup>94</sup> While election of this option would be inappropriate in most closely-held corporations, the flexibility it would accord to public corporations has led to adoption of similar provisions in a substantial number of states.<sup>95</sup> This change is therefore recommended.

An interesting contrast in approach to board functioning appears in the RMA and MBCA provisions concerning committees. The MBCA requires that authorization for the creation of committees be made in the articles or bylaws; however, its restrictions on delegable powers are rather narrow in scope.<sup>96</sup> The

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<sup>89</sup> REVISED MODEL BUSINESS CORP. ACT § 8.20(b)(1984). The statute actually speaks in terms of "any means of communication by which all directors participating may simultaneously hear each other during the meeting," the wording of which would seem to embrace possible future advances in communications technology. Section 43 of the Model Act has permitted conference telephone meetings since 1973. See, *Report of Committee on Corporate Laws—Changes in the Model Business Corporation Act*, 29 BUS. LAW. 947, 948 (1974). Mississippi is one of but five states that has no comparable provision. 2 REVISED MODEL BUSINESS CORP. ACT ANN. § 8.20, at 876 (1985).

<sup>90</sup> MISS. CODE ANN. § 79-3-283 (1972).

<sup>91</sup> REVISED MODEL BUSINESS CORP. ACT § 8.21(a), (b)(1984).

<sup>92</sup> MISS. CODE ANN. § 79-3-77 (1972).

<sup>93</sup> REVISED MODEL BUSINESS CORP. ACT § 8.24(a) & official comment (1984).

<sup>94</sup> *Id.* § 8.24(b).

<sup>95</sup> See 2 REVISED MODEL BUSINESS CORP. ACT ANN. § 8.24, at 903 (1985)(overview of state laws dealing with quorum).

<sup>96</sup> Under the MBCA, committees cannot exercise the authority of the board in refer-



RMA, conversely, empowers the board to create such committees as it desires unless restricted by the articles or bylaws;<sup>97</sup> however, its list of non-delegable functions is considerably more detailed.<sup>98</sup> In view of the almost universal use of committees in public corporations, the RMA approach appears the more reasonable of the two.

### B. Management Duties

#### 1. Duty of Care.

Section 67 of the MBCA provides that "[T]he business and affairs of a corporation shall be managed by a board of directors."<sup>99</sup> Except in limited circumstances, however, the MBCA offers no statutory guidance as to the specific content of this duty, the standard of conduct to which directors are held, or potential

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ence to amending the articles of incorporation, adopting a plan of merger or consolidation, recommending to the shareholders the sale, lease, exchange, mortgage, pledge or other disposition of all or substantially all the property and assets of the corporation otherwise than in the usual and regular course of its business, recommending to the shareholders a voluntary dissolution of the corporation or a revocation thereof, or amending the bylaws of the corporation. MISS. CODE ANN. § 79-3-79 (1972).

<sup>97</sup> REVISED MODEL BUSINESS CORP. ACT § 8.25(a)(1984).

<sup>98</sup> *Id.* § 8.25(e), which provides:

A committee may not, however:

- (1) authorize distributions;
- (2) approve or propose to shareholders action that this Act requires to be approved by shareholders;
- (3) fill vacancies on the board of directors or any of its committees;
- (4) amend articles of incorporation pursuant to section 10.02;
- (5) adopt, amend, or repeal bylaws;
- (6) approve a plan of merger not requiring shareholder approval;
- (7) authorize or approve reacquisition of shares, except according to a formula or method prescribed by the board of directors; or
- (8) authorize or approve the issuance or sale or contract for sale of shares, or determine the designation and relative rights, preferences, and limitations of a class or series of shares, except that the board of directors may authorize a committee (or a senior executive officer of the corporation) to do so within limits specifically prescribed by the board of directors.

*Id.* As with the MBCA, the RMA provides that delegation to a committee does not itself absolve the directors from their duties of management. Compare MISS. CODE ANN. § 79-3-79 (1972) (delegation "shall not operate to relieve the board . . . of any responsibility imposed by law") with REVISED MODEL BUSINESS CORP. ACT § 8.25(f)(1984) (creation, delegation to, or action by committee "does not alone constitute compliance by a director with the standards of conduct described in section 8.30").

<sup>99</sup> MISS. CODE ANN. § 79-3-67 (Supp. 1985).

liabilities for failure to meet any such standard as may be imposed.<sup>100</sup> In addition, few Mississippi cases exist on the issue of mismanagement absent self-dealing or a conflict of interest.<sup>101</sup> Thus there is but little authority concerning two distinct, but interrelated concepts: the duty of care and the business judgment rule.

In its simplest sense, the duty of care recognizes that as a corollary to their duties of management, directors may be liable to the corporation for negligence in the performance of those duties.<sup>102</sup> There exists, then, the possibility of liability for waste,

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<sup>100</sup> Specific statutory liability is imposed upon directors who vote for or assent to (1) payment of an improper dividend or distribution, (2) an improper repurchase of shares, (3) distribution of assets in liquidation without adequate provisions for corporate obligations, (4) a loan to an officer or director or a loan secured by the corporation's shares, or (5) the commencement of business before the minimum capital of \$1,000.00 has been paid in for shares. Miss. CODE ANN. § 79-3-91 (1972). This provision is derived from § 48 of the Model Act. See MODEL BUSINESS CORP. ACT § 48 (1969)(providing framework for first three instances listed above).

<sup>101</sup> Two leading cases each involve an element of self-dealing. In *Landstreet v. Meyer*, 201 Miss. 826, 29 So. 2d 653 (1947), the court held that the minority shareholders of a corporation had a right to enjoin the payment of the president's salary upon a showing that it was clearly excessive and wasteful; however, the president had cast the deciding vote on his salary. *Id.* at 833, 29 So. 2d at 655. In a more recent case, *Home Tel. Co. v. Darley*, 355 F. Supp. 992 (N.D. Miss. 1973), *aff'd per curiam*, 489 F.2d 1403 (5th Cir. 1974), directors were held liable to the corporation for negligence in inducing the corporation to breach a merger agreement; however, in addition to the fact that this action had no corporate purpose, the court emphasized that the defendants personally benefited from the breach. *Darley*, 355 F. Supp. at 998. The case is one of very few in Mississippi attempting to articulate the business judgment rule: "Although an officer is surely not liable for honest errors or mistakes in judgment when acting in good faith, this does not excuse mistakes where the loss is the result of failure to exercise ordinary care, skill and diligence." *Darley* 355 F. Supp. at 1000. While the court spoke in terms of negligence, however, there was a clear conflict of interest on the part of the defendants which should have rendered any consideration of the business judgment rule moot. See *infra* text accompanying note 112.

In addition, a number of Mississippi cases, while not explicitly premised on the business judgment rule, emphasize the tradition of judicial deference to the concept of majority rule in corporations. See, e.g., *Crocker v. Farmers & Merchants Bank*, 293 So. 2d 438, 442 (Miss. 1974)(court should not enter area of corporate management except in cases where judicial action is essential to justice); *Hudson v. Belzoni Equip. Co.*, 211 Miss. 178, 188, 51 So. 2d 223, 226 (1951)(courts are not to control corporations except in cases where such control is essential to justice).

<sup>102</sup> See, e.g., HENN & ALEXANDER, *supra* note 53, § 234, at 621. For general background on the topic see 3A W. FLETCHER, *supra* note 53, § 1035; Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341, 367-71 (1965); Lewis, *The Business Judgment Rule and Corporate Directors' Liability for Mismanagement*, 22 BAYLOR L. REV. 157,

mismanagement, or other acts resulting in loss to the corporation even absent self-dealing on the director's part.<sup>103</sup> Judicial formulations of the content of this duty abound. A common expression of the duty is that care which "ordinarily careful and prudent men would use in similar circumstances."<sup>104</sup> The Mississippi Supreme Court has described the standard as "that degree of care in managing [the corporation] that ordinarily prudent and diligent men would exercise under similar circumstances in the conduct and management of their own business."<sup>105</sup> The

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157-60 (1970).

<sup>103</sup> The reality of that threat has been the source of no little debate. In a well-known article, Professor Joseph W. Bishop, Jr. argued that virtually no cases existed which imposed liability for breach of the duty of care in non-financial corporations without some component of self-dealing. Bishop, *Sitting Ducks*, *supra* note 14, at 1099. That argument, however, has not gone unchallenged. See, e.g., Harris, *Standards of Conduct Under Common Law, Present Day Statutes and the Model Act*, 27 BUS. LAW. 61, 66 (1972)(contending that reported cases do not reflect possibility that substantial numbers of such actions may have been settled out of court). Certainly, recent cases suggest that the duty of care has more than a mere exhortative function. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985)(director's duty to exercise informed business judgment is in nature of duty of care); *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814, 824 (1981)(director's duty of care does not exist in abstract).

<sup>104</sup> *Graham v. Allis-Chalmers Mfg. Co.*, 41 Del. Ch. 78, 84, 188 A.2d 125, 130 (1963).

<sup>105</sup> *Boyd v. Applewhite*, 121 Miss. 879, 897, 84 So. 16, 23 (1920). It is noteworthy that *Boyd*, a case in which liability was imposed on directors for mismanagement, involved a banking corporation. It is commonly said that bank directors, due to their position of public trust, are held to higher standards of accountability than directors of other businesses. See, e.g., *Litwin v. Allen*, 25 N.Y.S.2d 667, 678 (N.Y. Sup. Ct. 1940)(director of bank, entrusted with funds of depositors and protection of stockholders, is held to stricter accountability than director of ordinary business corporation); 3A W. FLETCHER, *supra* note 53, §§ 1035, 1042 (undoubtedly director of bank held to stricter accountability than director of ordinary business corporation); Bishop, *supra* note 14, at 1098 (bank director's mismanagement viewed as something worse than ordinary negligence). *But see* *McDonnell v. American Leduc Petroleum*, 491 F.2d 380, 383 (2d Cir. 1974)(asserting that standard of care for directors of financial institutions is same as for directors of other corporations).

There is some disagreement as to whether the use of the words "in the conduct and management of their own business" or similar language has been of significance in any reported case involving director liability. In any event, the clear consensus is that the difference in this and the Model Act standard has no practical importance. See, e.g., Chittur, *The Corporate Director's Standard of Care: Past, Present, and Future*, 10 DEL. J. CORP. L. 505, 510 & nn.33-41 (1985)(citing *Selheimer v. Manganese Corp.*, 224 A.2d 634 (1966), as representing rare, if not only case in which inclusion of phrase "in their personal business affairs" has been determinative of outcome); Veasey & Manning, *Codified Standard - Safe Harbor or Unchartered Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 926-27 & n.36 (1979)(same).

level of performance required to discharge this duty is, however, unclear; authorities are divided as to whether ordinary negligence, or gross negligence, is the test of liability.<sup>106</sup>

In many instances, however, the question of the exact parameters of the duty of care is rendered moot because of the application of the business judgment rule: so long as a decision of the directors has a rational basis, and was made in good faith and for what they honestly believed to be in the best interest of the shareholders, it will not be reviewed by a court.<sup>107</sup> In its ordinary sense it serves as a defense for directors, who are thereby shielded from liability for honest mistakes of judgment.<sup>108</sup> The rule is traditionally justified on several bases: the recognition by courts of their inherent limitations in business matters and their concomitant reluctance to substitute their judgment for that of directors;<sup>109</sup> the realization that directors are fallible and that persons of ability would be reluctant to serve as directors if the law imposed an unreasonably demanding degree of foresight;<sup>110</sup>

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<sup>106</sup> See, e.g., Veasey & Manning, *supra* note 105, at 926-930 (asserting that there is no agreement on level of care required, and discussion of that conflict); Veasey & Seitz, *The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483, 1493 (1985) (commentators do not agree on level of care required—ordinary negligence or gross negligence) [hereinafter cited as Veasey & Seitz].

<sup>107</sup> 3A W. FLETCHER, *supra* note 53, § 1039; HENN & ALEXANDER, *supra* note 53, § 242, at 661. An excellent overview of this topic is found in Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979) [hereinafter cited as Arsht].

<sup>108</sup> Veasey & Seitz, *supra* note 106, at 1484-85.

A technical distinction is sometimes drawn by commentators between the business judgment rule and the business judgment doctrine. The business judgment rule is a defense invoked to shield directors from personal liability for damages. The same principle of deference to directors may also be applied in a case seeking to enjoin board action to uphold the decision itself. The latter is sometimes referred to as "transactional justification." Thus, the rule protects the decision maker, while the doctrine protects the decision. See, e.g., Hinsey, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609, 611-12, 618 (1984) [hereinafter cited as Hinsey]; Veasey & Seitz, *supra* note 106, at 1487-88. This terminology is not, however, commonly employed by courts, and this article will use the term "business judgment rule" as subsuming both aspects.

<sup>109</sup> See, e.g., *Auerbach v. Bennett*, 47 N.Y. 619, 629, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979) (doctrine bars judicial inquiry into actions of corporate directors in good faith and honest judgment in legitimate furtherance of corporate purposes); Hinsey, *supra* note 108, at 612 (same); Phillips, *Principles of Corporate Governance: A Critique of Part IV*, 52 GEO. WASH. L. REV. 653, 664 (1984).

<sup>110</sup> See Arsht, *supra* note 107, at 95-97. A related concern is that imposing liability

and the fact that many business decisions involve an inherent element of risk-taking.<sup>111</sup> The rule, however, is not unlimited. Directors may lose its benefit if they have a personal interest in the challenged transaction,<sup>112</sup> fail to exercise due care,<sup>113</sup> abuse their discretion,<sup>114</sup> or act in bad faith.<sup>115</sup> By the same token, in theory the business judgment rule need not be invoked at all unless a director cannot establish compliance with the standard of conduct prescribed by the duty of care.<sup>116</sup>

The Model Act first codified the duty of care of directors in 1974 by amending section 35; that amendment also incorporated

on directors may in many instances visit them with a crushing financial burden completely out of proportion to any possible degree of culpability. *See* R. HAMILTON, *CORPORATIONS* 705 (2d ed. 1981)(discussing financial burden of directors in proportion to culpability).

<sup>111</sup> *See* Arsht, *supra* note 107, at 100.

<sup>112</sup> *Id.* at 115-18.

<sup>113</sup> *Id.* at 118-21; *see* Hinsey, *supra* note 108, at 615 (business judgment rule not applicable where director has made no actual decision). Thus it is commonly said that the business judgment rule has no application where directors have failed to act or to make an informed decision. *See, e.g.,* Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984)(business judgment rule has no relevance to corporate decisionmaking until after decision has been made); Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (N.Y. Sup. Ct. 1944)(courts do not interfere with business judgment so long as reasonable diligence has been exercised); Arsht, *supra* note 107, at 119-20.

<sup>114</sup> Arsht, *supra* note 107, at 121-27.

<sup>115</sup> *Id.* at 127-30. *See generally* 3A W. FLETCHER, *supra* note 53, § 1040 (exemption of corporate officers from liability for mistakes and judgment errors only applies where there is exercise of skill, diligence, and care).

<sup>116</sup> *E.g.,* Section 8.30(d) of the RMA provides that "[a] director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section." The comments elaborate on this point:

Thus, both former section 35 and current section 8.30(d) are self-executing, and the individual director's exoneration from liability is automatic. If compliance with the standard of conduct set forth in former section 35 or section 8.30 is established, there is no need to consider possible application of the business judgment rule. The possible application of the business judgment rule need only be considered if compliance with the standard of conduct set forth in former section 35 or section 8.30 is not established.

REVISED MODEL BUSINESS CORP. ACT. § 8.30(d) official comment, at 224 (1984).

The point to emphasize, then, is that the duty of care and business judgment rule are not the same. Courts often lack precision, however, in their discussions of these concepts and those of self-dealing. *See, e.g.,* Home Tel. Co. v. Darley, 355 F. Supp. 992, 1000 (N.D. Miss. 1973) (although officer not liable for honest errors or mistakes of judgment when acting in good faith, this does not excuse mistakes where loss is result of failure to exercise ordinary care, skill, and diligence), *aff'd per curiam*, 489 F.2d 1403 (5th Cir. 1974), discussed *supra* note 101.

a general statutory right of reliance on information furnished by specified sources.<sup>117</sup> That provision was adopted in substance (but with some reorganization) by Section 8.30 of the RMA, the full text of which is as follows:

- (a) A director shall discharge his duties as a director, including his duties as a member of a committee:
  - (1) in good faith;
  - (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
  - (3) in a manner he reasonably believes to be in the best interests of the corporation.
  
- (b) In discharging his duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:
  - (1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable

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<sup>117</sup> See *Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act*, 30 BUS. LAW. 501 (1975). The text of the relevant portion of section 35 is as follows:

A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:

- (a) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented,
- (b) counsel, public accountants or other persons as to matters which the director reasonably believes to be within such person's professional or expert competence, or
- (c) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the articles of incorporation or the bylaws, as to matters within its designated authority, which committee the director reasonably believes to merit confidence,

but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted.

MODEL BUSINESS CORP. ACT § 35 (1974). For a useful, practical interpretation of the meaning of section 35, see *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1600 (1978).

- and competent in the matters presented;
- (2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or
  - (3) a committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.
- (c) A director is not acting in good faith if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.
- (d) A director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section.<sup>118</sup>

While at least thirty-two states have now codified the duty of care,<sup>119</sup> there is no direct analogue to Section 8.30 in the MBCA. Section 91 of the MBCA imposes a statutory liability on directors who vote for or assent to improper dividends, share repurchases, distributions in liquidation, loans to insiders, or the commencement of business before the receipt of the minimum

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<sup>118</sup> REVISED MODEL BUSINESS CORP. ACT § 8.30 (1984).

<sup>119</sup> ALA. CODE 10-2A-74 (1980); CAL. CORP. CODE § 309(a)(West 1977); COLO. REV. STAT. § 7-5-101(2)(Supp. 1985); CONN. GEN. STAT. ANN. § 33-313(d)(West Supp. 1986); FLA. STAT. ANN. § 607.111(4)(West 1977); GA. CODE ANN. §§ 14-2-152 (1982); HAWAII REV. STAT. § 416-91.5(c)(Supp. 1984); IDAHO CODE § 30-1-35 (1980); IND. CODE ANN. § 23-1-35-1 (Burns Supp. 1986); IOWA CODE ANN. § 496A.34 (West Supp. 1986); LA. REV. STAT. ANN. § 12.91 (West 1969); ME. REV. STAT. ANN. tit. 13-A, § 716 (1981); MD. CORP. & ASS'NS CODE ANN. § 2.405.1(a)(3)(1985); MASS. ANN. LAWS ch. 156B, § 65 (West Supp. 1986); MICH. COMP. LAWS ANN. § 450.1541(1)(1973); MINN. STAT. ANN. § 302A.251 (West 1985); MONT. CODE ANN. § 35-1-401(2)(1985); NEB. REV. STAT. § 21-2035 (1983); N.H. REV. STAT. ANN. § 293-A:35 (Supp. 1985); N.J. STAT./ ANN. § 14A:6-14 (West 1969); N.Y. BUS. CORP. LAW § 717 (McKinney 1986); N.C. GEN. STAT. § 55-35 (1982); OHIO REV. CODE ANN. § 1701.59 (Page 1985); OKLA. STAT. ANN. tit. 18, § 1.34 (West 1986); OR. REV. STAT. § 57.228 (1984); PA. STAT. ANN. tit. 15, § 1408 (Purdon 1967); R.I. GEN. LAWS § 7-1.1-33 (1985); S.C. CODE ANN. § 33-13-150 (Law. Co-op. 1977); TENN. CODE ANN. § 48-1-813 (1984); VA. CODE ANN. § 13.1-690 (Repl. Vol. 1985); WASH. REV. CODE ANN. § 23A.08.343 (Supp. 1986); WYO. STAT. § 17-1-133(b) (Supp. 1985). The new Tennessee Business Corporation Act, effective October 1, 1987, adopts section 8.30 of the RMA without change. 1986 Tenn. Pub. Acts ch. 887, §§ 8.30, 17.08.

capital.<sup>120</sup> Also, it includes a limited right of reliance for the purpose of determining liability under the section.<sup>121</sup> The MBCA does not otherwise speak to the issue of a standard of conduct for directors. The salient question, then, is whether it should.

Few, if any, issues in the field of corporate law have been subject to more extensive recent debate than the appropriate standard of conduct for directors. In addition to the development of the Model Act and RMA standards, the American Law Institute's Principles of Corporate Governance Project has dealt intensively with the issue,<sup>122</sup> as has an immense body of scholarly literature.<sup>123</sup> Any attempt at an in-depth analysis of the is-

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<sup>120</sup> MISS. CODE ANN. § 79-3-91 (1972).

<sup>121</sup> Specifically, a director may rely upon:

[F]inancial statements of the corporation represented to him to be correct by the president or the officer of such corporation having charge of its books of account, or stated in a written report by an independent public or certified public accountant or firm of such accountants fairly to reflect the financial condition of such corporation . . . .

*Id.* He is likewise shielded from liability if "in good faith in determining the amount available for any such dividend or distribution he considered the assets to be of their book value." *Id.*

<sup>122</sup> PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 4, 1985) [hereinafter cited as Tent. Draft No. 4].

<sup>123</sup> See, e.g., Andrews, *Corporate Governance Eludes the Legal Mind*, 37 U. MIAMI L. REV. 213 (1983); Arsht, *supra* note 107; Arsht & Hinsey, *Codified Standard-Same Harbor but Charted Channel: A Response*, 35 BUS. LAW. 947 (1980); Brudney, *The Role of the Board of Directors: The ALI and Its Critics*, 37 U. MIAMI L. REV. 223 (1983); Christy, *Corporate Mismanagement as Malpractice: A Critical Reanalysis of Corporate Managers' Duties of Care and Loyalty*, 21 HOUS. L. REV. 105 (1984); Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984) [hereinafter cited as Coffee]; Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Stands and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591 (1983); Dent, *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care*, 61 B.U.L. REV. 623 (1981); Eisenberg, *The Modernization of Corporate Law: An Essay for Bill Cary*, 37 U. MIAMI L. REV. 187 (1983); Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Frankel, *Corporate Directors' Duty of Care: The American Law Institute's Project on Corporate Governance*, 52 GEO. WASH. L. REV. 705 (1984) [hereinafter cited as Frankel]; Goldstein, *Future Articulation of Corporate Law*, 39 BUS. LAW. 1541 (1984); Hinsey, *supra* note 108; Kennedy, *The Standard of Responsibility for Directors*, 52 GEO. WASH. L. REV. 624 (1984) [hereinafter cited as Kennedy]; Knauss, *Corporate Governance - A Moving Target*, 79 MICH. L. REV. 478 (1981); Letts, *Corporate Governance: A Different Slant*, 35 BUS. LAW. 1505 (1980); Mace, *Directors: Myth and Reality - Ten Years Later*, 32 RUTGERS L. REV. 293 (1979); Mangrum, *In Search of a Paradigm of Corporate Social Responsibility*, 17 CREIGHTON L. REV. 21



sue is beyond the scope of this article. Some general observations, however, should be made.

Foremost among these is that there is obviously no consensus whatsoever as to the appropriate standard of care, whether existing formulations are too lax or too demanding, or indeed whether it is feasible to codify the duty of care at all. Even the drafters of the RMA have been inconsistent in their approach; the original version of section 8.30 attempted not only to state the duty of care but also to codify the business judgment rule.<sup>124</sup>

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(1983-84); Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984); Manning, *The Business Judgment Rule in Overview*, 145 OHIO ST. L.J. 615 (1984); Phillips, *Principles of Corporate Governance: A Critique of Part IV*, 52 GEO. WASH. L. REV. 653 (1984); Ruder, *Protections for Corporate Shareholders: Are Major Revisions Needed?*, 37 U. MIAMI L. REV. 243 (1983); Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983); Steinberg, *The American Law Institute's Draft Restatement on Corporate Governance: The Business Judgment Rule, Related Principles, and Some General Observations*, 37 U. MIAMI L. REV. 295 (1983); Veasey, *New Insights into Judicial Deference to Directors' Business Decisions: Should We Trust the Courts?*, 39 BUS. LAW. 1461 (1984); Veasey & Manning, *supra* note 105; Williamson, *Corporate Governance*, 93 YALE L.J. 105 (1984).

<sup>124</sup> 1983 REVISED MODEL BUSINESS CORP. ACT § 8.30 (Exposure Draft March, 1983).

The 1983 Draft provides:

- (a) A director shall discharge his duties as a director, including his duties as a member of a committee:
  - (1) in good faith;
  - (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
  - (3) When exercising his business judgment, with the belief, premised on a rational basis, that his decision is in the best interests of the corporation.
- (b) In discharging his duties a director is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, if prepared or presented by:
  - (1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;
  - (2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or
  - (3) a committee of the board of which he is not a member, as to matters within its jurisdiction, if the director reasonably believes the committee merits confidence.
- (c) A director is not acting in good faith if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

This latter effort was abandoned in the final version of section 8.30.<sup>125</sup>

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- (d) Subject to compliance with section 8.31 if a director has an interest in a transaction:
    - (1) the director is not liable for the performance of the duties of his office if he acted in compliance with this section; and
    - (2) a person alleging a violation of this section has the burden of proving the violation.
  - (e) Subject to compliance with other provisions of this Act and other applicable law, a proceeding to enjoin, modify, rescind, or reverse a business decision, based on an alleged violation of this section, may not prevail if the directors who made the decision discharged their duties in compliance with this section.

*Id.*

<sup>125</sup> The explanation for the change is that extensive adverse comments were received to the proposed section; in light of these, the drafters concluded that the issues involved were too complex to resolve at that time and returned to the more traditional formulation finally adopted. See 2 MODEL BUSINESS CORP. ACT ANN. 933 (3d ed. 1985); Goldstein, *supra* note 8, at 1475.

This criticism has not deterred the American Law Institute; Section 4.01 of the proposed Principles of Corporate Governance embraces both concepts:

- (a) A director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.
  - (1) This duty includes the obligation to make, or cause to be made, such inquiry as the director or officer reasonably believes to be appropriate under the circumstances.
  - (2) In performing any of his functions (including his oversight functions), a director or officer is entitled to rely on materials and persons in accordance with §§ 4.02-.03.
- (b) Except as otherwise provided by statute or by a standard of the corporation and subject to the board's ultimate responsibility for oversight, in performing its functions (including oversight functions), the board may delegate, formally or informally by course of conduct, any function (including the function of identifying matters requiring the attention of the board) to committees of the board or to directors, officers, employees, experts, or other persons; a director may rely on such committees and persons in fulfilling his duty under this Section with respect to any delegated function if his reliance is in accordance with §§ 4.02-.03.
- (c) A director or officer who makes a business judgment in good faith fulfills his duty under this Section if:
  - (1) he is not interested in the subject of his business judgment;
  - (2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and
  - (3) he rationally believes that his business judgment is in the best inter-

The Model Act (and RMA) standard has been criticized on various grounds. Some argue that the inclusion of the "reasonable belief" test may tend to undercut the good faith standard of the business judgment rule and expand the scope of judicial review of decisions which would otherwise not be subject to attack.<sup>126</sup> Others suggest that, due to its different variables, it is difficult to construct, apply, and understand.<sup>127</sup> Interestingly, in drafting the new Virginia Stock Corporation Act, the Virginia Code Commission concluded that RMA Section 8.30 could hold directors to an unrealistically high standard.<sup>128</sup> Virginia, however, apparently has adopted a standard that requires only good faith, thereby foreclosing any inquiry into a director's competence.<sup>129</sup> Certainly the high cost and, indeed, increasing unavailability of directors' and officers' insurance has created very legitimate concerns on the part of corporate management as to its potential liability. The Virginia Legislature was, no doubt, moti-

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ests of the corporation.

Tent. Draft No. 4, *supra* note 122, § 4.01. So long as a business decision is made on an informed basis, then, it is reviewed not against the "reasonable man" standard generally applicable but against the more lenient business judgment rule. Murphy, *The New Virginia Stock Corporation Act: A Primer*, 20 U. RICH. L. REV. 67, 106 n.111 (1985) [hereinafter cited as Murphy]. Extensive commentary on the ALI standard can be found in Frankel, *supra* note 123; Hinsey, *supra* note 108; Kennedy, *supra* note 123; Phillips, *supra* note 123.

<sup>126</sup> See, e.g., Veasey & Manning, *supra* note 105, at 930-42.

<sup>127</sup> Murphy, *supra* note 125, at 105-06. The author suggests the following methodology for applying the Model Act test:

Application of this standard requires the trier of fact first to construct a factual background including the time and information constraints, the makeup of the board, and its role in corporate decision making (the "in like position" and "in similar circumstances" elements). Next, what the ordinarily prudent person, as measured against that factual background, would do with respect to the issue in question must be determined. Finally, the trier of fact must decide if the conduct or action of the directors in question was consistent with the reasonable man standard.

*Id.* at 105.

<sup>128</sup> VA. CODE COMM'N, REPORT ON THE REVISION OF CHAPTERS 1 AND 2 OF TITLE 13.1 OF THE CODE OF VIRGINIA, H. DOC. NO. 13, app. 4, at 248 (1985).

<sup>129</sup> As enacted, the new Virginia statute requires a director to act "in accordance with his good faith business judgment of the best interests of the corporation." VA. CODE ANN § 13.1-690(A)(repl. vol. 1985). By eliminating any semblance of a reasonable man standard, the Virginia Act may reduce the duty of care to a purely subjective inquiry into the director's good faith. In so doing the statute may invite protection for "the utterly inept, but well-meaning, good faith director." Murphy, *supra* note 125, at 108.

vated in part by those concerns in its actions. On the other hand, it is disingenuous to ignore the revenue-enhancing potential of provisions which, understandably, are appealing to corporate managers and promoters.<sup>130</sup> While certainly any corporate legislation enacted in Mississippi should create as favorable a climate for business as reasonably practicable, one must balance against this the possible prejudice to shareholders from the adoption of an overly lax standard.

The burgeoning case law involving hostile takeover bids and the permissible range of conduct by management in responding to them has brought into focus issues involving the duty of care and the business judgment rule with an intensity never before experienced in American corporate law.<sup>131</sup> Moreover, suggestions

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<sup>130</sup> The Virginia Act contains other models on this point. In addition to possibly eliminating a meaningful duty of care, it includes a separate set of provisions dealing with "affiliated transactions" between a corporation and a potentially dominant shareholder. See VA. CODE ANN. §§ 13.1-725 to -728 (repl. vol. 1985). The clear thrust of these provisions is to discourage hostile takeover attempts, although the statute is admittedly more broadly drawn. See Murphy, *supra* note 125, at 124-27 (general discussion of provisions dealing with transactions between corporations and potentially dominant shareholders).

<sup>131</sup> See, e.g., *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986); *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255 (2d Cir. 1984); *Gearhart Indus. v. Smith Int'l, Inc.*, 741 F.2d 707 (5th Cir. 1984); *Buffalo Forge Co. v. Ogden Corp.*, 717 F.2d 757 (2d Cir. 1983); *Mobile Corp. v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981); *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981); *Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980); *Crouse-Hinds Co. v. Inter North Inc.*, 634 F.2d 690 (2d Cir. 1980); *Minstar Acquiring Corp. v. AMF, Inc.*, 621 F. Supp. 1252 (S.D.N.Y. 1985); *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623 (D. Md. 1982); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Moran v. Household Int'l Inc.*, 490 A.2d 1059 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985); *Veasey & Seitz, supra* note 106, at 1489-93. For background on the various defense mechanisms utilized to combat hostile takeovers see A. FLEISCHER, *TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING* (1981); M. LIPTON & E. STEINBERGER, *TAKEOVERS AND FREEZEOUTS* (1978); Black & Smith, *Antitakeover Charter Provisions: Defending Self-Help for Takeover Targets*, 36 WASH. & LEE L. REV. 699 (1979); *Friedenberg, Jaws III: The Impropriety of Shark-Repellant Amendments as a Takeover Defense*, 7 DEL. J. CORP. L. 32 (1982); *Gilson, A Structural Approach to Corporations: The Case Against Defense Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); *Weiss, Defensive Responses to Tender Offers and the Williams Act's Prohibition Against Manipulation*, 35 VAND. L. REV. 1087 (1982); *Comment, Delaware's Attempt to Swallow a New Takeover Defense: The Poison Pill Preferred Stock*, 10 DEL. J. CORP. L. 569 (1985); *Note, Target Defensive Tactics as Manipulative under Section 14(e)*, 84 COLUM. L. REV. 228 (1984); *Note, Protecting Shareholders Against Partial and*

that the protections of the business judgment rule have limited the duty of care to an aspirational function,<sup>132</sup> or that the duty of care is "dead,"<sup>133</sup> have been largely put to rest by *Smith v. Van Gorkom*<sup>134</sup> (the "Trans Union" case), in which the Delaware Supreme Court held that the board of directors of Trans Union Corporation was guilty of "gross negligence" in evaluating and recommending to the shareholders for approval a merger proposal.<sup>135</sup> The court imposed liability on them for the difference between the price paid by the purchaser and the "fair value" of the corporation's stock as of the date of the merger.<sup>136</sup>

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*Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964 (1984); Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U.L. REV. 621 (1983).

<sup>132</sup> See Hinsey, *supra* note 108, at 614-15.

<sup>133</sup> See Frankel, *supra* note 123, at 715-16.

<sup>134</sup> 488 A.2d 858 (Del. 1985).

<sup>135</sup> *Id.* at 881.

<sup>136</sup> *Id.* at 893. It is difficult to impart the full flavor of *Van Gorkom* without a detailed reading of the rather lengthy opinion. Essentially, Van Gorkom, Trans Union's chairman, formulated a plan to sell the corporation for \$55 a share in a leveraged buy-out and presented the plan to industrialist Jay Pritzker of Chicago. Although the corporation's chief financial officer had suggested that a feasible range for such a transaction was \$50 to \$60 per share, no extensive study on that question was undertaken; rather Van Gorkom seized upon the \$55 figure as a price for which he would be willing to sell his 75,000 shares. Immediately before the merger was announced, the stock was selling at a high of \$38.25 and a low of \$29.50. The negotiations between Van Gorkom and Pritzker were private and not specifically authorized by the board; no price negotiations took place. When Pritzker presented a merger offer with a three day deadline, Van Gorkom called a board meeting for the next day; the notice did not disclose the purpose of the meeting. At the meeting, Van Gorkom made a twenty minute presentation concerning the proposal; he did not disclose the methodology by which he had arrived at the \$55 price or that he proposed that price to Pritzker. The only other matters of substance presented to the board were (1) its attorney's advice that a fairness opinion was not required as a matter of law; (2) the chief financial officer's statement that \$55 was in the range of a fair price; and (3) a supporting statement by the corporation's president. The entire meeting lasted about two hours; the result was board approval of the merger agreement, which at that time (and indeed as of its execution) had not been read by any member of the board, including Van Gorkom. *Id.* at 866-69.

The court held that the directors (five inside and five outside) breached their "fiduciary duty" to shareholders by "their failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend the Pritzker merger," thus denying them the protection of the business judgment rule. *Id.* at 893. The case was thereafter settled for \$23,500,000. R. HAMILTON, CORPORATIONS 679 (3d ed. 1986).

Predictably, *Van Gorkom* has attracted a firestorm of controversy and commentary (both critical and supportive). See, e.g., Chittur, *supra* note 105; Fischel, *The Business*

Clearly, then, this is an area of the law currently in a state of substantial ferment.

The fact that corporate law nationally is in a period of rapid change on these issues, coupled with the paucity of authority in Mississippi, leads to the conclusion that codification of the duty of care may be premature in this state. This is based on two

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*Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1455 (1985) (describing *Van Gorkom* as "one of the worst decisions in the history of corporate law") [hereinafter cited as Fischel, *Trans Union*]; Manning, *Reflections and Practical Tips on Life in the Boardroom after Van Gorkom*, 41 BUS. LAW. 1 (1985); Moskin, *Trans Union: A Nailed Board*, 10 DEL. J. CORP. L. 405 (1985); Prickett, *An Explanation of Trans Union to "Henny Penny" and Her Friends*, 10 DEL. J. CORP. L. 451 (1985); Quillen, *Trans Union, Business Judgment and Neutral Principles*, 10 DEL. J. CORP. L. 465 (1985); Schwartz & Wiles, *Trans Union: Neither "New" nor "Bad" Law*, 10 DEL. J. CORP. L. 429 (1985); Veasey & Seitz, *supra* note 106, at 1497-1503; Comment, *Mining the Safe Harbor? The Business Judgment Rule After Trans Union*, 10 DEL. J. CORP. L. 545 (1985); Baldo, *Delaware Rocks the Boat*, FORBES, April 8, 1985, at 126; Bordon, *First Thoughts on Decision in Delaware on Trans Union*, N.Y.L.J. Feb. 25, 1985, at 1, col. 3. The ultimate impact of the decision is, of course, unclear. Some see it as part of a continuing attempt by the Delaware Supreme Court to respond to those who criticize Delaware's corporate statutes as inadequately protecting the rights of shareholders, particularly those in the minority. See, e.g., Fischel, *Trans Union, supra*, at 1454; Fischel, *Reflections, supra* note 14, at 923 (in recent decisions Delaware Supreme Court has limited discretion of managers and controlling shareholders while increasing power of minority shareholders); see also *supra* note 14 and accompanying text (discussing criticisms of "liberal" statutes). On the other hand, the Delaware court has certainly proven itself to be capable of mercurial conduct in this regard. E.g., compare *Singer v. Magnavox Co.*, 380 A.2d 969, 979 (Del. 1977) (holding that controlling shareholders in "freezeout" merger must show legitimate business interest for merger other than sole purpose of eliminating minority shareholders) with *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703-04 (Del. 1983) (overruled business purpose test, substituted "intrinsic fairness" test and expanded appraisal valuation; thus absent egregious misconduct on part of controlling shareholders, minority's only remedy is appraisal); see Berger & Allingham, *A New Light on Cash-Out Mergers: Weinberger Eclipses Singer*, 39 BUS. LAW. 1 (1983); Note, *Freezeouts Under the 1983 Illinois Business Corporation Act: The Need for Protection of Minority Shareholders from "Going Private" Mergers*, 1985 U. ILL. L. REV. 679, 688-693 (1985). In any event, *Trans Union* demonstrates that the duty of care is not rendered an empty threat by the shield of the business judgment rule.

For another well-known (although arguably less dramatic) recent case imposing substantial liability for director misconduct see *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814 (1981), holding the estate of the widow of a reinsurance corporation's principal owner liable for over \$10,000,000 in funds which her two sons, the other directors of the corporation, siphoned off in the form of bogus loans. *Id.* at 825-26. The court imposed liability on the basis of her negligence in failing entirely to undertake any effort whatsoever to acquaint herself with the affairs of the corporation. *Id.* Of course, because of her total lack of any action, the business judgment rule had no application to the claim. See *supra* note 113.

premises: first, that codification is not inherently superior to common law determinations of these issues; and second, that any statute adopted dealing with such currently controversial questions may not be determinative in the way courts decide cases.<sup>137</sup> The risk that a standard either unreasonably high or undesirably lax might be enacted may be too great until the present flux in decisional law is resolved.

Significantly, Illinois, which revised its business corporation act in 1983, incorporated much of the Exposure Draft of the RMA but deleted section 8.30 or any other codification of the duty of care.<sup>138</sup> It is recommended that Mississippi do likewise, with one exception. The express reliance provisions of Section 8.30 of the RMA<sup>139</sup> are reasonable and provide a desirable safe harbor for directors acting in good faith. It is suggested, however, that no other attempt to define the appropriate standard of conduct for directors should be made at this time. This approach would be consistent with that of Delaware, which provides for a right of reliance but which otherwise does not codify the duty of care.<sup>140</sup>

## 2. Duty of Loyalty.

Directors, as fiduciaries, owe a duty of undivided loyalty and utmost good faith to their corporations.<sup>141</sup> Broadly read, this

<sup>137</sup> See Veasey & Seitz, *supra* note 106, at 1505. For example, a court may in effect exonerate a director acting in good faith regardless of the language of a statute.

<sup>138</sup> See generally ILLINOIS BUSINESS CORP. ACT OF 1983, ILL. REV. STAT. ch. 32, §§ 1.01-17.05 (Supp. 1983). Interestingly, Illinois adopted without substantial amendment the Exposure Draft provision on conflicts of interest. Compare *id.* § 8.60 with REVISED MODEL BUSINESS CORP. ACT § 8.31 (Exposure Draft March, 1983)(comparison of "conflict of interest" sections of Illinois Business Corporation Act of 1983 and Revised Model Business Corporation Act).

<sup>139</sup> REVISED MODEL BUSINESS CORP. ACT § 8.30(b), (c)(1984); see *supra* text accompanying note 117.

<sup>140</sup> See DEL. C. DE ANN. tit. 8, § 141(e)(1983). Should a codified standard prove both desirable and feasible in light of subsequent developments, such action can, of course, be taken at that time.

<sup>141</sup> 3 W. FLETCHER, *supra* note 53, § 850; HENN & ALEXANDER, *supra* note 53, § 236, at 628. A classic statement of the principle is found in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928)(Opinion by Cardozo, J.):

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behav-

duty restricts directors from competing with their corporations;<sup>142</sup> a more particularized application is the avoidance of transactions that involve conflicts of interest.<sup>143</sup>

The common law rule of automatic voidability of such transactions has long since been abandoned by most courts.<sup>144</sup> The modern approach by courts has been to emphasize the elements of fairness and disclosure; in many instances, ratification by a disinterested board of directors has the effect of shifting the burden of proving lack of fairness to the party challenging the transaction.<sup>145</sup> Nonetheless, lack of uniformity on the part of courts considering the issue has been the rule.<sup>146</sup>

Due in part to the lack of certainty engendered by the jurisprudence on the subject, the recent trend has been to enact statutory provisions dealing with conflicts of interest. The first state to do so was California; the Model Act added a similar provision

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ior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions.

*Id.* at 463-64, 164 N.E. at 546.

<sup>142</sup> HENN & ALEXANDER, *supra* note 53, § 236, at 628. The Mississippi Constitution and MBCA reflect this prohibition by requiring stockholder consent for a person who is "engaged or interested in a competing business either individually or as employee or stockholder" to be elected to the board of directors. MISS. CONST. art. 7, § 194; MISS. CODE ANN. § 79-3-67 (1972). As a practical matter, of course, this mandates disclosure and express stockholder approval. This is contrary to the common law rule, at least in the absence of detriment to the corporation. 3 W. FLETCHER, *supra* note 53, § 856.

<sup>143</sup> 3 W. FLETCHER, *supra* note 53, § 913; HENN & ALEXANDER, *supra* note 53, § 238.

<sup>144</sup> See, e.g., 3 W. FLETCHER, *supra* note 53, § 917; Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 39 (1966) [hereinafter cited as Marsh].

<sup>145</sup> See HENN & ALEXANDER, *supra* note 53, § 238, at 638-40; Marsh, *supra* note 144; Hodge & Perry, *supra* note 2 at 388-89.

<sup>146</sup> E.g., courts have differed on the following issues; (1) whether the interested director can be counted in determining the presence of a quorum of the board; (2) whether the vote of an interested director could be counted; and (3) whether a conflict of interest transaction was voidable on the basis of the conflict alone, on the basis of the conflict plus an element of bad faith or fraud, or on the basis of the conflict plus a showing of unfairness to the corporation. HENN & ALEXANDER, *supra* note 53, § 238, at 639-40. Most courts appear to concede that ratification by *shareholders* will validate the transaction, in the absence of fraud or unfairness; again, however, there is conflicting authority as to whether the vote of the interested director as a shareholder can be counted, although the majority answer seems to be affirmative. Marsh, *supra* note 143, at 48-49 & nn.50-51.



in 1966.<sup>147</sup> Currently at least thirty-eight states have adopted such statutes.<sup>148</sup>

The RMA carries forward the approach taken by former Model Act Section 41. Section 8.31 of the RMA provides in pertinent part:

(a) A conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a direct or indirect interest. A conflict of interest transaction is not voidable by the corporation solely because of the director's interest in the transaction if any one of the following is true:

- (1) The material facts of the transaction and the director's interest were disclosed or known to the board of directors or a committee of the board of directors and the board of directors or committee authorized, approved, or ratified the transaction;
- (2) the material facts of the transaction and the director's interest were disclosed or known to the shareholders entitled to vote and they authorized, approved, or ratified the

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<sup>147</sup> HENN & ALEXANDER, *supra* note 53, § 238, at 640 n.10.

<sup>148</sup> See ALA. CODE § 10-2A-63 (1980); ARIZ. REV. STAT. ANN. § 10-041 (1977); CAL. CORP. CODE § 310 (WEST 1977); COLO. REV. STAT. § 7-5-114.5 (Supp. 1985); CONN. GEN. STAT. ANN. § 33-323 (West Supp. 1986); DEL. CODE ANN. tit. 8, § 144 (1983); FLA. STATE ANN. § 607.124 (West 1977); GA. CODE ANN. § 14-2-155 (1982); IDAHO CODE § 30-1-41 (1980); ILL. REV. STAT. ch. 32, ¶ 8.60 (1985); IND. STAT. ANN. § 23-1-35-2 (Supp. 1986); IOWA CODE ANN. § 496A.34 (West Supp. 1986); KAN. STAT. ANN. § 17-6304 (1981); KY. REV. STAT. ANN. § 271A.205 (Baldwin 1983); LA. REV. STAT. ANN. § 12.84 (West 1969); ME. REV. STAT. ANN. tit. 13-A, § 717 (1981); MD. CORPS & ASS'NS CODE ANN. § 2-419 (1985); MICH. COMP. LAWS ANN. § 450.1545 (West 1973); MINN. STAT. ANN. § 302A.255 (West 1985); MO. STAT. ANN. § 351.327 (Vernon Supp. 1986); MONT. CODE ANN. § 35-1-413 (1985); NEB. REV. STAT. § 21-2040.01 (1983); NEV. REV. STAT. § 78.140 (1985); N.H. REV. STAT. ANN. § 293-A:41 (Supp. 1985); N.J. STAT. ANN. § 14A:6-8 (West Supp. 1986); N.Y. BUS. CORP. LAW, § 713 (McKinney 1986); N.C. GEN. STAT., § 55-30 (1982); OHIO REV. CODE ANN. § 1701.60 (Page 1985); OKLA. STAT. ANN. tit. 18, § 1.175a (West 1986); OR. REV. STAT. § 57.265 (1984); PA. STAT. ANN. tit. 15, § 1409.1 (Purdon Supp. 1986); R.I. GEN. LAWS § 7-11-37.1 (1985); S.C. CODE ANN. § 33-13-160 (Supp. 1985); TENN. CODE ANN. § 48-1-816 (1979); VT. STAT. ANN. tit. 11, § 1888 (1984); VA. CODE ANN. § 13.1-691 (repl. vol. 1985); W. VA. CODE § 31-1-25 (1982); WIS. STAT. ANN. § 180.355 (West Supp. 1985); WYO. STAT. § 17-1-136.1 (Supp. 1985).

The Indiana and Virginia statutes cited above and the new Tennessee Business Corporation Act, effective 1987, have adopted section 8.31 without substantial change. See 1986 Tenn. Pub. Acts 887, § 8.31. For a discussion of the different approaches taken by various states see 2 REVISED MODEL BUSINESS CORP. ACT. ANN. 968-70 (3d ed. 1985); Note, *Director Conflict of Interest under the 1983 B.C.A.: A Standard of Fairness*, 1985 U. ILL. L. REV. 741, 743 n.12 (1985) [hereinafter cited as Note, *Fairness*].

transaction; or

(3) the transaction was fair to the corporation.<sup>149</sup>

Presumably few corporate practitioners in Mississippi would question the desirability of a statutory standard in this state. The confusion engendered by the leading Mississippi case, *Knox Glass Bottle Co. v. Underwood*,<sup>150</sup> has received extensive comment previously in this *Journal*,<sup>151</sup> and those discussions need not be repeated at length here. Suffice it to say that the opinion raises several troublesome questions: e.g., whether ratification by disinterested directors is essentially irrelevant to the issue of the voidability *vel non* of a conflict of interest transaction;<sup>152</sup> whether the mere fact that an interested director represents

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<sup>149</sup> REVISED MODEL BUSINESS CORP. ACT § 8.31(a)(1984). The text of former section 41 is as follows:

No contract or other transaction between a corporation and one or more of its directors or any other corporation, firm, association or entity in which one or more of its directors are directors or officers or are financially interested, shall be either void or voidable because of such relationship or interest or because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction or because his or their votes are counted for such purpose, if:

(a) the fact of such relationship or interest is disclosed or known to the board of directors or committee which authorizes, approves or ratifies the contract or transaction by a vote or consent sufficient for the purpose without counting the votes or consents of such interested directors; or

(b) the fact of such relationship or interest is disclosed or known to the shareholders entitled to vote and they authorize, approve or ratify such contract or transaction by vote or written consent; or

(c) the contract or transaction is fair and reasonable to the corporation.

Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction.

MODEL BUSINESS CORP. ACT § 41 (1969). It should be noted that section 41 speaks in terms of disclosure of the "relationship or interest" of the director, while section 8.31 requires disclosure of the material facts of the transaction as well as the director's interest. As to the possible significance of this distinction see *infra* note 156.

<sup>150</sup> 228 Miss. 699, 89 So. 2d 799 (1956), *suggestion of error overruled per curiam*, 228 Miss. 699, 91 So. 2d 843, *cert. denied*, 353 U.S. 977 (1957).

<sup>151</sup> See generally Hodge & Perry, *supra* note 2, at 386-90 (discussion of director conflict of interest); Comment, *Transactions*, *supra* note 11, at 889-95.

<sup>152</sup> See Hodge & Perry, *supra* note 2, at 388 (discussion of *Knox Glass*). *But cf.* Comment, *Transactions*, *supra* note 11, at 894 (noting language in opinion that indicates that disclosure to and approval by disinterested majority of directors would validate transaction).

both himself and the corporation in the transaction renders it automatically voidable without regard to fairness;<sup>153</sup> and whether ratification by shareholders validates a transaction even though it may be unfair.<sup>154</sup> Clearly more specific direction than this is needed. It is debatable, however, whether that direction is adequately provided by the RMA.

It has been noted that existing conflict of interest statutes are generally narrow in scope,<sup>155</sup> and RMA Section 8.31 follows this pattern. The fundamental question, however, is precisely what it seeks to accomplish: does it state a rule by which a transaction can be *validated* for all purposes, or does it merely *save* a conflict of interest transaction from automatic voidability if the prescribed procedures are followed? Section 41 of the Model Act, and most existing state statutes, were ambiguous on this issue, and the RMA unfortunately carries forward this ambiguity. Arguably, the disjunctive nature of the statute suggests that *either* ratification by disinterested directors *or* ratification by disinterested shareholders *or* a showing of fairness will validate a transaction. Thus, in theory, an unfair transaction might be saved if proper ratification were effected.

The leading cases interpreting statutes similar to the Model Act have, admittedly, rejected this construction and held that ratification does not preclude judicial inquiry into the question of fairness.<sup>156</sup> This view, in turn, poses the question of what is

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<sup>153</sup> See Hodge & Perry, *supra* note 2, at 388 (discussion of *Knox Glass*); Comment, *Transactions*, *supra* note 11, at 894 (comparison of Model Act with Mississippi rule in *Knox Glass*). Indeed, the very sense in which the court used the term "representation" is unclear.

<sup>154</sup> Comment, *Transactions*, *supra* note 11, at 894.

<sup>155</sup> They do not address the types of transactions to which they are directed; do not refer to differing aspects of the duty of loyalty, such as competition with the corporation, corporate opportunities, or the use of corporate property, information or resources for personal gain; and do not extend to officers or major shareholders, or to those having close association with directors, officers, and major shareholders. Sommer, *The Duty of Loyalty in the ALI's Corporate Governance Project*, 52 GEO. WASH. L. REV. 719, 722 (1984) [hereinafter cited as Sommer].

<sup>156</sup> See, e.g., *Remillard Brick Co. v. Remillard-Dandini Co.*, 109 Cal. App. 2d 405, 241 P.2d 66, 86 (1952) (held directors in violation of fiduciary duty by entering contract on behalf of corporation); *Fliegler v. Lawrence*, 361 A.2d 218, 224-25 (Del. 1976) (directors must show fairness of transaction). In addition, most commentators have supported this view, although there is some opinion to the contrary. See *Bulbulia & Pinto*, *supra* note 14, at 207 nn. 47-48 (discussion of *Remillard Brick*). Perhaps the leading advocate

the effect of ratification. While many courts have held that it has the effect of shifting the burden of proof to those attacking the transaction, others have held that it simply lowers the standard of proof of fairness or that the burden remains on the director in all events.<sup>157</sup> The drafters of the Model Act were somewhat vague on the effect of section 41, stating only that its purpose was "not to provide a basis for validating for all purposes a contract or transaction . . . but simply to establish that such contract or transaction is not automatically void or voidable solely by reason of the director's interest."<sup>158</sup> No mention was made of burden of proof. Similarly, the comments to RMA Section 8.31 provide only that "[t]he sole purpose of section 8.31 is to sharply limit the common law principle of automatic voidability."<sup>159</sup> There is likewise no reference to burden of proof.

Given the significance of the question and the confusion that continues to cloud this area under current statutes, it seems

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of the latter position was Professor Ernest Folk, who argued that since the Delaware statute requires disclosure not only of the director's interest but of the material facts of the transaction, the purpose of the statute was to validate the transaction if any of the statutory tests were met. Thus, full disclosure would remove the question of fairness from court scrutiny so long as the requirement of approval by directors or stockholders was met. DEL. CODE ANN. tit. 8, § 144 (1974); E. FOLK, *THE DELAWARE CORPORATION LAW* 75-88 (1972). The effect would be to substitute full disclosure for fairness. Bulbulia & Pinto, *supra* note 14, at 213. However, the Delaware Supreme Court rejected Folk's position. *Fliegler v. Lawrence*, 361 A.2d 218, 224-25 (Del. 1976). Section 8.31 of the RMA, like Delaware but unlike Section 41 of the Model Act, requires disclosure of both the interest and material facts of the transaction. *See supra* note 149 and accompanying text.

<sup>157</sup> *See Comment, Transactions, supra* note 11, at 888 nn. 65-69 (discussion of burden of proof of interested directors).

<sup>158</sup> 1 MODEL BUSINESS CORP. ACT ANN. § 41, at 844 (2d ed. 1971). This avowal was somewhat undercut, however, by another statement that the section "validates, if the prescribed tests are satisfied, transactions with interested directors which common law rules often make voidable, if not void." *Id.* at 842 (emphasis added).

<sup>159</sup> REVISED MODEL BUSINESS CORP. ACT § 8.31 official comment (1984). The comments are somewhat more detailed on the question of validation, stating that:

[T]he elimination of the automatic rule of voidability does not mean that all transactions that meet one or more of the tests set forth in section 8.31(a) are automatically valid. These transactions may be subject to attack on a variety of grounds independent of section 8.31—for example, that the transaction constituted waste, that it was not authorized by the appropriate corporate body, that it violated other sections of the [RMA], or that it was unenforceable under other common law principles.

*Id.*

clear that any conflict of interest statute that Mississippi adopts should state explicitly its purpose; or, whether it provides a procedure for absolute validation or whether it is merely a savings provision with procedural implications that retains fairness as the ultimate test of validity. Some recent statutes appear to take the former approach,<sup>160</sup> and arguments have been advanced that Mississippi should do so.<sup>161</sup> With deference, I disagree and believe that Mississippi should take the latter course.

The Exposure Draft of the RMA made it plain that the Draft was a savings provision and that ratification operated only to shift the burden of proof from the director to the person attacking the transaction.<sup>162</sup> This approach was ultimately aban-

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<sup>160</sup> The present California statute appears to validate for all purposes transactions ratified by disinterested *shareholders* without regard to fairness. See CAL. CORP. CODE § 310 & legislative committee comment (West 1977); Bulbulia & Pinto, *supra* note 14, at 218-23.

<sup>161</sup> See Comment, *Transactions*, *supra* note 11, at 899-900 (proposed absolute validation for Mississippi).

<sup>162</sup> REVISED MODEL BUSINESS CORP. ACT § 8.31 (Exposure Draft March, 1983):

(a) If a transaction is fair to a corporation at the time it is authorized, approved, or ratified, the fact that a director or officer of the corporation has a direct or indirect interest in the transaction is not a ground for invalidating the transaction or for imposing liability on that director or officer.

(b) In a proceeding contesting the validity of a transaction in which a director or officer has an interest, the person asserting validity has the burden of proving fairness unless:

(1) the material facts of the transaction and the director's or officer's interest were disclosed or known to the board of directors or a committee of the board and the board or committee authorized, approved, or ratified the transaction by the vote of a requisite quorum of directors who had no interest in the transaction; or

(2) the material facts of the transaction and the director's or officer's interest were disclosed to the shareholders entitled to vote and they authorized, approved, or ratified the transaction by the vote of a requisite quorum of shareholders who had no interest in the transaction.

(c) The presence of, or votes entitled to be cast by, the director or officer who has a direct or indirect interest in the transaction may be counted in determining whether a quorum is present but may not be counted when the board of directors, a committee of the board, or the shareholders vote on the transaction.

(d) For purposes of this section, a director or officer has an indirect interest in a transaction if an entity in which he has a material financial interest or in which he is an officer, director, or general partner is a party to the transaction. A vote or consent of that entity is deemed to be a vote or consent of the director or officer for purposes of subsection (c).

done, however, and the drafters of the RMA returned to a more traditional approach.<sup>163</sup> Significantly, Professor Robert Hamilton, Reporter for the RMA, has expressed his strong disagreement with the decision of the Committee,<sup>164</sup> and one major state, Illinois, has adopted the substance of the Exposure Draft in its new business corporation act.<sup>165</sup>

I believe that the Illinois approach is sound and should be followed in Mississippi. To be sure, the attractions of a validat-

*Id.* Moreover, the proposed comments to the Draft stated that "Section 8.31 validates only fair transactions and allocates the burden of proof on the issue of fairness." This was said to "follow the judicial construction placed on earlier versions of the Model Act dealing with the subject of self-dealing transactions." *Id.* official comment.

<sup>163</sup> The only official explanation for the change was that "adverse comments" were received on the proposed section. 2 REVISED MODEL BUSINESS CORP. ACT ANN. § 966 (3d ed. 1985); see Goldstein, *supra* note 8, at 1475-76 (explaining changes in two versions).

<sup>164</sup> Hamilton, *supra* note 8, at 1455, 1463, 1468 n.35

<sup>165</sup> ILL. ANN. STAT. ch. 32, ¶ 8.60 (1985):

¶ 8.60 Director conflict of interest.

(a) If a transaction is fair to a corporation at the time it is authorized, approved, or ratified, the fact that a director of the corporation is directly or indirectly a party to the transaction is not grounds for invalidating the transaction.

(b) In a proceeding contesting the validity of a transaction described in subsection (a), the person asserting validity has the burden of proving fairness unless:

(1) The material facts of the transaction and the director's interest or relationship were disclosed or known to the board of directors or a committee of the board and the board or committee authorized, approved or ratified the transaction by the affirmative votes of a majority of disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts of the transaction and the director's interest or relationship were disclosed or known to the shareholders entitled to vote and they authorized, approved or ratified the transaction without counting the vote of any shareholder who is an interested director.

The presence of the director, who is directly or indirectly a party to the transaction described in subsection (1), or a director who is otherwise not disinterested, may be counted in determining whether a quorum is present but may not be counted when the board of directors or a committee of the board takes action on the transaction.

For purposes of this Section, a director is "indirectly" a party to a transaction if the other party to the transaction is an entity in which the director has a material financial interest or of which the director is an officer, director or general partner.

*Id.* Unlike the Exposure Draft, Illinois (like most states) continues to limit its conflict of interest rules to directors, not nondirector officers. See *supra* note 162. For an analysis of the Illinois statute see Note, *Fairness*, *supra* note 148.

ing statute (particularly to corporate counsel) are obvious: it provides a substantial measure of predictability, and would seem to provide a far surer basis for an opinion on the enforceability of an interested party transaction. This, however, may be somewhat illusory; even validating statutes customarily require that ratification be made "in good faith,"<sup>166</sup> a notoriously elusive concept. Fundamentally, however, the potential for abuse militates against the adoption of a validating statute, or even one (like the present RMA) that could conceivably be so construed.<sup>167</sup> Ratification by directors, even if technically disinterested, may be tainted by their association with the interested director. Particularly if the interested director is a dominant member of the board, it may be disingenuous to believe that his colleagues could exercise independent judgment.

While shareholder ratification might, on the surface, provide a more substantial basis for validation, this likewise may be more apparent than real. The ease with which shareholder votes can be manipulated in public corporations is well known to anyone with experience in that type of representation. Moreover, the argument that any infirmity in the vote can be adequately avoided by preventing the interested director's shares from being counted towards a quorum or in the vote is too simplistic.<sup>168</sup> Section 8.31 of the RMA does not deal adequately with this problem. While the provision disqualifies the interested director from voting, it provides that a majority of the *remaining* shares constitutes a quorum for purposes of ratification, and a majority

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<sup>166</sup> See, e.g., CAL. CORP. CODE § 310(a)(1977).

<sup>167</sup> Notwithstanding the substantial authority to the contrary and the avowals in the commentary to the RMA, the possibility of such a construction of § 8.31 should not be discounted. For example, the new Virginia Act adopts § 8.31 without substantial change. VA. CODE ANN. § 13.1-691 (repl. vol. 1985). The Joint Bar Committee appointed to study the draft statute stated in its commentary that while "[s]ome courts have read the fairness element into the disclosure and voting sections . . . [t]his section does not adopt this approach." VA. CODE COMM'N REPORT ON THE REVISION OF CHAPTERS 1 AND 2 OF TITLE 13.1 OF THE CODE OF VIRGINIA, H. DOC. NO. 13, App. 4, at 251 (1985) [hereinafter cited as VA. CODE COMM'N REPORT]. For an argument that the new Virginia Act does not depart from prevailing interpretations of prior law despite the uncertainty caused by the traditional formulation, see Murphy, *supra* note 125, at 111-12.

<sup>168</sup> See Comment, *Transactions*, *supra* note 11, at 899-900 (proposed preventing shares of interested directors from being counted).

vote of *those* shares will be sufficient to constitute ratification.<sup>169</sup> The result may be ratification by the majority of a minority of shares.<sup>170</sup> This hardly insulates the ratification from the influence of the interested director, since a quorum could be obtained without his shares but composed of a majority of shares sympathetic to his interests.

In sum, I submit that the approach of Illinois and the RMA, while surely not perfect,<sup>171</sup> best accommodates management's interest in stability and predictability with the need to provide protection to all shareholders, particularly those in the minority, against overreaching by members of management. Shifting the burden of proof upon ratification accomplished according to the prescribed procedure should provide adequate assurance to management that transactions for which there is no cause for concern will be upheld.<sup>172</sup> On balance, then, the enactment of a saving statute with an explicit allocation of the burden of proof best serves the interests of all of a corporation's constituent groups.<sup>173</sup>

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<sup>169</sup> REVISED MODEL BUSINESS CORP. ACT § 8.31(d)(1984).

<sup>170</sup> *Id.* official comment 2(b).

<sup>171</sup> One may legitimately question what "fairness" means. Clearly it has both procedural and substantive connotations; various definitions have been applied. For an extensive discussion of this question, see Bulbulia & Pinto, *supra* note 14, at 223-27. The Exposure Draft stated that a transaction would in most cases be deemed fair "if it is a transaction that might reasonably have been entered into at arms-length by disinterested persons." REVISED MODEL BUSINESS CORP. ACT § 8.31 official comment (Exposure Draft March, 1983); see also Note, *Fairness*, *supra* note 148, at 750-56 (recommending analytical approach to be taken to new Illinois statute).

<sup>172</sup> Of course, it would be naive to think that "grey area" questions will not arise, and it is surely possible that a transaction approved in good faith will later be ruled voidable upon the suit of shareholders on the basis of lack of fairness. The party primarily at risk in this instance is, however, the interested director. The business judgment rule should protect the other directors who either ratified the transaction or recommended its ratification to the shareholders. In the final analysis, then, such decisions may be for the most part a question of business risk for the interested director.

<sup>173</sup> The ALI Corporate Governance Project has taken an approach to this question that provides an interesting contrast to existing statutes and the RMA. For example, it extends the duty of loyalty to senior executives and dominating shareholders as well as directors; describes in detail the types of conduct which may involve breaches of the duty of loyalty; provides explicit allocation of the burden of proof; and is in general substantially more detailed than current statutes. See generally AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, §§ 5.01-5.14 (Tent. Draft No. 5, April 15, 1986). For a discussion of an earlier draft of the ALI



### 3. Loans to Management.

The MBCA takes a simple approach to the question of loans to officers and directors: they are absolutely prohibited.<sup>174</sup> Historically, this was a common response to what was seen as an inherent possibility for abuse. As has been previously discussed in depth in this *Journal*, legitimate reasons exist for imposing restraints on the ability of a corporation to make loans to management.<sup>175</sup> In recent years, however, the trend has been to recognize that some such loans may have a legitimate purpose, and that an element of flexibility is desirable.<sup>176</sup> Thus, Mississippi is now one of but four states with an explicit statutory prohibition of all management loans.<sup>177</sup> Most states now provide limited circumstances under which such loans are valid,<sup>178</sup> a position first taken by the Model Act in 1969.<sup>179</sup> So long as the interests of shareholders, particularly those in the minority, are adequately protected, it would seem some modification of the rule of *per se* invalidity under the MBCA is in order.<sup>180</sup> Again, the question is

duty of loyalty provisions, see Sommer, *supra* note 155, at 726-42.

<sup>174</sup> MISS. CODE ANN. § 79-3-89 (1972).

<sup>175</sup> See Hodge & Perry, *supra* note 2, at 390-92 (discussion of loans to officers and directors). For other background on the subject see Mann, *Moral and Ethical Problems: Loans to Management and Compensation Problems*, 31 BUS. LAW 1305 (1976); Rich, *Corporate Loans to Officers, Directors and Shareholders*, 14 BUS. LAW. 658 (1959).

<sup>176</sup> For example, strictly read, the MBCA could prohibit a salary advance to an employee.

<sup>177</sup> The others are Alaska, Nebraska, and Oklahoma. See ALASKA STAT. § 10.05-213 (1985); NEB. REV. STAT. § 21-2045 (1983); OKLA. STAT. ANN. tit. 18, § 1.175 (1986).

<sup>178</sup> 2 REVISED MODEL BUSINESS CORP. ACT ANN. 1018 (3d ed. 1985). Not all recent statutes, however, have followed the trend towards codification. For example, the new Virginia Act makes no provision, thereby treating director loans the same as any self-dealing transaction. See VA. CODE COMM'N REPORT, *supra* note 167, at 52.

<sup>179</sup> MODEL BUSINESS CORP. ACT § 47 (1969). The 1969 Model Act prohibited loans to directors unless authorized by the shareholders, but permitted loans to employees (including employees who were directors) if the board of directors determined that the loan might benefit the corporation. The comments to section 47 stated that "business purpose or benefit to the corporation" was the criterion for determining the validity of employee loans. 1 MODEL BUSINESS CORP. ACT ANN. § 47, ¶ 2, at 950-51 (2d ed. 1971).

<sup>180</sup> Arguably, of course, creditors are a second group whose interests should be considered in this regard. See, e.g., Hodge & Perry, *supra* note 2, at 392 (suggesting that management loans should be subject to same limitations as corporate distributions in order to protect creditors). For a variety of reasons, I do not believe that the potential for prejudice to creditors is substantial enough to justify such a rule. At least insofar as the rights of contract creditors are concerned, other adequate safeguards exist. A major creditor could, for example, impose contractual limitations on management loans as a

whether the RMA provision accomplishes this purpose.

Section 8.32 of the RMA permits loans to directors under either of two circumstances. The first is that the loan is approved by a majority of the outstanding shares of all classes voting as a single voting group<sup>181</sup> with the interested director's shares being disqualified.<sup>182</sup> The second is that the board of directors determines that the loan benefits the corporation and approves either the particular loan or a general plan authorizing loans.<sup>183</sup>

I submit that each of these provisions should be modified before enactment in Mississippi. As to the first, one of the most compelling reasons for restricting loans to directors is to guard against majority oppression of minority shareholders,<sup>184</sup> particularly in closely-held corporations. Merely disqualifying the votes of the interested director himself does not, in my view, adequately guard against this possibility. On the other hand, in a public corporation (where such loans are less likely to occur on an individualized basis) no greater statutory protection is probably needed. Thus, section 8.32 should be amended to permit a corporation to impose a higher (even unanimous) vote requirement in its articles or bylaws. This would permit minority shareholders in a closely-held corporation to guard against such problems as a matter of negotiation at the time the corporation is formed.<sup>185</sup>

For similar reasons, the RMA goes too far in permitting the

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condition to the extension of credit. Even in the absence of such leverage, a contract creditor is always free to decline to extend credit if it believes that a corporation has an excessive amount of management debt. Involuntary or tort creditors, of course, have somewhat different standing; but neither the presence of legally available surplus (to use the MBCA standard) nor the mere solvency of a corporation (the RMA standard for distributions) assures an adequate fund for the satisfaction of claims.

Corporate distributions and applicable limitations thereon will be discussed in Part 2 of this article.

<sup>181</sup> The concept of voting groups under the RMA is discussed *infra* at notes 289-92 and accompanying text.

<sup>182</sup> REVISED MODEL BUSINESS CORP. ACT § 8.32(a)(1)(1984).

<sup>183</sup> *Id.* § 8.32(a)(2). In each instance, the RMA treats a corporate guarantee of a director's indebtedness the same as a loan.

<sup>184</sup> See Hodge & Perry, *supra* note 2, at 391 (suggested majority shareholders-directors could redirect corporate assets to themselves without stockholder vote).

<sup>185</sup> *Cf. id.* at 392 (discussion of prejudice to minority shareholders).

board to authorize particular loans without shareholder participation. Indeed, the interested director is not even disqualified by the statute from voting on his own loan. Thus, I would restrict the discretion of the board acting alone to approve general plans authorizing loans to directors (as well as officers and employees), an authority which presumably would encompass such matters as loans of petty cash, advances for expenses incurred in furtherance of the corporation's business, and employee benefit plans.<sup>186</sup> Major loans made on an ad hoc basis should be approved, if at all, only by the shareholders as discussed above.

### C. Officers

Subchapter D of Chapter 8 of the RMA, dealing with corporate officers, is substantively different from the MBCA in only two respects. The first appears somewhat mundane, but represents a departure from prevailing practice in most states: the RMA does not prescribe the designation of any particular officers, and likewise has no prohibition against an individual holding any two or more offices at the same time.<sup>187</sup> The RMA approach in this regard is distinctly a minority one. At present, only four states have similar provisions.<sup>188</sup> Like most states,<sup>189</sup> the MBCA mandates a president, secretary, and treasurer.<sup>190</sup> The same person cannot be both president and secretary.<sup>191</sup>

The official explanation for deleting this statutory mandate in the RMA is that "little purpose is served by a statutory requirement that there be certain officers, and statutory requirements may sometimes create problems of implied or apparent authority or confusion with non-statutory offices the corporation

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<sup>186</sup> See REVISED MODEL BUSINESS CORP. ACT § 8.32 official comment (1984).

<sup>187</sup> REVISED MODEL BUSINESS CORP. ACT § 8.40(a), (d)(1984).

<sup>188</sup> The four are Delaware, Illinois, North Carolina, and New York. See DEL. CODE ANN. tit. 8, § 142 (1983); ILL. REV. STAT. ch. 32, § 8.50 (Smith-Hurd 1985); N.C. GEN. STAT. § 55-34 (1982); N.Y. BUS. CORP. LAW § 715 (McKinney 1986).

<sup>189</sup> See 2 MODEL BUSINESS CORP. ACT ANN. 1040-41 (3d ed. 1985)(listing of states requiring president, secretary, and treasurer).

<sup>190</sup> Miss. CODE ANN. § 79-3-95 (1972). The MBCA further requires "one or more vice presidents as may be provided in the bylaws;" of course, the bylaws may provide for no such officers. *Id.*

<sup>191</sup> *Id.*

desires to create."<sup>192</sup> Agency law questions aside, however, it is probable that the notion of mandated officers is so deeply engrained with most corporate practitioners that its elimination may engender more confusion than it saves. It is noteworthy that at least two states that have recently revised their corporate statutes with substantial reference to the RMA have rejected this provision, each continuing to require at least a president and secretary.<sup>193</sup>

Thus, it is recommended that Mississippi continue to require that a corporation have at least a president and secretary. On the other hand, logically the prohibition against one person holding those offices simultaneously should be eliminated<sup>194</sup> unless the bylaws provide otherwise. It would seem anomalous to permit a corporation to be governed by a board of directors composed of one person and, at the same time, require the fiction of a separate president and secretary. Admittedly, certain business transactions sometimes involve the performance of formal functions that would ordinarily require separate officers, such as cross-certification of the other's signature. It is unlikely, however, that this would pose a problem in the extremely closely-held corporation, and realistically it is only such a corporation that would avail itself of this option. Should the interests of the participants be better served by mandating that these offices be separated, an appropriate provision could be inserted in the bylaws.

The second distinction between the RMA and MBCA in this area is a matter of perhaps greater substance: as is true for directors, RMA Section 8.32 prescribes a standard of conduct for officers vested with "discretionary authority."<sup>195</sup> In most re-

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<sup>192</sup> REVISED MODEL BUSINESS CORP. ACT § 8.40 official comment (1984).

<sup>193</sup> See 1986 Tenn. Pub. Acts 887, § 8.40(a) (effective Oct. 1, 1987); VA. CODE ANN. § 13.1-872(A)(repl. vol. 1985). To be fair, however, the new Illinois Business Corporation Act follows the RMA in this regard, although it requires bylaw authority for an individual to hold more than one office simultaneously. ILL. REV. STAT. ch. 32, § 8.50 (Smith-Hurd 1985). Indiana likewise adopts the RMA but requires at least one officer. IND. STAT. ANN. § 23-1-36-1 (Burns Supp. 1986).

<sup>194</sup> This is the approach taken in Virginia. VA. CODE ANN. § 13.1-872(A), (D)(repl. vol. 1985).

<sup>195</sup> REVISED MODEL BUSINESS CORP. ACT § 8.42 (1984). Interestingly, there was an additional element of parallelism in the Exposure Draft that was not carried over to the

spects, this section is substantively identical to the provision for directors,<sup>196</sup> the sole difference being a more limited "safe harbor" right of reliance.<sup>197</sup>

Primarily for the reasons previously discussed relating to the duty of care of directors,<sup>198</sup> this provision of the RMA should not be adopted. Although it is clear that officers, as fiduciaries, owe duties of care and diligence to their corporations,<sup>199</sup> few states, even those codifying a standard for director conduct, have attempted to define statutorily the scope of officers' duties.<sup>200</sup> Moreover, at least three states adopting much of the RMA deleted section 8.42.<sup>201</sup> Fundamentally, though, I believe that such efforts are premature for Mississippi, and would recommend that no similar statute be enacted here.<sup>202</sup>

#### D. Indemnification

Subchapter E of Chapter 8 of the RMA composes in its entirety a set of complex, and potentially controversial, provisions involving the indemnification of corporate directors, officers, agents, and employees. The current "crisis" (perceived or real)

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RMA. In the Exposure Draft, the rules on conflicts of interest embraced officers as well as directors. As previously noted, the final draft of RMA Section 8.31 speaks only of directors, a decision with which I personally agree. It is curious, however, that neither the official comment to the RMA nor the commentary in the new Revised Model Business Corporation Act Annotated addresses the rationale for this change.

<sup>196</sup> See *supra* text at note 117.

<sup>197</sup> The statute does not grant an officer the right to rely upon data supplied by a committee of the board. Compare REVISED MODEL BUSINESS CORP. ACT § 8.30(b)(3)(1984)(director is entitled to rely on reports by committee of board of which he is not a member and which he reasonably believes merit confidence) with *id.* § 8.42(b) (officer is entitled to rely on reports prepared by employees whom he reasonably believes to be competent or legal counsel as to matters within the person's expert competence). Presumably this reflects the greater degree of familiarity with corporate affairs that can reasonably be demanded of officers. See *id.* § 8.42 official comment.

<sup>198</sup> See *supra* notes 99-140 and accompanying text.

<sup>199</sup> See HENN & ALEXANDER, *supra* note 53, §§ 231-234 (discussion of duties of management).

<sup>200</sup> See 2 REVISED MODEL BUSINESS CORP. ACT ANN. 1068 (3d ed. 1985).

<sup>201</sup> These states are Illinois, Indiana, and Virginia. Tennessee, however, adopted it without change. 1986 Tenn. Pub. Acts 887, § 8.42.

<sup>202</sup> I would include in this recommendation the right of reliance for officers, although certainly this aspect of the statute is less objectionable than the overall effort to define a standard of conduct.

surrounding the imposition of liability on corporate fiduciaries for breach of their managerial responsibilities, coupled with increasing restrictions on the availability and coverage of directors and officers ("D & O") insurance, has focused heretofore unparalleled attention on this area.<sup>203</sup> Clearly an entire article could be devoted to this one topic, but such an exegesis is beyond the scope of this work. In order to maintain this discussion within manageable bounds, some comments concerning the approach to be taken are in order.

First, the Mississippi law on indemnification<sup>204</sup> and its relationship to the 1969 Model Act have been extensively developed previously in this *Journal*.<sup>205</sup> That discussion is important as background to much that is to follow, since I will undertake no such detailed comparison here. Rather, other than a brief summary of existing Mississippi law, this article will focus on the RMA and its approach to the issue.

Second, this article will accept the premise that the obvious trend nationwide is towards broad indemnification provisions, as evidenced by the fact that at least thirty-five states have adopted at least substantial equivalents to either the 1969 Model Act or the RMA, although the exact detail of such statutes varies fairly widely from state to state.<sup>206</sup> As will be seen, the MBCA approach is considerably out of step with current statutes; thus some modification of existing Mississippi law is in order. On the other hand, I believe that in some respects modern statutes may go too far,<sup>207</sup> although my views on this are not as

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<sup>203</sup> An excellent comprehensive text is J. BISHOP, *THE LAW OF CORPORATE DIRECTORS AND OFFICERS: INDEMNIFICATION AND INSURANCE* (1982) [hereinafter cited as BISHOP, *INDEMNIFICATION*]. For general background on recent issues in this area, see Hinsey, *The New Lloyd's Policy Form for Directors and Officers Insurance—An Analysis*, 33 BUS. LAW. 1961 (1978); Johnson, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993 (1978) [hereinafter cited as Johnson].

<sup>204</sup> MISS. CODE ANN. § 79-3-7(o)(1972).

<sup>205</sup> See Hodge & Perry, *supra* note 2, at 393-98 (discussing Mississippi law on indemnification and its relationship to 1969 Model Act).

<sup>206</sup> See 2 REVISED MODEL BUSINESS CORP. ACT ANN. 1093-99 (3d ed. 1985) (containing detailed analysis of existing statutes). Since that annotation was prepared, Indiana, Tennessee, and Virginia have substantially adopted the RMA provisions.

<sup>207</sup> For example, under a 1986 amendment to its corporation laws, the board of directors of a Delaware corporation can adopt a general authorization of advancement of expenses to a director or officer, rather than requiring a case-by-case determination of

extreme as some.<sup>208</sup> Thus, the primary purpose of this discussion will be to suggest those respects in which the RMA, the approach of which is generally recommended, should be modified to conform with sound policy. The goal, as it has been stated, should in all instances be to strike the balance between encouraging managers not to violate their duties, and discouraging them from serving at all.<sup>209</sup>

In order fully to evaluate the desirability of the RMA approach to indemnification and related issues, however, a brief summary of current Mississippi law is necessary. The operative provision is section 79-3-7(o) of the MBCA. Following the pattern of earlier versions of the Model Act, it only establishes the corporate *power* to indemnify; indemnification is thus elective, never mandatory.<sup>210</sup> Indemnification extends only to directors and officers and persons who served at the corporation's request as a director or officer of a subsidiary corporation or a corporation of which it is a creditor. It speaks only of "expenses actually and reasonably incurred" in the defense of a civil or criminal action, suit, or proceeding. Thus, the power to indemnify for

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the entitlement to such, with the corresponding commitment by the recipient being limited to an agreement to reimburse the corporation only if he is affirmatively determined not to be entitled to indemnification. DEL. CODE ANN. tit. 8, § 145(3)(1986). Moreover, the state now provides that the provisions of the Act on advancement of expenses, as well as indemnification, are expressly non-exclusive. *Id.* § 145(f).

Indeed, in an unprecedented move, the Delaware Legislature has empowered corporations to adopt charter provisions or amendments that eliminate or limit the personal liability of directors for breaches of the duty of care, although liability cannot be limited for a director who breaches his duty of loyalty, does not act in good faith, engages in intentional misconduct or a knowing violation of the law, receives an improper personal benefit, or pays an illegal dividend or approves an illegal stock repurchase. *Id.* § 102(b)(7). According to a synopsis of the new legislation, the legislature is responding to "recent changes in the market for directors' liability insurance" resulting in an unavailability of traditional policies, or any type of policy from traditional insurance carriers. *Cf.* Johnson, *supra* note 203, at 2035-36 (suggesting that statutes fixing maximum liability for certain claims may be desirable in order to allow management and insurers to evaluate legal risks they are assuming).

<sup>208</sup> See, e.g., Bishop, *Sitting Ducks*, *supra* note 14 (discussing criticism of trend toward permissive or management-oriented statutes).

<sup>209</sup> Johnson, *supra* note 203, at 1994.

<sup>210</sup> For discussions of the power of indemnification at common law, see J. BISHOP, *INDEMNIFICATION*, *supra* note 203, ¶¶ 5.01-5.05; HENN & ALEXANDER, *supra* note 53, § 379; Cheek, *Control of Corporate Indemnification: A Proposed Statute*, 22 VAND. L. REV. 255, 258-61 (1969)[hereinafter cited as Cheek].

judgments, settlements, or attorney's fees is unclear. Moreover, no distinction exists between third party and derivative actions. Indemnification is prohibited if the director or officer is adjudged liable for negligence, misconduct, or violations of the Mississippi antitrust or fair trade statutes; no other standard or conduct is addressed. The statute is expressly non-exclusive, and it permits "any other indemnification" authorized by the articles, bylaws, or shareholder resolution. However, it imposes no specific limitations on the ability of a corporation to make indemnification that might contravene public policy.<sup>211</sup> Finally, the statute does not refer to either advancement or expenses of insurance.<sup>212</sup>

In contrast, Sections 8.50 through 8.58 of the RMA set forth a detailed and integrated set of rules dealing with indemnification. The source of the provisions was an amendment to the 1969 Model Act adopted in 1980. The RMA reorganizes that provision to add clarity without altering its substance.<sup>213</sup> In general, it deals with indemnification of three types: permissive, mandatory, and court ordered. It also incorporates an extensive and extremely useful set of definitions which apply only to subchapter E.<sup>214</sup>

Section 8.51 establishes the criteria for permissive (or discretionary) indemnification. Under that section an individual who is or was a director and who is made a party to a proceeding<sup>215</sup> may be indemnified so long as he acted in good faith and, in addition, meets the following tests: (1) in the case of conduct in his official capacity, he reasonably believed his conduct was in

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<sup>211</sup> MISS. CODE ANN. § 79-3-7(o)(1972); Hodge & Perry, *supra* note 2, at 393-97 (corporation may make indemnification in any situation authorized by articles of incorporation, bylaws, or stockholders' resolution).

<sup>212</sup> See Hodge & Perry, *supra* note 2, at 397-98.

<sup>213</sup> See 2 REVISED MODEL BUSINESS CORP. ACT ANN. 1088-91 (3d ed. 1985). Thus, an extremely valuable source document for understanding the RMA rules on indemnification is *Changes in the Model Business Corporation Act Affecting Indemnification of Corporate Personnel*, 34 BUS. LAW. 1595 (1979) (report of the Committee on Corporate Laws) [hereinafter cited as *Changes Affecting Indemnification*], which details the new law and the respects wherein it differs from the 1969 Model Act.

<sup>214</sup> REVISED MODEL BUSINESS CORP. ACT ANN. § 8.50 (1984).

<sup>215</sup> "Proceeding" is defined as "any threatened, pending, or completed action, suit, or proceeding, whether civil, criminal, administrative, or investigative and whether formal or informal." *Id.* § 8.50(7).



the corporation's best interest; (2) if not acting officially, he reasonably believed his conduct was at least not opposed to the corporation's best interest; and (3) if in a criminal proceeding, he had in addition to the above no reasonable cause to believe his conduct was unlawful.<sup>216</sup>

Under this section indemnification is prohibited in two instances: (1) in a derivative action where the individual was adjudged liable to the corporation; and (2) in any other proceedings where liability is imposed on the grounds that the individual received an improper personal benefit.<sup>217</sup> Finally, in a derivative action permissive indemnification is limited to expenses (which expressly includes attorneys' fees<sup>218</sup>) incurred in connection with the action.<sup>219</sup>

This much of the RMA appears to strike an appropriate balance between the interests of the corporation and management. While it certainly will allow indemnification of directors adjudged liable for certain breaches of duty so long as the applicable standard of conduct is met,<sup>220</sup> sufficient procedural safeguards are established elsewhere by the RMA to make the likelihood of abuse remote.<sup>221</sup> Before discussing those safeguards, however, the more potentially controversial area of mandatory indemnification must be considered.

Section 8.52 provides that a director who is "wholly success-

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<sup>216</sup> *Id.* § 8.51(a). A separate standard of conduct exists for ERISA claims. *Id.* § 8.51(b) & official comment 2.

<sup>217</sup> *Id.* § 8.51(d).

<sup>218</sup> *Id.* § 8.50(3).

<sup>219</sup> *Id.* § 8.51(e). The commentary explains that this is intended to prevent the corporation from seeking to indemnify a director for a settlement which the director has paid to the corporation. Judgments would of course be excluded by § 8.51(d)(1). *See id.* § 8.51(e) & official comment 5 (limits indemnification in suits brought by or in right of corporation for expenses incurred in connection with proceedings in order to avoid circuitry that would be involved if corporation sought to indemnify directors for payments made in settlement by director to corporation).

<sup>220</sup> It should be noted that the standard defined in § 8.51 is not a purely subjective one; rather, both the subjective test of good faith and the objective test of *reasonable* belief must be met. Arguably this could work to the detriment of the "honest but dumb" director. At the same time, however, it serves as a check upon the ability to indemnify a party who may be admittedly liable. For criticism of the objective standard see Cheek, *supra* note 210, at 279-80.

<sup>221</sup> *Cf.* Hodge & Perry, *supra* note 2, at 395-96 (discussing similar issues under 1969 Model Act).

ful on the merits *or otherwise*" in a proceeding is entitled to payment of his reasonable expenses.<sup>222</sup> The idea that the director must be "wholly successful" is a salutary one; it is intended to preclude the possibility of partial indemnification of a director who successfully defends some but not all counts, a result that had been reached under other statutes.<sup>223</sup> The objection to the statute, however, should be obvious: the "or otherwise" language could make mandatory the indemnification of a director who, for example, might be liable for breach of the duty of loyalty yet have a valid procedural defense such as the statute of limitations.<sup>224</sup>

Admittedly, this provision appears in most indemnification statutes. The justification given by the drafters of the RMA for this seeming anomaly is that a defendant with a valid procedural defense should not be put to the burden of a long and expensive trial on the merits merely to establish his right to indemnification.<sup>225</sup> While this may doubtless have merit in some situations, I believe that for public policy reasons *mandatory* indemnification should be limited to persons who are successful on the merits.<sup>226</sup> I submit that this imposes no undue burden on the director with a valid procedural defense, because the RMA would still allow him to seek permissive indemnification, so long as the requirements of section 8.51 are met,<sup>227</sup> or to seek court-ordered indemnification<sup>228</sup> in other instances.<sup>229</sup>

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<sup>222</sup> REVISED MODEL BUSINESS CORP. ACT § 8.52 (1984)(emphasis added).

<sup>223</sup> *Id.* official comment. The notorious case to the contrary was *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138 (Del. 1974), which held that a defendant who successfully obtained the dismissal of some but not all counts of an indictment was entitled to partial indemnification. *Id.* at 141.

<sup>224</sup> Hamilton, *Reflections*, *supra* note 8, at 1465 n.30.

<sup>225</sup> REVISED MODEL BUSINESS CORP. ACT § 8.52 official comment (1984); Hamilton, *Reflections*, *supra* note 8, at 1465 n.30; see also BISHOP, INDEMNIFICATION, *supra* note 203, ¶ 6.12, at 70 (defendant who is otherwise successful by pleading statute of limitations creates no right to indemnity, which may encourage unnecessary prolongation of costly litigation).

<sup>226</sup> This is the approach taken in California. See CAL. CORP. CODE § 317(d) (West 1985)(mandatory indemnification is limited to persons who are successful on merits of their suit).

<sup>227</sup> See *supra* notes 215-21 and accompanying text.

<sup>228</sup> See *infra* notes 230-32 and accompanying text.

<sup>229</sup> Cf. Cheek, *supra* note 210, at 282-83 n.117 (limiting mandatory indemnification to persons successful on merits of suit does not impose harsh burden on those who win

The third method of indemnification under the RMA is that by court order. Subject to limitation in the articles of incorporation, a director may apply to the court conducting a proceeding or another court of competent jurisdiction for an order of indemnification.<sup>230</sup> Indemnification can then be ordered in two instances: first, to enforce a right to mandatory indemnification;<sup>231</sup> or second, because the court determines that "the director is fairly and reasonably entitled to indemnification in view of all the relevant circumstances," whether or not his conduct meets the standard of section 8.51 or notwithstanding that he was adjudicated liable in a derivative action or for receipt of an improper personal benefit. In this latter instance, however, indemnification is limited to reasonable expenses incurred.<sup>232</sup>

On balance, the RMA provision on court-ordered indemnification appears to be a desirable addition. Changes in control, for instance, may motivate a corporation to refuse to make mandatory indemnification or to decline a request for permissive indemnification without valid reason. Some enforcement or review mechanism is, therefore, clearly indicated.

In order to obtain discretionary indemnification under sec-

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on technicalities). It would seem unlikely that a corporation would, for example, refuse to indemnify a director who clearly meets the standard of § 8.51; even if it should, however, the director would still have recourse to a court to seek an order compelling indemnification on that basis. See REVISED MODEL BUSINESS CORP. ACT § 8.54(2) (1984)(director is entitled to indemnification in view of all relevant circumstances whether or not he met standards in § 8.51 or was adjudged to be liable).

<sup>230</sup> REVISED MODEL BUSINESS CORP. ACT § 8.54 (1984).

<sup>231</sup> *Id.* § 8.54(1)(1984). In this instance the court is also required to award the director his expenses incurred in obtaining court-ordered indemnification. *Id.*

<sup>232</sup> *Id.* § 8.54(2). Thus court-ordered indemnification would be the sole means whereby a director could obtain indemnification with respect to derivative suits or improper benefit. *Id.* official comment.

Of course, one might question the appropriateness of granting any indemnification to a director who has been adjudged liable to his corporation for breach of duty. The drafters of the RMA apparently felt, however, that an absolute prohibition on such awards was less desirable than delegating such discretion to a presumably impartial court. While this provision may provide some comfort to management, it seems unlikely that such awards would be made with any frequency. Only in truly extraordinary circumstances (as, for example, where a court might establish a new legal standard of conduct much stricter than a director could have reasonably anticipated) would it seem possible that a court would take such action. Johnson, *supra* note 203, at 1997. In any event, the right to seek such indemnification can be eliminated in the corporation's articles. REVISED MODEL BUSINESS CORP. ACT § 8.54 official comment (1984).

tion 8.51, a director must first establish that he has met the standards established by that section.<sup>233</sup> The determination of eligibility is to be made by either (1) a majority of a quorum of directors not parties to the proceeding, or, if such a quorum cannot be obtained, by majority vote of a committee appointed by the entire board, which consists of two or more directors who are not parties;<sup>234</sup> (2) by special legal counsel;<sup>235</sup> (3) or by the shareholders excluding the votes of directors who are parties to the proceeding.<sup>236</sup> Assuming that it is determined that indemnification is permissible, the RMA then requires a separate authorization of indemnification, which is usually made by the same body which determined that indemnification was permissible.<sup>237</sup>

To be sure, this procedure can be criticized on various grounds.<sup>238</sup> On the whole, however, I believe that it provides a

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<sup>233</sup> REVISED MODEL BUSINESS CORP. ACT § 8.55(a) (1984).

<sup>234</sup> *Id.* § 8.55(b)(1) & (2)(1984).

<sup>235</sup> *Id.* § 8.55(3). By use of the term "special legal counsel," the RMA has reference to attorneys with no prior professional relationship to those seeking indemnification, who are retained for the special occasion, and who are neither inside counsel or regular outside counsel. *Id.* official comment. In so doing, the RMA wisely avoids the ambiguities posed by some statutes (including earlier versions of the Model Act) which speak of "independent legal counsel." See, BISHOP, INDEMNIFICATION, *supra* note 203, ¶ 6.03[9], at 45-46 (requisite independence of "independent legal counsel" is uncertain); Johnson, *supra* note 203, at 1998-99 (indemnification under Delaware law must be authorized upon determination by board of directors or by "independent legal counsel" or by stockholders). On the other hand, the RMA rejects the approach of at least one state, Ohio, in defining the counsel eligible to serve. See OHIO REV. CODE § 1701.13(E)(4) (Page 1985)(counsel cannot qualify as "independent" if he or his firm has been retained by or has performed services for corporation or person to be indemnified within previous five years); *Changes Affecting Indemnification*, *supra* note 213, at 1612 (characterization of legal counsel authorized to make required determination has been changed from "independent" to "special"; change is not intended to indicate that counsel chosen should not be independent in accordance with governing ethical precepts).

<sup>236</sup> REVISED MODEL BUSINESS CORP. ACT § 8.55(b)(4)(1984).

<sup>237</sup> *Id.* § 8.55(c). The exception is where special legal counsel determined the permissibility of indemnification, in which event authorization is made by the body empowered to appoint counsel under § 8.55(b)(3). According to the comments, the factors to be considered in this authorization include the reasonableness of expenses, the financial ability of the corporation to pay, and the extent to which resources should be allocated to this or some other purpose. *Id.* official comment.

<sup>238</sup> For example, one might question the extent to which other directors can truly exercise disinterested judgment when dealing with a colleague. Moreover, it is doubtful whether many attorneys would be willing to opine as to such matters, rendering this an impracticable alternative. See Johnson, *supra* note 203, at 1999 (discussing problems inherent in obtaining opinion of independent counsel); cf. Hodge & Perry, *supra* note 2, at

workable structure that adequately protects the interests of shareholders, with two exceptions. First, I do not believe that the decisions on eligibility or authorization should be delegated to a committee. If a quorum of disinterested directors (*i.e.*, directors not parties to the proceeding) cannot be obtained, eligibility should be determined only by special counsel or the shareholders,<sup>239</sup> with the final decision on authorization left to the shareholders alone. The participation of interested directors should be limited solely to the designation of special counsel in instances where that alternative is adopted.<sup>240</sup>

Second, I would enact the requirement imposed by the 1979 amendments to the Model Act, as modified in part in the RMA, that any indemnification of a director made in accordance with the statute be reported in writing to the shareholders either prior to or together with the notice of the next succeeding shareholders' meeting.<sup>241</sup> Such disclosure may provide a significant procedural safeguard against abuse of the indemnification process and should be adopted by Mississippi.<sup>242</sup>

One of the most practically important aspects of indemnification under the RMA is the authorization of advancement of

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395-96 (determinations made by independent legal counsel are questionable but lack of reasonable alternatives makes solution acceptable).

<sup>239</sup> This was the approach of the 1969 Model Act. MODEL BUSINESS CORP. ACT § 5(d) (1969).

<sup>240</sup> This, of course, would necessitate rewording of § 8.55(b) and (c) to conform with this result. The drafters of the RMA take the position that the somewhat more extensive role sanctioned by § 8.55 is "justified by a principle of necessity." REVISED MODEL BUSINESS CORP. ACT § 8.55 official comment (1984). While it is surely true that it facilitates the process, particularly in the publicly-held corporation, in this respect the RMA seems to swing the balance too far in the interests of management.

<sup>241</sup> REVISED MODEL BUSINESS CORP. ACT § 16.21(a)(1984); MODEL BUSINESS CORP. ACT § 5(1)(1980). By use of the words "in accordance with," the 1979 amendment contemplated not only any indemnification made under the statute, but also pursuant to a charter, bylaw, or other provision in accordance with the statute. The Committee on Corporate Laws apparently believed that reporting of mandatory or court-ordered indemnification was not mandated by § 5(1). See *Changes in Indemnification*, *supra* note 213, at 1615 (reporting of indemnification payments or advances to nondirectors not required by § 5(1)). The "in accordance with" language would, however, seem broad enough to encompass this as well.

<sup>242</sup> See Cheek, *supra* note 210, at 288 (such notice is necessary to provide full protection to corporate officers and thus has been adopted for inclusion in proposed model statute); Hodge & Perry, *supra* note 2, at 396 (same).

expenses, a provision that, as previously noted, is absent in Mississippi. Under section 8.53, advancement or payment of reasonable expenses can be made if (1) the director states in writing his good faith belief that he meets the criteria of section 8.51; (2) the director undertakes in writing to repay the advance if it is ultimately determined that he did not meet the applicable standard; and (3) a determination is made pursuant to the procedure of section 8.55 that "the facts then known . . . do not preclude indemnification."<sup>243</sup>

Given the potentially crushing burden of legal expenses alone in protracted proceedings, this provision is clearly reasonable. Without it, eventual indemnification may as a practical matter be meaningless to the director who has already suffered financial ruin as a result of legal fees. While one might argue that the "undertaking" to repay should be secured in order to guarantee repayment, this may work only to discriminate unfairly against the less wealthy director who cannot afford security.<sup>244</sup> Moreover, the same procedure for determining eligibility and authorizing payment must be followed as for discretionary indemnification, again providing an adequate safeguard against abuse.

As previously noted, the MBCA only specifically extends the power to indemnify to directors and officers, although the "any other indemnification" language could be construed to allow indemnification of agents and employees pursuant to provisions in the articles, bylaws, or by shareholder resolution. The RMA separately provides for indemnification of officers, employees, and agents, and treats them in a manner distinct from directors in some instances. In substance, the operation of Section 8.56 of the RMA is as follows: officers, employees, and agents of the corporation who are not directors may receive discretionary indemnification on the same basis as directors under section

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<sup>243</sup> REVISED MODEL BUSINESS CORP. ACT § 8.53(a), (c)(1984).

<sup>244</sup> Johnson, *supra* note 203, at 1999. Moreover, as previously noted in this *Journal*, "inability to pay" is a risk taken not only by the corporation which makes advances; the corporation itself may be financially unable to provide discretionary indemnification which is clearly justified, or mandatory indemnification pursuant to a court decree. See Hodge & Perry, *supra* note 2, at 397 (corporation may be financially unable to indemnify director even though he is entitled to indemnification as matter of right).

8.51. In light of their different capacities and the different duties that may attach thereto, however, the RMA also allows a corporation to provide *broader* indemnification rights than does the statute, whether by the articles, bylaws, board action or contract, subject only to the overriding limitation of public policy. Second, officers who are not directors (but not employees or agents) have the same right to mandatory indemnification as directors. In each of these cases, however, the articles can limit the rights otherwise granted by statute. Finally, directors who also serve in another capacity are in all events limited to indemnification under the other sections of subchapter E.<sup>246</sup>

Clearly it is salutary to extend indemnification to employees and agents. The major disadvantage of the RMA is the lack of clarity in the "public policy" limitation to the expansion of indemnification rights for non-director officers, employees and agents.<sup>246</sup> While the interests of simplicity would be served by making the indemnification provisions for such persons coextensive with those of directors, the RMA is probably correct in concluding that different considerations might apply to them that would make the limitations imposed upon director indemnification inappropriate. Moreover, any board action in this regard is subject to the obligations of the duty of care, and just as broader rights can be extended by corporate action, even the statutory rights can be eliminated by provision in the articles.

On a related point, even as to directors the RMA is nonexclusive; that is, it recognizes that corporations may make provisions for indemnification of directors in their articles, bylaws, or otherwise. This would permit, for example, a provision mandating indemnification that would otherwise be permissive, or commitments to indemnify directors to the fullest extent permitted by law.<sup>247</sup> The RMA, however, clarifies an ambiguity in earlier versions of the Model Act and in some other states with nonexclusive provisions by explicitly providing that such provisions

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<sup>246</sup> REVISED MODEL BUSINESS CORP. ACT § 8.56 & official comment (1984).

<sup>246</sup> Cf. Johnson, *supra* note 203, at 2009-11 (since limits of permissible indemnification are unclear under existing law, adoption of bylaw or charter provisions stating that corporation shall indemnify directors and officers "to the full extent permitted by law" may be best alternative).

<sup>247</sup> REVISED MODEL BUSINESS CORP. ACT § 8.58(a) official comment (1984).

must be consistent with subchapter E.<sup>248</sup> Thus under no circumstances can indemnification for directors be broadened beyond that permitted by the RMA. The RMA approach is desirable and should be followed.

The final significant provision of subchapter E involves directors and officers insurance,<sup>249</sup> an issue not addressed by the MBCA.<sup>250</sup> Generally D & O coverage has two aspects: reimbursement to the corporation for amounts paid to individuals pursuant to indemnification laws, and direct liability coverage to directors and officers for liabilities and expenses for which a corporation cannot legally indemnify them, such as liability to the corporation itself for negligence. This latter coverage would also extend to instances where the corporation could make indemnification but does not, either because it is insolvent or control has changed.<sup>251</sup>

A potentially controversial aspect of the RMA is that it, like many modern statutes,<sup>252</sup> permits the corporation to purchase insurance for a director, officer, agent or employee, against lia-

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<sup>248</sup> *Id.* The question frequently posed was whether a nonexclusive statute could be effectively circumvented merely by provisions in the articles or bylaws, and the extent of public policy restraints on such provisions. *See, e.g.,* BISHOP, INDEMNIFICATION, *supra* note 203, ¶ 6.03[1][a] (discussing ambiguities arising from use of nonexclusive language and extent to which courts will enforce); Cheek, *supra* note 210, at 276-78 (nonexclusive clause minimizes effectiveness by injecting elements of uncertainty as to how far courts will allow corporations to go); Hodge & Perry, *supra* note 2, at 396-97 (limitations on indemnification are easy to circumvent); Johnson, *supra* note 203, at 1996 (bylaws or agreements could be drafted providing for more extensive protection than specified in other provisions of nonexclusive statutes although public policy limits extent to which bylaws or agreements may exceed statutory formulation).

<sup>249</sup> Presumably the "other indemnification" language of MISS. CODE ANN. § 79-3-7(o)(1972) could be construed to authorize the purchase of such insurance.

<sup>250</sup> For general background on D & O insurance policies see BISHOP, INDEMNIFICATION, *supra* note 203, ¶¶ 8.01-8.07; Hinsey, *supra* note 108; Johnson, *supra* note 203, at 2012-36.

<sup>251</sup> *See* BISHOP, INDEMNIFICATION, *supra* note 203, ¶ 8.03[1] (any cost which is lawfully indemnifiable is also "insurable"); Johnson, *supra* note 203, at 2013-23, 2034-36 (discussing coverage of D & O policies and liabilities that cannot be covered by corporate indemnification or D & O liability insurance). Of course, various exclusions exist, those most notable being uninsurable risks and matters such as dishonesty, self-dealing, and willful misconduct. Johnson, *supra* note 203, at 2035.

<sup>252</sup> *E.g.,* CAL. CORP. CODE § 317(i) (West 1985) (corporation may purchase insurance on behalf of agent of corporation against liability whether or not corporation would have power to indemnify agent against such liability under provisions of this section).



bilities arising from his status as such, whether or not the corporation would have the power to indemnify him under sections 8.51 and 8.52.<sup>253</sup> Arguments have been made on policy grounds that the corporation's power to purchase insurance should be limited to liabilities for which statutory indemnification is permitted.<sup>254</sup> That objection, however, seems misplaced, because the exclusions contained in D & O policies are consistent with generally accepted notions of public policy. Moreover, the statute does not make an uninsurable risk insurable.<sup>255</sup> The effect, then, is to render the purchase of insurance by the corporation a form of compensation, which should be a matter within the board's discretion.<sup>256</sup> Thus, I would recommend the adoption of section 8.57 in its present form.

### *E. Shareholders*<sup>257</sup>

#### 1. Voting of Shares.

The most obvious and potentially significant departure of the RMA from the MBCA provisions on voting is the elimination of compulsory cumulative voting. A majority of states now make cumulative voting elective.<sup>258</sup> Mississippi is one of a handful that has a constitutional mandate for cumulative voting.<sup>259</sup>

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<sup>253</sup> REVISED MODEL BUSINESS CORP. ACT § 8.57 (1984).

<sup>254</sup> See, e.g., Hodge & Perry, *supra* note 2, at 397 (current Model Act authorizes corporations to purchase insurance covering liability of director even if corporation would not have power to indemnify him against such liability).

<sup>255</sup> Johnson, *supra* note 203, at 1999-2000, 2016-21, 2034-36.

<sup>256</sup> *But cf.* Cheek, *supra* note 210, at 273-74 (although insurance should be considered compensation, director indemnification should not be considered justified as part of executive's compensation protecting him against future liability which has not arisen since payment is predicated on determinations of liability or on settlements, in which case corporations must reimburse executive).

<sup>257</sup> This section will discuss shareholders only in the context of their general role in the statutory scheme of management and control. Other issues relating to capitalization (e.g., preemptive rights), shareholder litigation, and shareholders in the context of the closely-held corporation will be dealt with in Part 2 of this article.

<sup>258</sup> 1 REVISED MODEL BUSINESS CORP. ACT ANN. 676 (3d ed. 1985). The 1950 Model Act, upon which the MBCA was based, made cumulative voting mandatory. Beginning in 1960, however, the option of permissive cumulative voting was recognized, and the 1969 Model Act eliminated mandatory cumulative voting altogether as an option in section 33. *Id.* at 673.

<sup>259</sup> MISS. CONST. art. VII, § 194. The others are Arizona, Idaho, Kentucky, Missouri, South Dakota, and West Virginia. See ARIZ. CONST. art. XIV, § 10; IDAHO CONST. art. XI,

Section 7.28(b) of the RMA denies the right of cumulative voting unless the corporation "opts in" by its articles of incorporation.<sup>260</sup>

Whether accomplished by an "opt in" or "opt out" provision, mandatory cumulative voting should be eliminated in Mississippi. Given its traditional justification, *i.e.*, the facilitation of minority representation on the board of directors, the broad reasons for this recommendation are twofold: in the public corporation, it serves little purpose at all, and in the closely-held corporation, it does not provide an efficient, or even effective, means to its avowed end.

Specifically, in the public corporation it is unlikely that any group of shareholders will pool sufficient votes, and then cumulate their votes with the requisite common guiding intelligence, to alter the outcome of an election where management has solicited proxies. Thus, in most instances mandatory cumulative voting serves only to unnecessarily complicate the election process.<sup>261</sup>

In the closely-held business, there are other devices that are simply more effective in ensuring minority representation on the board such as shareholders' agreements providing for the election of certain persons, classification of shares with different classes entitled to elect a specified number of directors, or supermajority vote provisions which could give the minority an

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§ 4; Ky. CONST. § 207; Mo. CONST. art. XI, § 6; S.D. CONST. art. XVII, § 5; W. VA. CONST. art. XI, § 4.

An extensive body of literature exists debating the merits of cumulative voting. For general reference see Axley, *The Case Against Cumulative Voting*, 1950 WIS. L. REV. 278; Bhagat & Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 J. LAW & ECON. 339 (1984); Easterbrook & Fischel, *Voting in Corporate Law*, 26 J. LAW OF ECON. 395 (1983); Sobieski, *In Support of Cumulative Voting*, 15 BUS. LAW. 316 (1960); Sturdy, *Mandatory Cumulative Voting: An Anachronism*, 16 BUS. LAW. 550 (1961); Young, *The Case for Cumulative Voting*, 1950 WIS. L. REV. 49.

<sup>260</sup> REVISED MODEL BUSINESS CORP. ACT § 7.28(b)(1984).

<sup>261</sup> This situation assumes, of course, the ordinary election in which there has been no countervailing solicitation by an insurgent group seeking to oust incumbent directors. It is only fair to say that these are contrary views of cumulative voting in public corporations. See, e.g., Bhagat & Brickley, *supra* note 259, at 340-41 (discussing proponents' arguments in favor of cumulative voting); Sobieski, *supra* note 259, (importance of cumulative voting to minority shareholders); Young, *supra* note 259, at 49-56 (arguing in favor of statute granting shareholders the right to cumulative voting).

effective veto of any election that did not include minority representation.<sup>262</sup> The "protection" of cumulative voting is more apparent than real, since its impact can easily be undercut by staggering the board of directors or simply reducing the size of the board.<sup>263</sup> Indeed, mandatory cumulative voting may be directly disadvantageous to minority stockholders, in that it may obscure the need for more explicit and careful planning of the parties' relationship.<sup>264</sup>

To be sure, the issues involved in eliminating mandatory cumulative voting are not entirely clear cut, and substantial debate continues on the question. Still, Mississippi is in a shrinking minority in rendering it nonelective. Of course, cumulative voting should be available as a planning device to those who desire it. It should not, however, be forced arbitrarily upon those corporations for which it is clearly inappropriate. Thus, I would recommend the amendment of the Mississippi Constitution to eliminate compulsory cumulative voting and the enactment of an elective provision similar to the RMA.

On the other hand, if the election of cumulative voting is made, the RMA engrafts procedural impediments upon the exercise of that right which should not be adopted. Specifically, even if cumulative voting rights exist, under the RMA shares cannot be voted cumulatively unless the notice of the meeting or proxy statement states conspicuously that cumulative voting is authorized, or a shareholder gives not less than 48 hours notice of his

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<sup>262</sup> See, e.g., HENN & ALEXANDER, *supra* note 53, § 265, at 719 (discussing voting alternatives within closely-held corporations); Comment, *The Constitutionality of the 1983 Illinois Business Corporation Act's Voting Provisions*, 1985 U. ILL. L. REV. 647, 653 (discussing effects of cumulative voting). Certain of these devices will be discussed in Part 2 of this article.

<sup>263</sup> See HENN & ALEXANDER, *supra* note 53, § 189, at 496 (outlining ways to weaken cumulative voting); Hamilton, *Reflections*, *supra* note 8, at 1468-69 (discussing effects of cumulative voting). In Mississippi, reduction of the board's size could be accomplished by amendment of the by-laws by the board, absent contrary provision in the articles. MISS. CODE ANN. §§ 79-3-51, -69 (1972). Classifying or staggering the board must, however, be authorized by the articles, so that admittedly it is procedurally more difficult to achieve. *Id.* § 79-3-71.

<sup>264</sup> Cf. Hamilton, *Reflections*, *supra* note 8, at 1468-69 (corporations may be willing to structure transactions in manner which circumvents statute giving impression that statute provides greater protection than actually exists).

intent to cumulate.<sup>265</sup> If the corporation elects cumulative voting, there seems to be no justification for permitting such obvious methods of circumventing that right. No sanction is imposed by the RMA on management for failing to give such notice (although it is required by the SEC proxy rules),<sup>266</sup> and it is unlikely that the average shareholder would have sufficient sophistication and knowledge of the law to expect him to comply. Only a few states have adopted similar notice requirements<sup>267</sup> and the drafters' assertion that it is intended to ensure that all voting shareholders understand the rules is not compelling.<sup>268</sup> This provision, then, should be eliminated in Mississippi.

A final aspect of section 7.28 that deserves comment is the provision for the election of directors by a plurality of votes.<sup>269</sup> Prior versions of the Model Act were simply silent on the question of the vote required to elect a director,<sup>270</sup> although there seems to be a common assumption that it is by a plurality.<sup>271</sup> The MBCA likewise makes no such reference.<sup>272</sup> As a practical matter, of course, this rule is necessary in any corporation where shares are factionalized to the extent that no group can muster a majority of votes. Since the RMA provides a corporation the op-

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<sup>265</sup> REVISED MODEL BUSINESS CORP. ACT § 7.28(d)(1984).

<sup>266</sup> 17 C.F.R. § 240.14a-101(5)(c)(1986). Likewise, it would be only fair to note that the SEC has generally encouraged cumulative voting whenever it has been in a position to do so. HENN & ALEXANDER, *supra* note 53, § 189, at 497-98 n.24.

<sup>267</sup> 1 REVISED MODEL BUSINESS CORP. ACT ANN. 676 (3d ed. 1985).

<sup>268</sup> See REVISED MODEL BUSINESS CORP. ACT § 7.28 official comment (2)(1984).

<sup>269</sup> REVISED MODEL BUSINESS CORP. ACT § 7.28(a)(1984). It should be noted that the RMA adopts the general rule of one vote per share subject to contrary provisions in the articles. The Exposure Draft took the position that different voting rights could be extended to shares of the same class. REVISED MODEL BUSINESS CORP. ACT § 7.21 official comment (1)(Exposure Draft March, 1983). The RMA deleted this statement, thereby casting doubt on the question. In any event, under the MBCA nonvoting common stock is not permitted and all common stock, regardless of class, has the right to one vote per share. MISS. CODE ANN. §§ 79-3-27, -63 (1972). The RMA provides desirable flexibility for control arrangements in the closely-held corporation and is preferable. This issue will be more fully developed in Part 2.

<sup>270</sup> See, e.g., MODEL BUSINESS CORP. ACT § 35 (1969)(no mention of voting requirements for election of director).

<sup>271</sup> See, e.g., HENN & ALEXANDER, *supra* note 53, § 189, at 494 (discussing voting techniques used to elect directors).

<sup>272</sup> See MISS. CODE ANN. § 79-3-69 (1972)(no mention of voting requirements for election of director).

tion of selecting a different regime, this is an appropriate clarification of existing law.

The RMA would effect a needed change in Mississippi law by providing some guidance on the circumstances under which a proxy may be irrevocable. The MBCA makes no reference to irrevocable proxies,<sup>273</sup> thus leaving the question to be resolved by application of the common law doctrine of proxies coupled with an interest. Section 7.22 of the RMA provides that a proxy will be irrevocable if it so states in a conspicuous manner and if the appointment is coupled with an interest; it then enumerates non-exclusive examples of such appointments.<sup>274</sup> In addition, a safe harbor provision permits the corporation to accept a proxy's authority notwithstanding the death or incapacity of the granting shareholder unless notice is received before the proxyholder votes.<sup>275</sup>

The RMA also contains various provisions of an essentially procedural nature that would be desirable additions to the MBCA. For example, section 7.04 elaborates on the process of effecting shareholder action by unanimous consent, clarifying (as is true for directors) that such action can be taken by signing separate documents describing the action taken. Moreover, notice of such action must be given to holders of any nonvoting shares who would have been entitled to notice of a meeting.<sup>276</sup> Unlike the corresponding provision for directors,<sup>277</sup> however, section 7.04 is curiously ambiguous on the question of the effective time of such consent and the right of a shareholder to withdraw

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<sup>273</sup> See *id.* § 79-3-63 (statute dealing with voting of shares).

<sup>274</sup> REVISED MODEL BUSINESS CORP. ACT § 7.22(d)(1984). Proxies coupled with an interest include those held by a pledgee, a purchaser of the stockholder's shares, a creditor of the corporation who required the appointment as a condition to the extension of credit, an employee of the corporation whose contract required appointment, or a party to a shareholders' voting agreement. Any such appointment is revoked when the interest is extinguished. *Id.* § 7.22(f).

<sup>275</sup> *Id.* § 7.22(e). The rule at common law, of course, is that death or disability of the shareholder revokes a proxy automatically. HENN & ALEXANDER, *supra* note 53, § 196. The RMA also protects a bona fide purchaser of shares as to which an irrevocable proxy has been given. If the certificate (or information statement for shares without certificates) does not conspicuously note the appointment, such a purchaser has the right to revoke the appointment. REVISED MODEL BUSINESS CORP. ACT § 7.22(g).

<sup>276</sup> *Id.* § 7.04(a),(d).

<sup>277</sup> See *supra* notes 90-91 and accompanying text.

his consent. The comments assert that consent action is effective only when the last consent is received by the secretary of the corporation and that any shareholder is free to withdraw his consent before that time;<sup>278</sup> explicit language to that effect in the statute itself seems a preferable alternative.

Recognizing that the shares of many publicly held companies are registered in the name of a nominee, the RMA permits (but does not require) corporations to establish procedures whereby the beneficial owners of such shares can be "recognized" by the corporation as the shareholders.<sup>279</sup> Although the extent of this recognition is to be as defined in the procedure, the comments clearly contemplate the right not only to receive communications but also to vote the shares so registered, thus bypassing the nominee.<sup>280</sup>

A feature of the RMA that is of particular benefit to the publicly held company is the fairly detailed set of rules in section 7.24 dealing with a corporation's acceptance of votes, consents, waivers, or proxy appointments.<sup>281</sup> Recurring and frequently vexing problems arise in attempting to reconcile and decipher ambiguous signatures or those that do not correspond to the corporation's records, and section 7.24 provides needed measures of guidance and protection. In particular, the corporation is authorized to reject any vote or related document if the responsible officer has a good faith, reasonable belief about the validity of the signature or about the signatory's authority to sign for the corporation, and both the corporation and responsible officer are absolved from liability for a rejection which meets this standard.<sup>282</sup>

An important change in the RMA appears in the general provisions concerning voting. Under the MBCA, shareholder action is deemed effective if there is a quorum at the meeting and there is an affirmative vote of a majority of the shares repre-

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<sup>278</sup> REVISED MODEL BUSINESS CORP. ACT § 7.22 official comment 2 (1984).

<sup>279</sup> *Id.* § 7.23(a).

<sup>280</sup> *Id.* official comment.

<sup>281</sup> *Id.* § 7.24. The comments to this section are particularly useful in illustrating the possible applications of the rules to various situations.

<sup>282</sup> *Id.* § 7.24(c).

sented at the meeting.<sup>283</sup> The effect of this is to treat an abstention as a negative vote. In some instances this may lead to anomalous results. Shareholders who may be indifferent to the resolution of a specific matter may effectively defeat it simply by manifesting that indifference. The RMA adopts a rule that is probably more consistent with a layperson's expectation, that being that action is effective if the votes cast in favor of an action exceed those cast against it, subject to contrary provisions of the articles or the statute.<sup>284</sup> This may, of course, lead to approval by less than a majority of a quorum, but the basis for the RMA rule is at least as rational as the traditional response to abstentions and should be adopted.

On an issue, the RMA contains a blanket authorization for supermajority quorum or voting requirements for any shareholder action; such provisions must of course appear in the articles. A procedural safeguard also prevents alteration of any such provision except by compliance with the standard that is the subject of the proposed amendment.<sup>285</sup>

In one respect, the RMA would create an ambiguity that does not exist under the MBCA. Section 61 of the MBCA allows the articles of incorporation to set a less-than-majority quorum requirement for shareholders, but not less than one-third.<sup>286</sup> Apparently in the belief that the one-third limitation was unduly restrictive, the RMA eliminated that provision.<sup>287</sup> Section 7.27, however, authorizes only a *greater* than majority quorum. By implication, this would prohibit a *less* than majority quorum, absent some modification of the statutory language. Thus, section 7.27 should be amended to permit the articles to fix a quorum requirement of no fewer than one-third of the shareholders.<sup>288</sup>

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<sup>283</sup> MISS. CODE ANN. § 79-3-61 (1972).

<sup>284</sup> REVISED MODEL BUSINESS CORP. ACT § 7.25(c)(1984).

<sup>285</sup> *Id.* § 7.27. Thus a provision requiring the affirmative vote of 80% of all shares to take action could not be amended except by the same vote.

<sup>286</sup> MISS. CODE ANN. § 79-3-61 (1972).

<sup>287</sup> REVISED MODEL BUSINESS CORP. ACT § 7.25 official comment 5 (1984).

<sup>288</sup> This is also the rule as to directors. See *id.* § 8.24(a), (b); see also *supra* note 94-95 and accompanying text.

The RMA treats differently the issue of the withdrawal of directors or shareholders once a quorum is constituted. Under section 8.24(c), a quorum must at all times be pre-

Older versions of the Model Act and the MBCA recognized the right of certain classes of shares to vote separately on some issues.<sup>289</sup> The RMA introduces the general notion of voting by voting group. A voting group is defined as "all shares of one or more classes or series that under the articles of incorporation or this Act are entitled to vote and be counted together collectively on a matter at a meeting of shareholders."<sup>290</sup> Thus, preferred shares with class voting rights in the MBCA would be considered a voting group under the RMA, as would common shares with special voting rights, which are currently not permitted by the MBCA.<sup>291</sup>

The effect of sections 7.25 and 7.26 of the RMA is to impose on each voting group separately the quorum and voting rules of the Act. Thus, if separate approval of a voting group is required for a transaction, the quorum and voting standards must be met for each voting group.

On the other hand, section 1.40 provides that "[a]ll shares entitled by the articles of incorporation or this Act to vote generally on [a] matter are for that purpose a single voting group."<sup>292</sup> Thus, if a class of shares is to be treated as a voting group, appropriate provisions to that effect must be made in the articles. Draftsmen thus should be aware that separate voting

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sent in order for a valid board vote to take place. Thus, directors may prevent action from being taken by simply withdrawing from the meeting. REVISED MODEL BUSINESS CORP. ACT § 8.24(c)(1984). This is not possible under section 7.25(b); once a share is represented at a meeting of shareholders for any purpose (including objection to the transaction of business), it is deemed to be present thereafter at all times for purposes of determining a quorum. *Id.* § 7.25(b). This rule also applies to any adjournment for which a new record date is not set. Thus shareholders cannot withdraw and "break the quorum," an issue upon which courts have reached different conclusions. REVISED MODEL BUSINESS CORP. ACT §§ 7.25(c) & official comment 3, 8.24(c)(1984); see also 1 REVISED MODEL BUSINESS CORP. ACT ANN. 653 (3d ed. 1985); Murphy, *supra* note 125, at 91. The wording of the MBCA suggests that a quorum must be present at all times in order for shareholders to act. See MISS. CODE ANN. § 79-3-61 (1972)(if quorum is present, affirmative vote of majority of represented shares is act of all shareholders in absence of other statutory requirements).

<sup>289</sup> See, e.g., MISS. CODE ANN. §§ 79-3-119, -145, -157, -167, (1972)(dealing with rights of holders of outstanding shares, rights of stockholders to dissent, and voluntary dissolution by shareholders).

<sup>290</sup> REVISED MODEL BUSINESS CORP. ACT § 1.40(26)(1984).

<sup>291</sup> See *supra* note 262.

<sup>292</sup> REVISED MODEL BUSINESS CORP. ACT. § 1.40(26)(1984).



rights must be specifically conferred by the articles unless provision therefor is otherwise made by the RMA itself.

## 2. Inspection Rights.

At common law, shareholders were granted the right to inspect the books and records of the corporation at proper times and places and for a proper purpose. In practice, however, that right was often an empty one, since the burden of establishing the propriety of his purpose was, at least in earlier cases, imposed upon the shareholder.<sup>293</sup> As a practical matter the right could be enforced only by a mandamus action, the delay and expense of which in many cases simply foreclosed the issue. As a result, Mississippi, like most states, passed remedial legislation to make the right of inspection a more realistic one.<sup>294</sup> Under traditional statutes such as the MBCA, however, a number of problems remain.

The MBCA grants the statutory right of inspection only to shareholders who either have held their shares for at least six months or who own at least one percent of all outstanding shares. This does not prohibit those who cannot meet the requisite standard from obtaining inspection since the common law right is specifically preserved. The advantage of the statutory right, of course, is that while the shareholder must state his purpose in writing, the burden of proving that it is improper is on the corporation. The relevance of the size or length of time of a shareholder's ownership to the propriety of his purpose is, however, far from clear. Thus it is doubtful whether this limitation serves any rational policy.<sup>295</sup>

Moreover, the sanction for wrongful refusal to allow inspection is a penalty of ten percent of the value of the shares owned by the shareholder, assessed against the corporation or its officer or agent responsible for the refusal. In practice, however, the *in terrorem* effect of this has been questionable. The value of the shareholder's stock may be minimal and thus the penalty may

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<sup>293</sup> See 5 W. FLETCHER, *supra* note 53, § 2214; HENN & ALEXANDER, *supra* note 53, § 199, at 537 (discussing common law right of shareholders to inspect records).

<sup>294</sup> See MISS. CODE ANN. § 79-3-99 (1972)(any shareholder holding for six months preceding demand or holding at least 1% of all outstanding shares has right to examine books and records for proper purpose).

<sup>295</sup> See 4 REVISED MODEL BUSINESS CORP. ACT ANN. 1725 (3d ed. 1985).

be negligible. Moreover, even if the penalty would be substantial, courts have shown but little inclination to assess it.<sup>296</sup> Indeed, the enforceability of similar statutes has sometimes been questioned on the basis that the penalty had no relation to actual damages.<sup>297</sup>

In other respects, the MBCA is simply undesirably vague. For example, while the shareholder is accorded the right to examine certain books and records "and to make extracts therefrom,"<sup>298</sup> the meaning of this is ambiguous—does it, for example, give the shareholder (or his agent and attorney) only the right to copy by hand, or must the opportunity to photocopy be provided? Obviously the right to inspect could be substantially frustrated if the statute is read literally, as representatives of a corporation may be inclined to do.

Chapter 16 of the RMA, dealing with records and reports, makes substantial improvements to the traditional approach of the MBCA. Section 16.01 mandates that a corporation maintain generally the same records as does the MBCA: actions of the directors and shareholders, accounting records, and a record of shareholders.<sup>299</sup> Additionally, it requires that the corporation keep at its principal office a number of essentially public records (e.g., its articles, bylaws and annual report) as to which shareholders are given an absolute right to inspect.<sup>300</sup>

The heart of the RMA inspection provisions is section 16.02,

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<sup>296</sup> For a collection of the few reported cases on the issue see *id.* at 1765-67.

<sup>297</sup> See, e.g., *Schaefer v. H.B. Green Transp. Line, Inc.*, 232 F.2d 415 (7th Cir. 1956), holding such a statute unenforceable. *Id.* at 417. The basis for the decision was that the plaintiff, an Illinois resident of an Iowa corporation doing business in both states, could not extend extraterritorially the penalty provision of Illinois law where Iowa law made no such provision. *Id.*

<sup>298</sup> MISS. CODE ANN. § 79-3-99 (1972).

<sup>299</sup> REVISED MODEL BUSINESS CORP. ACT § 16.01(a)-(c)(1984). In some instances, the RMA description is somewhat more exact. In addition to "minutes of the proceedings of shareholders and directors" as required by the MBCA, the RMA includes all actions taken by consent or without a meeting (as by conference telephone call) and all actions taken by committees. *Id.* § 16.01(a). In addition, the RMA specifies that the shareholders' list must be in alphabetical order, a logical requirement omitted by the MBCA. *Id.* § 16.01(b). Finally, one difference in nomenclature exists: the RMA requires "appropriate accounting records," while the MBCA dictates "correct and complete books and records of account." *Id.*

<sup>300</sup> REVISED MODEL BUSINESS CORP. ACT §§ 16.01(e), 16.02(a)(1984).

which seeks to strike a balance between the interests of shareholders and corporations. Section 16.02 eliminates any distinction based on time or size of stockholdings, and the statutory right is extended to all shareholders. On the other hand, in order to inspect records of the actions of directors and shareholders, accounting records, and the record of shareholders, a shareholder must meet a somewhat more detailed standard. He must make his demand in good faith and for a proper purpose, must describe with reasonable particularity his purpose and the desired records, and those records must be directly connected to his stated purposes.<sup>301</sup> The avowed goal is to force the shareholder to make a more "meaningful" statement of the reasons he seeks inspection.<sup>302</sup>

In addition to this specific right of inspection, section 16.02 also recognizes the shareholders' separate rights to inspect the record of shareholders in connection with the annual meeting,<sup>303</sup> and to obtain information pursuant to discovery in litigation with the corporation.<sup>304</sup> As with the MBCA, the common law right of inspection is specifically preserved.<sup>305</sup>

The RMA also prohibits a corporation from limiting the statutory right of inspection by its articles or bylaws.<sup>306</sup> While the public policy implicit in the MBCA provision would seem to prevent this, some state statutes have permitted "reasonable" restrictions and an explicit denial of this power is desirable.

The RMA also substantially alters the procedure for enforcing inspection rights. The financial penalty for unjustified refusal to permit inspection is eliminated. Instead, section 16.04

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<sup>301</sup> *Id.* § 16.02(b), (c). The MBCA requires only that the shareholder make a "written demand stating the purpose thereof."

The RMA does not purport to define "proper purpose," although the official comment to section 16.02 states that it means "a purpose reasonably relevant to the demanding shareholder's interest as a shareholder." *Id.* § 16.02 official comment. This, in turn, begs the question of what "interest" means. See, e.g., *State ex rel. Pillsbury v. Honeywell, Inc.*, 291 Minn. 322, 191 N.W.2d 406, 411 (1971) ("interest" contemplates concern with investment return). For a collection of cases on this issue see 3 REVISED MODEL BUSINESS CORP. ACT. ANN 1737-46 (3d ed. 1985).

<sup>302</sup> REVISED MODEL BUSINESS CORP. ACT § 16.02 official comment 3 (1984).

<sup>303</sup> See *id.* §§ 7.20, 16.02.

<sup>304</sup> *Id.* § 16.02(e)(1).

<sup>305</sup> *Id.* § 16.02(e)(2).

<sup>306</sup> *Id.* § 16.02(d).

authorizes a shareholder to institute a judicial proceeding to compel inspection of the records covered by either 16.02(a) or (b).<sup>307</sup> If inspection is ordered and the corporation cannot carry its burden of proving that it refused inspection due to a good faith, reasonable doubt that the shareholder had the right to inspect the requested records, the shareholder is entitled to payment of his costs including reasonable attorney's fees.<sup>308</sup> In order to prevent abuses by a shareholder, however, the court ordering inspection can place reasonable restrictions on use or dissemination of the information he obtains.<sup>309</sup>

The RMA also clarifies the scope of the inspection right, providing that the right to "inspect and copy" under section 16.02 includes, where reasonable, the right to receive photographic or similar copies, for which the corporation can assess a reasonable charge not exceeding the estimated cost of production or reproduction.<sup>310</sup>

The RMA provisions on inspection, then, eliminate certain restrictions imposed without rational basis by the MBCA as well as many of the ambiguities of our present law. Thus, I would recommend the adoption of sections 16.01 through 16.04 of the RMA without change.

### 3. Dissemination of Financial Information.

Historically state corporation statutes have done little affirmatively to mandate the disclosure of any information to shareholders. This has been true even though those same statutes sanction the device of proxy voting, by which a shareholder can empower another person (often a member of management) to vote his shares for him. The result has been a system whereby, absent the elaborate disclosure rules applicable to companies registered under the Securities Exchange Act of

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<sup>307</sup> *Id.* § 16.04(a)(b).

<sup>308</sup> *Id.* § 16.04(c). In contrast, the MBCA lists a number of specific acts of shareholder misconduct which provide a defense to a shareholder's claim to a penalty. See MISS. CODE ANN. § 79-3-99 (1972)(corporation has defense if shareholder improperly used information from prior examination, did not act in good faith, or has offered shareholder's list for sale).

<sup>309</sup> REVISED MODEL BUSINESS CORP. ACT § 16.04(d)(1984).

<sup>310</sup> *Id.* § 16.03(b), (c).

1934,<sup>311</sup> management can solicit proxies for its re-election without providing a shareholder with any information whatsoever concerning the condition of his company.<sup>312</sup>

Like most states, Mississippi only requires a corporation to provide a shareholder with financial information upon his written request.<sup>313</sup> The RMA adopts a considerably more detailed and burdensome requirement. Under section 16.20, every corporation is required annually to furnish each shareholder its annual financial statements, including a balance sheet as of the end of the fiscal year, an income statement for that year, and a statement of changes in shareholders' equity for that year.<sup>314</sup> The corporation must mail the statements within 120 days of the end of the year to existing shareholders and thereafter during the ensuing year to any new shareholder who makes a written request.<sup>315</sup> Under the RMA, this obligation is mandatory and cannot be altered by the articles or bylaws.

While the intent of the RMA is laudable, I believe that it places an unnecessary burden on many closely-held corporations, the shareholders of which may be generally familiar with the corporation's condition due to their active participation in its affairs. On the other hand, I do not believe that simply leaving mandatory disclosure to the arena of the federal securities laws is the appropriate answer since many corporations which should legitimately be considered as publicly-held would not

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<sup>311</sup> Under § 12(g)(1) of the Act, every issuer with total assets exceeding \$1,000,000 and a class of equity security held of record by 500 or more persons must register that security. 15 U.S.C. § 781(g)(1982). By rule the asset threshold was increased to \$3,000,000 in 1982, 17 C.F.R. § 240.12 g-1 (1986), and to \$5,000,000 in 1986. 51 Fed. Reg. 25,360 (1986).

<sup>312</sup> See, e.g., MISS. CODE ANN. § 79-3-63 (1972)(no mention of necessity of disclosure when soliciting proxies); FREY, CHOPPER, LEACH & MORRIS, *supra* note 53, at 428-29 (outlining proxy solicitation procedure). Indeed the inadequacy of state law in this area was a primary impetus to the promulgation of the proxy regulations of the SEC.

<sup>313</sup> Under Section 99 of the MBCA, a shareholder is entitled to receive the corporation's "most recent financial statements showing in reasonable detail its assets and liabilities and the results of its operations." MISS. CODE ANN. § 79-3-99 (1972). The overwhelming majority of states follow this pattern. 4 REVISED MODEL BUSINESS CORP. ACT ANN. 1773-74 (3d ed. 1985).

<sup>314</sup> REVISED MODEL BUSINESS CORP. ACT § 16.20(a)(1984). The statements are not absolutely required to be prepared on the basis of generally accepted accounting principles (GAAP), but must be if those prepared for the corporation itself are. *Id.*

<sup>315</sup> *Id.* § 16.20(c).

meet the filing requirements of the 1934 Act.<sup>316</sup> Thus, I would recommend the adoption of section 16.20, with a *de minimis* exception allowing corporations with fewer than a specified number of shareholders (perhaps fifty) to waive the mandatory requirement in their bylaws, while retaining the requirement that the same information be provided to any shareholder upon written request.<sup>317</sup> This would eliminate what might be an unnecessary formality in the truly closely-held business, while encouraging frank disclosure from the management of the larger company to its shareholders.<sup>318</sup>

### III. CONCLUSION—PART ONE

The first part of this article has attempted to expose a variety of areas of the MBCA which are in need of improvement or modification. The second part will undertake a similar goal in the areas of capitalization, organic changes, shareholder litigation, and the problems of the closely-held business.

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<sup>316</sup> See *supra* note 311.

<sup>317</sup> Cf. CAL. CORP. CODE § 1501(a)(West Supp. 1986)(permitting corporations with fewer than 100 shareholders to waive mandatory requirement).

<sup>318</sup> To be sure, one objection to mandatory disclosure is that management may bear liability for inaccurate information, even to a shareholder who may have no interest in that information in the first instance. See Murphy, *supra* note 125, at 135 (discussing alternatives for complete mandatory disclosure). While the possibility of second-guessing is inherent in any disclosure requirement, the RMA, unlike the federal proxy rules, has no express provision dealing with false and misleading statements. In any event, a *de minimis* exception is likely to allay many of these concerns, since most larger companies would be likely to employ an outside accountant, and no certification by management would be required in that instance. See REVISED MODEL BUSINESS CORP. ACT § 16.20(b) (1984). In the smaller corporation, it seems unlikely that a court would impose substantial liability for good faith errors by a corporate official who is not a trained professional accountant. See *id.* official comment (noting different standards which should be applied to professionals and non-professionals under this provision).