Changes in the Model Business Corporation Act—Proposed Advance of Expenses
Amendments to Sections 8.53 and 8.54

By the Corporate Laws Committee, ABA Business Law Section*

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

The Committee has approved the changes described in this report on second reading and invites comments from interested persons. Comments should be addressed to Karl John Ege, Chair, Corporate Laws Committee, 1201 Third Avenue, Suite 4900, Seattle, WA 98101-3099, or sent to him by e-mail at kege@perkinscoie.com. Comments should be received by July 31, 2014, in order to be considered by the Committee before adoption of the amendments on third reading.

The proposed amendments to section 8.53 address the prerequisites for advancing expenses to directors and officers, and are being proposed at a time when the volume and cost of litigation have continued to increase dramatically. Such amendments eliminate the requirement in subsection (a) that a director or officer seeking advancement provide a written affirmation that he or she has met the applicable standards for indemnification under the Model Act, or, in the case of a director, that the proceeding involves conduct for which liability has been eliminated under the articles of incorporation. The amendments do not, however, eliminate a corporation’s ability to require such an affirmation. Section 8.53 will continue to require that a director or officer seeking advancement provide a written undertaking to repay funds advanced if it is ultimately determined that such individual is not entitled to indemnification. The repayment undertaking has been, and will remain, the cornerstone for protecting the corporation’s interests when it advances expenses. Amended subsection (a) applies to both permissive and obligatory expense advancement, like the current subsection.

The Committee recognizes that there is a range of viewpoints on whether to require a written affirmation in connection with advancement. For example, those who believe an affirmation should not be statutorily required point out that advances to pay legal expenses are typically requested during the early stages

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of a proceeding, when few facts underlying a claim are available to either the corporation or the individual seeking advancement, raising the question of the value provided by the affirmation. Also, directors and officers who expect advancement to be available face the risk, under the current provision, that a corporation obligated to advance such individual’s legal expenses (whether pursuant to a provision in its articles of incorporation or bylaws, a resolution adopted by the board or shareholders, or a contract approved by the board or shareholders) will challenge an affirmation in order to deny advancement. Related to that risk is the phenomenon of “mini-trials” under section 8.54 concerning entitlement to advancement. Such preliminary proceedings often result in duplicative litigation, since they address many of the issues involved in the underlying proceedings; strain judicial resources; and may place undue pressure on a director or officer with limited financial resources.

Accordingly, the Committee is recommending amendments to section 8.53 that enable each corporation to make its own determination as to the prerequisites, if any, for advancement, beyond the written repayment undertaking.

Eliminating the affirmation requirement is consistent with the views expressed in the Official Comments to the advancement provisions of the Model Act that (a) an individual serving a corporation in a representative capacity should not be required to finance his or her own defense, (b) adequate legal representation often involves substantial expenses during the course of a proceeding, and (c) many individuals will not be willing to serve as directors or senior officers in the absence of rights to advancement.

In considering the prerequisites for advancement under the Model Act, it is important to distinguish advancement from indemnification. Advancement is prospective, while indemnification is retrospective and based upon known facts. Advancement is neither dependent upon nor determined by whether a party is entitled to indemnification.

Following the adoption of the proposed amendments in a jurisdiction, a corporation with articles of incorporation or bylaws explicitly requiring a written affirmation should consider whether it wishes to retain that requirement or avail itself of the flexibility afforded by the amended statute.

The proposed amendments, including related changes to section 8.54, are set forth below. Changes to the existing provisions are marked with additions shown by underscored and deletions shown by strikethrough.

§8.53. ADVANCE FOR EXPENSES

(a) A corporation may, before final disposition of a proceeding, advance funds to pay for or reimburse expenses incurred in connection with the proceeding by an individual who is a party to the proceeding because that individual is a member of the board of directors if the director delivers to the corporation-
(1) a signed written affirmation of the director’s good faith belief that the relevant standard of conduct described in section 8.51 has been met by the director or that the proceeding involves conduct for which liability has been eliminated under a provision of the articles of incorporation as authorized by section 2.02(b)(4); and

(2) a signed written undertaking of the director to repay any funds advanced if (i) the director is not entitled to mandatory indemnification under section 8.52 and (ii) it is ultimately determined under section 8.54 or section 8.55 that the director has not met the relevant standard of conduct described in section 8.51 is not entitled to indemnification.

(b) The undertaking required by subsection (a)(2) must be an unlimited general obligation of the director but need not be secured and may be accepted without reference to the financial ability of the director to make repayment.

(c) Authorizations under this section shall be made:

(1) by the board of directors:

(i) if there are two or more qualified directors, by a majority vote of all the qualified directors (a majority of whom shall for such purpose constitute a quorum) or by a majority of the members of a committee consisting solely of two or more qualified directors appointed by such a vote; or

(ii) if there are fewer than two qualified directors, by the vote necessary for action by the board in accordance with section 8.24(c), in which authorization directors who are not qualified directors may participate; or

(2) by the shareholders, but shares owned by or voted under the control of a director who at the time is not a qualified director may not be voted on the authorization.

CROSS-REFERENCES

Committees of the board, see § 8.25.
“Corporation” defined, see § 8.50(1).
Court-ordered indemnification, see § 8.54.
Determination of indemnification, see § 8.55.
“Director” defined, see § 8.50(2).
“Expenses” defined, see § 1.40.
Limits on indemnification and advance for expenses, see § 8.58(c).
Obligatory advancement, see § 8.58(a).
“Party” defined, see § 8.50(5).
“Proceeding” defined, see § 8.50(6).
“Qualified director” defined, see § 1.43.
Quorum of directors, see § 8.24(a).
Standard for indemnification, see § 8.51.

OFFICIAL COMMENT

Section 8.53 authorizes, but does not require, a corporation to pay for advance or reimburse, in advance, a director’s reasonable expenses if two conditions are met. This authorization is subject to the delivery of the repayment undertaking required by subsection (a) and any limitations set forth in the articles of incorporation pursuant to section 8.58(d). The repayment undertaking required by section 8.53 is also required in connection with obligatory advancement pursuant to section 8.58(a).

Section 8.53 recognizes an important difference between indemnification and an advance for expenses: indemnification is retrospective and, therefore, enables the persons determining whether to indemnify to do so on the basis of known facts, including the outcome of the proceeding. Indemnification may include reimbursement for non-advanced expenses. Advance for expenses is necessarily prospective and, in situations where advancement is not obligatory, the individuals making the decision whether to advance expenses authorize expense advancement generally have fewer known facts on which to base their decision. Indemnification may include reimbursement for non-advanced expenses.

Section 8.53 reflects a determination that it is sound public policy to permit the corporation to advance (by direct payment or by reimbursement) the defense expenses of a director so long as the director (i) believes in good faith that the director was acting in accordance with the relevant standard for indemnification set forth in section 8.51 or that the proceeding involves conduct for which liability has been eliminated pursuant to section 2.02(b)(4) and (ii) agrees to repay any amounts advanced if it is ultimately determined that the director is not entitled to indemnification. This policy is based upon the view that a person who serves an entity in a representative capacity should not be required to finance his or her own defense. Moreover, adequate legal representation often involves substantial expenses during the course of the proceeding and many individuals are willing to serve as directors only if they have the assurance that the corporation will advance these expenses. In fact, Accordingly, many corporations enter into contractual obligations (e.g., by a provision in the articles or bylaws or by individual agreements) to advance expenses for directors. See section 8.58(a).

Section 8.53 requires the director’s signed written confirmation as to the good faith belief that the director has met the relevant standard of conduct necessary for indemnification by the corporation and a signed. A single written undertaking by the director to repay any funds advanced if it is ultimately determined that such standard of conduct has not been met. A single undertaking pursuant to subsection (a) may cover all funds advanced from time to time in connection with the proceeding. Under subsection (b), the undertaking need not be secured and financial ability to repay is not a prerequisite. The theory underlying
this subsection (b) is that wealthy directors should not be favored over directors whose financial resources are modest. The undertaking must be made by the director and not by a third party. If the director or the corporation wishes some third party to be responsible for the director's obligation in this regard, either is free to make those arrangements separately with the third party.

In the absence of an advancement is not obligatory provision established pursuant to section 8.58(a), the decision to advance expenses must be made in accordance with subsection (c). Section 8.53 does not address the question of the standard by which the decision to advance expenses is to be made. Accordingly, the standards of section 8.30 should, in general, govern. The conditions for advance for expenses are different from the conditions for indemnification. Directors normally meet the standards of section 8.30 in approving an advance for expenses if they limit their consideration to the financial ability of the corporation to pay the amount in question and do not have actual knowledge of facts sufficient to cause them to believe that the subsection (a)(1) affirmation was not made in good faith. The directors are not required by section 8.30 to make any inquiry into the merits of the proceeding or the good faith of the belief stated in that affirmation. Thus, in the great majority of cases, no special inquiry will be required. The decision of directors acting on a request for advancement. In making such a decision to advance expenses, the directors may, but are not required to, consider any additional matters they deem appropriate and may condition the advance of expenses upon compliance with any additional requirements they desire to impose believe are appropriate, including, for example, an affirmation of a requesting director's good faith belief that he or she is entitled to indemnification under section 8.51.

A corporation may obligate itself pursuant to section 8.58(a) to advance for expenses under section 8.53 by means of a provision set forth in its articles of incorporation or bylaws, by a resolution of its shareholders or board of directors, or by a contract or. Unless provided otherwise. However, any such section 8.58(a) deems a general obligatory arrangement must comply with provision requiring indemnification to the requirements of subsection (a) regarding furnishing of an affirmation and fullest extent permitted by law, even if not specifically mentioned, subject to providing the required repayment undertaking. No other procedures are required or contemplated, although obligatory arrangements may include notice and other procedures in connection with advancement of expenses and indemnification requests any other requirements that the directors believe are appropriate.

At least one court has held that a general obligatory provision requiring indemnification to the extent permitted by law does not include advance for expenses if not specifically mentioned. See, e.g., Advanced Mining Systems, Inc. v. Fricke, 623 A.2d 82 (Del. 1992). Unless provided otherwise, section 8.58(a) requires the opposite result, unless provided otherwise.

The advancement is not obligatory, the decision to advance expenses is required to be made only one time with respect to each proceeding rather than each time a request for payment of expenses is received by the corporation.
However, the directors are free to reconsider the decision at any time (e.g., upon a change in the financial ability of the corporation to pay the amounts in question). The decision as to the reasonableness of any expenses may be made by any officer or agent of the corporation duly authorized to do so.

The procedures set forth in subsection (c) for authorizing an advance for expenses parallel the procedures set forth in section 8.55(b) for selecting the person or persons to make the determination that indemnification is permissible. If the advance for expenses is not authorized by the shareholders under subsection (c)(2), the applicable procedure specified in subsection (c)(1)(i) must be used. If it is unavailable, then the procedure under subsection (c)(1)(ii) may be used.

Under subsection (c)(1)(i), the vote required when the qualified directors act as a group is an absolute majority of their number. A majority of the qualified directors constitutes a quorum for board action for this purpose.

The committee of two or more qualified directors referred to in subsection (c)(1)(i) may be a committee of the board of directors to which the power to authorize advances for expenses from time to time has been delegated, so long as (1) the committee was appointed by a majority vote of directors who were, at the time of appointment of the committee, qualified directors and (2) each advance is authorized by a majority vote of members of the committee who, at the time of the vote, are qualified directors.

Under subsection (c)(1)(ii), which is available only if subsection (c)(1)(i) is not available, the board’s action must be taken in accordance with section 8.20 or section 8.21, as the case may be, and directors who are not qualified directors may participate in the vote. Allowing directors who at the time are not qualified directors to participate in the authorization decision, if there is no or only one qualified director, is a principle of prudence that is based on the concept that, if there are not at least two qualified directors, then it is preferable to return the power to make the decision to the full board (even though it includes non-qualified directors) than to leave it with one qualified director.

**Illustration 1:** The board consists of 15 directors, four of whom are non-qualified directors. Of the 11 qualified directors, nine are present at the meeting at which the authorization is to be made (or the committee is to be appointed). Under subsection (c)(1)(i), a quorum is present and at least six of the nine qualified directors present at the board meeting must authorize any advance for expenses because six is an absolute majority of the 11 qualified directors. Alternatively, six of the nine qualified directors present at the board meeting may appoint a committee of two or more of the qualified directors (up to all 11) to decide whether to authorize the advance. Action by the committee would require an absolute majority of the qualified directors appointed as members of the committee.

**Illustration 2:** The board consists of 15 directors, only one of whom is a qualified director. Subsection (c)(1)(i) is not available because the number of qualified directors is less than two. Accordingly, the decision must be made by the board under subsection (c)(1)(ii) (or, as is always permitted, by the shareholders under subsection (c)(2)).
Authorizations by shareholders rather than by directors are permitted by With respect to shareholder authorizations under subsection (c)(2), but the prohibition on voting shares owned by or voted under the control of directors who at the time are not qualified directors may not be voted on the authorizations. This does not affect general rules, as to the required presence of a quorum at the meeting, otherwise governing the authorization.

The fact that there has been an advance for expenses does not determine whether a director is entitled to indemnification. Repayment of any advance is required only if it is ultimately determined that the director did not meet the relevant standard of conduct in section 8.51. A proceeding will often terminate without a judicial or other determination as to whether the director's conduct met the applicable standard of conduct in section 8.51. Nevertheless, the board of directors should make, or cause to be made, an affirmative determination of entitlement to indemnification at the conclusion of the proceeding. This decision should be made in accordance with the procedures set forth in section 8.55.

Judicial enforcement of rights granted by or pursuant to section 8.53 is specifically contemplated by section 8.54.

§ 8.54. COURT-ORDERED INDEMNIFICATION AND ADVANCE FOR EXPENSES

(a) A director who is a party to a proceeding because he or she is a director may apply for indemnification or an advance for expenses to the court conducting the proceeding or to another court of competent jurisdiction. After receipt of an application and after giving any notice it considers necessary, the court shall:

1. order indemnification if the court determines that the director is entitled to mandatory indemnification under section 8.52;
2. order indemnification or advance for expenses if the court determines that the director is entitled to indemnification or advance for expenses pursuant to a provision authorized by section 8.58(a); or
3. order indemnification or advance for expenses if the court determines, in view of all the relevant circumstances, that it is fair and reasonable
   (i) to indemnify the director, or
   (ii) to advance expenses to the director,
   even if, in the case of (i) or (ii), he or she has not met the relevant standard of conduct set forth in section 8.51(a), failed to comply with section 8.53 or was adjudged liable in a proceeding referred to in subsection 8.51(d)(1) or (d)(2), but if the director was adjudged so liable indemnification shall be limited to expenses incurred in connection with the proceeding.
(b) If the court determines that the director is entitled to indemnification under subsection (a)(1) or to indemnification or advance for expenses under subsection (a)(2), it shall also order the corporation to pay the director’s expenses incurred in connection with obtaining court-ordered indemnification or advance for expenses. If the court determines that the director is entitled to indemnification or advance for expenses under subsection (a)(3), it may also order the corporation to pay the director’s expenses to obtain court-ordered indemnification or advance for expenses.

**CROSS-REFERENCES**

Advance for expenses, see § 8.53.
“Corporation” defined, see § 8.50(1).
“Director” defined, see § 8.50(2).
“Expenses” defined, see § 1.40.
Limits on indemnification and advance for expenses, see § 8.58(c).
Mandatory indemnification, see § 8.52.
Obligatory indemnification, see § 8.58(a).
“Party” defined, see § 8.50(5).
Permissible indemnification, see § 8.51.
“Proceeding” defined, see § 8.50(6).

**OFFICIAL COMMENT**

Section 8.54(a) provides for court-ordered indemnification in three situations:

1. A director is entitled to mandatory indemnification under section 8.52. If so, the director may enforce that right by judicial proceeding.

2. A director is entitled to indemnification or advance for expenses pursuant to a provision in the articles or bylaws, board or shareholder resolution, or contract. If so, the director may enforce that right by judicial proceeding. To the extent that these rights are contractual, the corporation may have contractual defenses. If the corporation has contracted to indemnify a director to the fullest extent permitted by law, a court may, nevertheless, deny an advance for expenses if it determines that the director did not have, at the time of delivering the affirmation required by section 8.53(a)(1), a good faith belief that he or she met the relevant standard of conduct.

3. A court in its discretion determines that it is fair and reasonable under all the relevant circumstances to order an advance for expenses or indemnification for the amount of a settlement or judgment (in addition to expenses), whether or not the director met the relevant standard of conduct in section 8.51 or is otherwise ineligible for indemnification. However, there are two exceptions: an adverse judgment in a derivative proceeding (section 8.51(d)(1)) and an adverse judgment in a proceeding...
charging receipt of an improper financial benefit (section 8.51(d)(2)), although in either case the court may order payment of expenses. Thus, with these exceptions, section 8.54(a)(3) permits a court to order indemnification for amounts paid in settlement of and expenses incurred in connection with a derivative proceeding or a proceeding charging receipt of an improper financial benefit. Section 8.54(a)(3) applies to (a) a situation in which a provision in the articles of incorporation, bylaws, resolution, or contract obligates the corporation to indemnify or to advance expenses but the relevant standard of conduct has not been met and (b) a situation involving a permissive provision pursuant to which the board declines to exercise its authority to indemnify or to advance expenses. However, in determining whether indemnification or expense advance would be “fair and reasonable,” under section 8.54(a)(3), a court should give appropriate deference to an informed decision of a board or committee made in good faith and based upon full information. Ordinarily, a court should not determine that it is “fair and reasonable” to order indemnification or expense advance where the director has not met conditions and procedures to which he or she agreed.

The discretionary authority of the court to order indemnification of a derivative proceeding settlement under section 8.54(a)(3) contrasts with the denial of similar authority under section 145(b) of the Delaware General Corporation Law. A director seeking court-ordered indemnification or expense advance under section 8.54(a)(3) must show that there are facts peculiar to his or her situation that make it fair and reasonable to both the corporation and to the director to override an intra-corporate declination or any otherwise applicable statutory prohibition against indemnification, e.g., sections 8.51(a) or (d).

Aside from the two exceptions noted above and other than the fairness and reasonableness requirement, there are no statutory outer limits on the court’s power to order indemnification under section 8.54(a)(3). In an appropriate case, a court may wish to refer to the provisions of section 2.02(b)(4) establishing the outer limits of a liability-limiting charter provision in the articles of incorporation. It would be an extraordinary situation in which a court would want to provide indemnification beyond the limits of section 2.02(b)(4), but if the court, as the independent decision maker, finds that it is “fair and reasonable,” then the court is permitted to do so. It should be emphasized again, however, that the director seeking indemnification must make a showing of fairness and reasonableness and that exercise of the power granted by section 8.54(a)(3) is committed to the court’s discretion.

Among the factors a court may want to consider under section 8.54(a)(3) are the gravity of the offense, the financial impact upon the corporation, the occurrence of a change in control or, in the case of an advance for expenses, the in-
ability of the director to finance a defense. A court may want to give special attention to certain other issues. First, for example, has the corporation joined in the application to the court for indemnification or an advance for expenses? This factor may be particularly important where under section 8.51(d) indemnification is not permitted for an amount paid in settlement of a proceeding brought by or in the right of the corporation. Second, also, in a case where indemnification would have been available under section 8.51(a)(2) if the corporation had adopted a provision authorized by section 2.02(b)(5), was the decision to adopt such a provision presented to and rejected by the shareholders and, if not, would exculpation of the director's conduct have resulted under a section 2.02(b)(4) provision? Third, additionally, in connection with considering indemnification for expenses under section 8.51(d)(2) in a proceeding in which a director was adjudged liable for receiving a financial benefit to which he or she was not entitled, was such financial benefit insubstantial—particularly in relation to the other aspects of the transaction involved—and what was the degree of the director's involvement in the transaction and the corporate decision to participate?

Under section 8.54(b), if a director successfully sues to enforce the right to indemnification of expenses under subsection (a)(1) or to indemnification or advance for expenses under subsection (a)(2), the court must order the corporation to pay the director's expenses in the enforcement proceeding. However, if a director successfully sues for indemnification or advance for expenses under subsection (a)(3), the court may (but is not required to) order the corporation to pay the director's expenses in the proceeding under subsection (a)(3). The basis for the distinction is that the corporation breached its obligation in the first two cases but not in the third.

Application for indemnification under section 8.54 may be made either to the court in which the proceeding was heard or to another court of appropriate jurisdiction. For example, a defendant in a criminal proceeding who has been convicted but believes that indemnification would be proper could apply either to the court which heard the criminal proceeding or bring an action against the corporation in another forum.

A decision by the board of directors not to oppose the request for indemnification is governed by the general standards of conduct of section 8.30. Even if the corporation decided not to oppose the request, the court must satisfy itself that the person seeking indemnification is entitled to or otherwise deserving of receiving it under section 8.54.

As provided in section 8.58(cd), a corporation may limit the rights of a director under section 8.54 by a provision in its articles of incorporation. In the absence of such a provision, the court has general power to exercise the authority granted under this section.