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Mandatory Indemnification of Corporate Officers and Directors

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Most state general corporation statutes permit a corporation to indemnify its directors, officers, employees, and agents for expenses incurred in defending actions for personal liability arising from activities in their official capacities. New York was the first state to enact indemnification legislation. Its statutes furnished a limited right to indemnification, and permitted a corporation to provide for indemnification in its bylaws or charter. Delaware's original indemnification statute, enacted in 1943, and copied by many states, was repealed in 1967 and has been replaced with a statute similar to the Model Code provision. All but two states now have enacted indemnification provisions. The indemnification statutes vary in content, but can be classified into two categories, permissive or "enabling" statutes, which give a corporation the power to indemnify its officers or directors under certain circumstances, and mandatory or "right" statutes, which give the officer or director an enforceable right to indemnification when statutory standards of conduct are met. Some statutes, known as exclusive statutes, permit indemnification only as prescribed by the statute, while the more common nonexclusive statutes acknowledge the right of the corporation to indemnify in circumstances not expressly described in the statute. In a few

1. The Appendix lists the state indemnification statutes now in effect. There is no general common law rule entitling directors and officers of a corporation to indemnification. For a discussion of the treatment at common law of agreements to indemnify, see G. Washington & J. Bishop, Indemnifying the Corporate Executive 75-111 (1963) [hereinafter cited as Washington & Bishop]; H. Henn, Handbook of the Law of Corporations 800-04 (2d ed. 1970).

3. Id.
5. ABA-ALI Model Bus. Corp. Act Ann. § 5 (2d ed. 1971). The indemnification provision of the Model Business Corporation Act was revised in 1967. The committee responsible for drafting the Model Act provisions consulted with the Delaware Corporation Revision Commission responsible for the 1967 Delaware revision. As a result, the resulting Model Act § 4(a), now § 5, is almost identical to § 145 of the 1967 Delaware General Corporation Act.
6. Idaho and New Hampshire have no indemnification statutes.
8. The right is generally considered to be limited by public policy. The Appendix lists the statutes which are exclusive and those which are nonexclusive.
exclusive type statutes indemnification is mandatory up to the limits of the particular statute. 9

Most of the recently enacted statutes place more restrictions on the power of a corporation to indemnify for expenses arising from defending derivative suits than those arising from third-party actions, 10 a distinction many of the early statutes did not make. 11 The newer statutes also define more specifically the minimum standards of conduct which must be met before indemnification may be awarded by a corporation or ordered by a court. Even among the modern statutes, however, significant differences exist as to the discretion given the corporation in its decision to indemnify. The indemnification statutes of California 12 and New York 13 are examples of restrictive types, while the Delaware statute 14 and the Model Act provisions, 15 which are almost identical, are among the most permissive. 16 An analysis of the mandatory provisions of state indemnification statutes which grant insiders a statutory right to indemnification where certain conditions have been met is necessary to reveal the possible hidden traps for both management and shareholders. Of particular interest are court decisions interpreting and applying the statutes.

The mandatory indemnification provisions of three states, New York, California, and Delaware, will be compared in part I of this Comment. These statutes were chosen as representative statutes and also because of the large number of businesses incorporated in each of these states. These modern statutes will be contrasted with the Texas statute, an example of the old Delaware-type statute. In part II of this Comment problems of judicial interpretation of important terms of the older and the newer versions of indemnification statutes will be discussed. The suggestion that policies underlying federal securities law conflict with indemnification allowed under some of the statutes will be considered in part III.

10. Under DEL. CODE ANN. tit. 8, § 145 (1974), for example, a corporation may indemnify against fines, judgments and settlement payments in addition to legal expenses if the expenses arose from defense of a third-party suit. The rationale is that the director or officer could have been acting in the best interests of his corporation when he committed the offense. In a derivative suit, however, the corporation may not indemnify the executive for settlement payments or legal expenses incurred in an unsuccessful defense. To permit indemnification under such circumstances would tend to nullify the effect of the derivative suit. See generally E. FOLK, THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS 98-104 (1972); Sebring, Recent Legislative Changes in the Law of Indemnification of Directors, Officers and Others, 23 BUS. LAW. 95 (1967).
15. ABA-ALI MODEL BUS. CORP. ACt ANN. § 5 (2d ed. 1971).
16. At least 25 states have enacted indemnification provisions substantially like the Delaware and the Model Act provisions. See the Appendix.
I. THE STATUTORY FRAMEWORK

A. The Texas Statute

The Texas indemnification statute,\textsuperscript{17} patterned after the original Delaware statute, authorizes a corporation to indemnify a director or officer against expenses incurred in "any action, suit, or proceeding" in his official capacity, except where he was "adjudged in such action, suit or proceeding to be liable for negligence or misconduct in performance of duty."\textsuperscript{18} The statute is permissive rather than mandatory, and is nonexclusive. It does not distinguish between derivative suits and third-party actions,\textsuperscript{19} or between civil and criminal actions. Corporate employees and agents are not included. In 1973 the Texas statute was amended to provide that a corporation may purchase indemnification insurance on behalf of its officers, directors, employees, or agents, "whether or not the corporation would have the power to indemnify [them] against such liability under the provisions of this Article."\textsuperscript{20}

B. The New York, California, and Delaware Statutes

These three statutes are representative of the modern indemnification statutes, and they are likely to serve as patterns for other states wishing to amend their existing indemnification statutes.\textsuperscript{21} An understanding of the courts' interpretation and application of these statutes is, therefore, very important. Few indemnification claims are actually litigated, except in states where the court procedure is exclusive.\textsuperscript{22} Indemnification of insiders\textsuperscript{23} by corporations most frequently occurs under the authority of the permissive sections. The typical statutory pattern is to allow some disinterested person

\textsuperscript{17} TEX. BUS. CORP. ACT ANN. art. 2.02(A)(16) (1955), as amended, (Supp. 1975).
\textsuperscript{18} Id.
\textsuperscript{19} The term "derivative suit" is used to mean a suit by a shareholder to enforce a corporate cause of action, while the term "third-party suit" refers to actions other than by or in the right of the corporation.
\textsuperscript{20} TEX. BUS. CORP. ACT ANN. art. 2.02(A)(16), as amended, (Supp. 1975). For a discussion of indemnification insurance, see Knepper, Corporate Indemnification and Liability Insurance for Corporation Officers and Directors, 25 Sw. L.J. 240 (1971).
\textsuperscript{21} Many states already have statutes patterned after the Delaware or the Model Act provisions. See the Appendix.
\textsuperscript{22} California's court procedure is exclusive for claims arising from defending derivative suits. The corporation may indemnify without a court proceeding when the claim arises from defending a third-party suit. CAL. CORP. CODE § 830(f) (West Supp. 1975).
\textsuperscript{23} The term "insider" is used to represent those persons explicitly covered by each indemnification statute. Under Delaware's statute, directors, officers, agents, and employees are included. The statute also covers directors and officers of other corporations who serve at the request of the indemnifying corporation, and directors and officers of subsidiary corporations. The New York statute covers only directors and officers, but specifically reserves the rights to indemnification that employees and agents have under common law agency principles. N.Y. BUS. CORP. LAW § 721 (McKinney 1963), and comment thereto. In Sandfield v. Goldstein, 33 App. Div. 376, 308 N.Y.S.2d 25 (1970), aff'd, 28 N.Y.2d 794, 270 N.E.2d 723, 321 N.Y.S.2d 904 (1971), a manager of a corporation was denied mandatory reimbursement under the statute by the corporation for legal fees incurred in defending a stockholders' derivative action. The California statute includes directors, officers, and employees.
or group to make a determination that the insider has not breached his fiduciary duty to the corporation. The disinterested group is usually composed of the directors who are not involved in the litigation, the shareholders of the corporation, or independent legal counsel.24

Under a Delaware-type provision the corporation's shareholders often never learn of the reimbursement and never have the opportunity to contest the payment. California and New York, however, give the court power to require the corporation to notify shareholders that a claim for indemnification has been instituted.25 Claims for mandatory indemnification usually reach the courts only if a shift in corporate management has occurred and the new management refuses to indemnify the director or officer.26 When a suit for mandatory indemnification is brought, clear, equitable statutory standards are essential. The three mandatory indemnification provisions under discussion differ principally in two areas: the degree of court discretion allowed to deny or grant indemnification, considering all the circumstances of the case, and the related statutory right to partial indemnification, when a defense has been partially successful.

California's statute is the most restrictive of the three states under consideration. Section 830(a) gives an insider a statutory right to indemnification only where two conditions are met: "(1) the person sued is successful in whole or in part, or the proceeding against him is settled with the approval of the court, [and] (2) [t]he court finds that his conduct fairly and equitably merits such indemnity."27 The indemnification granted is for reasonable expenses incurred in the litigation, including attorney's fees.28 The California statute also imposes the prerequisite of a court proceeding when indemnification is sought for expenses arising from a derivative suit.29 While the court has discretion to refuse indemnification if the success was on a technical basis,30 partial indemnification is possible under the statute to the extent that the court deems it justified. The California statute is an exclusive indemnification statute, so the corporation may not provide indemnification in ways not prescribed by the statute.31 By interposing the court's discretion, the statute enhances the protection of shareholders against the possibility that


25. The New York statute requires the corporation to notify the shareholders of the indemnification payments if indemnification is not ordered by a court. N.Y. BUS. CORP. LAW § 726(c) (McKinney 1963). Bishop cites the General Motors' bylaw as the only corporate bylaw of which he has knowledge that requires that the stockholders be informed of indemnification payments. Bishop, supra note 24, at 1079-80.

26. When a state has a permissive statute, a corporation can make indemnification a matter of contract with its executives, either by corporate charter or bylaw, or by a separate agreement.

27. CAL. CORP. CODE § 830(a) (West Supp. 1975).

28. Id.

29. CAL. CORP. CODE §§ 830(e), (f) (West Supp. 1975).

30. Examples of technical grounds for success are the running of the statute of limitations and deficiency in an indictment.

an executive who has not acted in the best interest of the company may receive indemnification from corporate funds.32

New York’s present indemnification provision, enacted in 1963, is exclusive and contains both permissive and mandatory sections.33 It has been described as “[an] example of a legislative effort to restrict indemnification to insiders who deserve it.”34 Section 724 gives a statutory right to indemnification where a director or officer is “wholly successful, on the merits or otherwise, in the defense of a civil or criminal action.”35 Thus, a director or officer who has breached a fiduciary duty to his corporation but who has been completely successful on technical grounds is entitled to indemnification and a court must grant it if sought. The rationale generally expressed for such a provision is that a director or officer should not be forced to incur the expense of a defense on the merits when a technical defense would suffice.36 The director or officer who has been partially successful and whose corporation refuses to indemnify him may seek court-ordered indemnification under section 725,37 which gives the court power to order indemnification under circumstances in which the corporation itself could have indemnified.38 Thus, where only partial indemnification is sought, the New York court has statutory standards of good faith conduct to use as a guide and is not required to indemnify automatically those defendants who were successful on technical grounds. New York’s mandatory indemnification provision differs from California’s principally in that California gives the court discretion in every case where mandatory indemnification is sought, whereas New York courts have such discretion only when partial indemnification is sought.39 Another significant difference between the two statutes is that New York permits a corporation to modify the mandatory indemnification by a provision in its corporate documents in effect when the cause of action against the director or officer allegedly accrued,40 whereas Cali-

32. The California statute has been described as an attempt to prevent abuses to which the corporate treasury might be vulnerable under a Delaware-type provision. Washington & Bishop 138. For further analysis of the California statute see Knepper, supra note 20, at 243-44.
35. N.Y. Bus. Corp. Law § 724(a) (McKinney 1963). This codifies prior New York case law which interpreted the word “success” in the earlier New York statute to include success due to a technical defense. See cases cited at note 70 infra and accompanying text.
36. See, e.g., E. Folk, supra note 10, at 100. This rationale presupposes that the executive would have won on the merits. If the insider has breached his fiduciary duty to the corporation, the California procedure is preferable insofar as shareholders’ interests are concerned because the court has discretion to deny the award if not deserved.
38. See id. §§ 722, 723 detailing the circumstances under which a corporation may indemnify. The permissive sections, 722 and 723, become mandatory when read in conjunction with § 725.
39. An additional difference is that the New York statutes define more explicitly the standards of conduct to be met for an award of indemnification, whereas in the California court proceeding the standard in addition to success is simply that his conduct “fairly and equitably merits such indemnity.” Compare N.Y. Bus. Corp. Law §§ 722, 723 (McKinney 1963), with Cal. Corp. Code § 830(a) (West Supp. 1975).
fornia expressly disallows a corporation's attempt to modify the operation of the statute.41

The Delaware Corporation Law, extensively revised in 1967, contains permissive and mandatory provisions for indemnification.42 Sections 145(a) and (b) permit the corporation to indemnify in third-party actions when a good-faith standard is met43 and in derivative suits, under more restrictive circumstances.44 Section 145(c) supplies mandatory indemnification against expenses (including attorneys' fees) "to the extent that the director, officer, employee or agent of a corporation has been successful on the merits or otherwise in defense of any action, suit, proceeding referred to in subsections (a) or (b), or in defense of any claim, issue or matter therein."45 This grants an enforceable statutory right to indemnification in a broader range of situations than the California or New York statutes.46 Only the Delaware statute gives an enforceable right to partial indemnification without a court's determination that indemnification is merited under the circumstances of the case, or that a requisite standard of conduct has been met. If the insider meets the "success" criteria on any "claim, issue or matter" the court must grant indemnification.47

According to its drafters, Delaware's mandatory indemnification section was enacted primarily to protect vindicated directors and officers from a statute is exclusive, the corporation could not provide for indemnification beyond the limits of the statute or in contravention of its terms. For further analysis of the New York statute, see Knepper, supra note 20, at 244-46.

41. CAL. CORP. CODE § 830(e) (West Supp. 1975).
42. DEL. CODE ANN. tit. 8, § 145 (1974). The Delaware indemnification provision is nonexclusive. Id. § 145(f). For a discussion of what the nonexclusive provision was intended to cover, see Bishop, supra note 24, at 1085; Folk, supra note 10, at 100-01. For an interesting application of the nonexclusive provision, see text at notes 115-21 infra. 43. Del. Code Ann. tit. 8, § 145(a) (1974).
44. Id. § 145(b).
45. Id. § 145(c).
46. However, Delaware's provisions do not contain the equivalent of New York's § 725, which gives the court the authority to order indemnification in circumstances where the corporation could have indemnified but did not. In New York, an insider whose corporation refuses to indemnify him when he has been unsuccessful can seek a court determination that even though unsuccessful, he met the applicable standard of duty to the corporation and thus is entitled to indemnification. Under the Delaware statute, the corporation's finding would be final. In California it appears that the result would be like that in New York.

Another difference among the statutes should be mentioned. As a result of New York's § 725, giving a court-enforceable right to indemnification where the corporation could have indemnified but did not, it would be possible for an insider to receive indemnification for the amount of fines and judgments, as well as for legal expenses, in a mandatory proceeding. The Delaware and California mandatory statutes cover only expenses. Ordinarily, legal expenses far exceed fines and judgments, so the difference will usually not cause too much discrepancy.

47. The words "claim, issue or matter" leave some room for court interpretation. Assume, for example, that a shareholders' derivative suit were brought against an officer claiming $50,000 damages under one count and $50,000 on a separate count and one count was dismissed. Presumably, the court would be required to award expenses for the defense of the successful count, if mandatory indemnification were sought. If, however, the complaint alleged $100,000 damages on a single theory or count but the jury awarded $50,000, the court might well find that the defense had not been successful on a single claim. For further analysis of the Delaware statute see Knepper, supra note 20, at 241-43.
refusal to indemnify them when an adverse shift in management occurs.\(^48\)

The statute, however, does not limit its application to the situation where a shift in management has occurred.\(^49\) The mandatory section suggested by Professor Ernest L. Folk, III, the Reporter to the Delaware Corporation Law Revision Commission, would have incorporated the restrictions and good faith requirements of sections 145(a) and (b).\(^50\) This was rejected, and section 145(c), as enacted, is considerably more favorable to management than the version recommended by Professor Folk. Under section 145(c) an insider who has been successful wholly or partially on a technical defense may demand and receive indemnification, including legal fees, notwithstanding the standards of conduct in (a) and (b) that must be met if the corporation chooses to indemnify. An underlying policy for the enactment of an indemnification provision favorable to management was the desire to attract incorporators for the State of Delaware.\(^51\)

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48. See, e.g., Sebring, supra note 10, at 100; cf. Mooney v. Willys-Overland Motors, Inc., 204 F.2d 888, 898 (3d Cir. 1953); Essential Enterprises Corp. v. Automatic Steel Prods., Inc., 39 Del. Ch. 371, 379, 164 A.2d 437, 441-42 (1960). Legislative background of the reasons for the enactment of the Delaware mandatory provision is limited. A 1963 Delaware statute authorized the secretary of state to spend $25,000 to study revisions in the Delaware Corporation Law. Law of December 31, 1963, ch. 218, [1963] 54 Del. Laws 724. The secretary of state formed the Delaware Corporation Law Revision Commission to study and formulate proposed revisions. The Commission chose a reporter, Ernest L. Folk, III, whose published report contains the only detailed comments on the reasons for enacting the mandatory provision. E. FOLK, REVIEW OF THE DELAWARE CORPORATION LAW (1968). For a detailed account of the process of drafting and the composition and background of the members of the revision committee, see Comment, Law for Sale: A Study of the Delaware Corporation Law of 1967, 117 U. PA. L. REV. 861 (1961). The Delaware Law Revision Commission's final recommendation was passed unanimously by the legislature, and no legislative history or official explanation was published. Id. at 869-70. Several members of the Revision Commission published articles or books explaining the new law, but the mandatory section is explained by most of these drafters simply as giving vindicated directors and officers an enforceable right to indemnification in the event of a shift in management. See, e.g., S. ARSHT & W. STAPLETON, ANALYSIS OF THE NEW DELAWARE CORPORATION LAW (1967); E. FOLK, THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS (1972); Arsht & Stapleton, Delaware's New General Corporation Law: Substantive Changes, 23 BUS. LAW. 75 (1967); Canby, Delaware's New Corporation Law, 39 PA. B. ASS'N Q. 380 (1968).

49. Professor Folk indicated that the provision was desirable where "a change of management refuses to indemnify old management personnel in situations where indemnity would be proper; or if a by-law is unduly and needlessly restrictive on indemnity . . . or where management hesitates to indemnify voluntarily for some or no reason." E. FOLK, REVIEW OF THE DELAWARE CORPORATION LAW 91-92 (1968).

50. Professor Folk suggested the following provision: "A director or officer or employee who has been wholly successful on the merits or otherwise, in defense of any action, suit, or proceeding, or in defense of any claim, issue or matter therein, shall be entitled to indemnification as provided in subsections (a) and (b) of this section." Id. at 96 (emphasis added). Subsections (a) and (b) contained the standards of conduct for permissive indemnification. Under Professor Folk's proposed statute, mandatory indemnification would not be available to a director or officer who had not met those standards. Folk also suggested that if a right to indemnification were provided for the successful executive, "it could easily be provided further that the court may also allocate indemnifiable expenses and items when a director is adjudicated liable as to some but not all claims to the extent that the court deems fair and equitable." Id. at 88 (emphasis added). Professor Folk's final draft did not give the court such discretion.

51. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 663 (1974); Comment, supra note 48. In the same bill that authorized expenditures for a revision study of the corporation statutes, Delaware's legislature declared it to be the public policy of the state "to maintain a favorable business climate and to encourage corporations to make Delaware their domicile." Law of Dec. 31, 1963, ch. 218, [1963]
II. PROBLEMS OF INTERPRETATION

A. INTERPRETING THE OLD STATUTES

One reason for the enactment of the new Delaware statute was that the original Delaware statute failed to resolve several important issues. For example, the old statute was silent as to whether it was exclusive or nonexclusive, that is, whether the corporation had the power to indemnify in situations not expressly covered by the statute. Also, the statute did not specify whether indemnification was permitted in all forms of actions against directors, such as criminal proceedings or derivative suits. As the Delaware statute served as a prototype for so many other state indemnification statutes, these problems still persist in many jurisdictions.

The present Texas indemnification statute is almost identical to the original Delaware statute, except for a 1973 amendment to the Texas Act which permits a corporation to purchase indemnification insurance for its directors, officers, and certain other persons, even though the corporation itself may not be authorized by the statute to indemnify the executive. Although the Texas Bar Committee responsible for drafting revisions to the Texas Business Corporation Act considered an extensive revision of the Texas indemnification statute in 1973, the insurance amendment was the only new provision submitted to the legislature. The statute under consideration was similar to the current Delaware-Model Act provision. Due to objections from some members of the Committee as to the breadth of situations where indemnification would be authorized, the Committee did not report the entire bill to the legislature for approval, but revision of the statute is almost certain to be considered again soon. Because of the uncertainty as to the scope of the Texas statute as it stands, with the exception of the express authorization for insurance, many corporations will

54 Del. Laws 724. Professor Folk's report to the Commission described a mandatory indemnification section as "a feature by which the Delaware Statute would gain added attractiveness." E. Folk, supra note 49, at 91.
57 See Appendix.
59 Id. The insurance provision is similar to a provision in the current Model Act and Delaware codes. Many writers have questioned the propriety of permitting a corporation to use its funds to buy insurance against situations in which it could not indemnify directly. See note 137 infra.
60 Committee on Revision of Corporation Law of the State Bar Section on Corporation, Banking and Business Law.
63 According to Lebowitz, supra note 59, the Committee decided not to submit a proposed indemnification statute to the legislature until 1977.
find that indemnification insurance is the most desirable method of handling the problem of indemnification in Texas.\textsuperscript{61}

\section*{B. Interpreting the Modern Statutes}

In interpreting its modern indemnification statute, the Delaware superior court recently reached a result which suggests that the Model Act-Delaware type statutes should be drafted more carefully.\textsuperscript{62} Among the important problems of interpretation of the Delaware-type statute are the problems of interpreting the meaning of "successful defense," and the related issue of the proper treatment of a suit for indemnification by a director or officer who has pleaded nolo contendere\textsuperscript{63} to the charges against him.

\textit{Successful Defense.} Under each of the three modern statutes discussed herein, a successful defense is a prerequisite to mandatory indemnification.\textsuperscript{64} Under the Delaware statute the standard for indemnification as of right is "successful on the merits or otherwise."\textsuperscript{65} In New York, it is "wholly successful, on the merits or otherwise,"\textsuperscript{66} while in California, the standard is "successful in whole or in part."\textsuperscript{67} Since indemnification may be obtained by showing a "successful defense" to a suit, the meaning of the term is critical in Delaware and New York. The courts in California have discretion to refuse the award even where a defense was successful if they find from all the circumstances of a case that indemnification is not merited.

The problem of interpreting the term "successful defense" arose originally in New York under its older indemnification statute.\textsuperscript{68} The New York courts treated the statutory term "successful" in a literal fashion.\textsuperscript{69} In several cases under the old statute, directors were awarded indemnification where a suit was dismissed for technical reasons, such as the running of the statute of limitations.\textsuperscript{70} The present New York statute expressly provides that the

\textsuperscript{61} To date, no Texas cases have interpreted the Texas indemnification provision. For a discussion of indemnification insurance, see Knepper, \textit{supra} note 20; Lebowitz, \textit{supra} note 59, at 749-52.

\textsuperscript{62} See notes 87-96 infra and accompanying text.

\textsuperscript{63} Nolo contendere is a plea in a criminal action by which the defendant does not contest the charge and thereby may be sentenced as if he had been found guilty.

\textsuperscript{64} One exception is New York's § 725, which when considered in conjunction with §§ 722 and 723 allows a court to order indemnification where the director or officer has not been successful, but nevertheless has met the good faith standards of conduct toward his corporation. \textit{N.Y. Bus. Corp. Law} § 725 (McKinney 1963).

\textsuperscript{65} \textit{Del. Code Ann. tit. 8, § 145(c) (1974).}

\textsuperscript{66} \textit{N.Y. Bus. Corp. Law} § 724 (McKinney 1963).

\textsuperscript{67} \textit{Cal. Corp. Code} § 830(a) (West Supp. 1975). Settlement with court approval is an alternative to success.

\textsuperscript{68} The standard for indemnification under the predecessor of the present New York statute was "successful prosecution or defense." Law of April 14, 1941, ch. 350, § 1, [1941] \textit{N.Y. Laws} 164th Sess. 1034, 1035 (repealed 1945).

\textsuperscript{69} \textit{WASHINGTON \\& BISHOP} 151.

success may be on the merits or otherwise, which would include technical defenses.

Since the enactment in Delaware of the mandatory provision, the question of what constitutes a "successful" defense has been presented in three important cases. In *Merritt-Chapman & Scott Corp. v. Wolfson* the claimants seeking indemnification had been convicted on five counts of violating the federal securities laws. In the indictment on count one, charging conspiracy to violate federal securities laws, several elements were included, but at the conclusion of the Government's case, the 10b-5 fraud element was removed by the court from that count. The jury returned guilty verdicts for all three directors under the conspiracy count with its remaining elements. The directors sought indemnification under section 145(c) of the Delaware law, contending that the removal of the 10b-5 fraud element constituted success. The Delaware superior court denied indemnification, finding it difficult to understand the defendants' claim of success, when they had been charged with and convicted of conspiracy on count one. The court described section 145 as having been enacted "to give vindicated directors and officers involved in corporate affairs a judicially enforceable right to indemnification. It would be anomalous, indeed, and diametrically opposed to the spirit and purpose of the statute and sound public policy to extend the benefits of indemnification to these defendants under the facts and circumstances of this case." The court thus limited the construction which could be given to the "claim, issue, or matter" element of the Delaware partial indemnification statute.

In *Galdi v. Berg* a defendant in a stockholders' derivative suit in federal district court in Delaware sought indemnification under section 145(c) when

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71. *See N.Y. Bus. Corp. Law § 724* (McKinney 1963), and comment thereto.
74. SEC rule 10b-5 makes it a federal offense to make statements, omissions, or to engage in any course of conduct which operates on persons as a fraud or deceit in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b-5 (1975).
75. 264 A.2d at 359.
76. *Id.*
77. *Id.* at 360.
78. *Id.*
79. *Id.*
the derivative claim against him was dismissed without prejudice because the company was actively pursuing the claim against the defendant in another proceeding. The other suit had not been resolved, and the court found it "clear that the dismissal of count five in the action decided nothing with respect to the allegations of wrongdoing by Power or any other defendant." Quoting Professor Folk's statement that the purpose of the statute was to give vindicated directors the right to indemnification, the court said dismissal of the count did not vindicate the defendant; rather, the charge was "simply erased." Indemnification in such situations would thus not fall within the underlying purpose of section 145, as construed in the Wolfson case. The Galdi court thus refused to extend "success on the merits or otherwise" to include a dismissal without prejudice where the identical cause of action was apparently being vigorously pursued by the same parties in another proceeding.

In 1974 an indemnification suit brought by four persons against Merritt-Chapman & Scott, three of whom were claimants in the earlier Wolfson case, reached the Delaware superior court. The guilty verdicts in the first suit had been reversed on appeal, and in two retrials, the juries had failed to agree on a verdict. Following the second retrial, Wolfson pleaded nolo contendere to count five, and the other four counts against him were dropped. He received a fine of ten thousand dollars and a suspended sentence of eighteen months. Defendant Gerbert agreed not to appeal his conviction on count three, and the other charges against him were dropped. He received a fine of two thousand dollars and a suspended sentence of eighteen months.

Wolfson and Gerbert sought indemnification for the expenses incurred in defending the dropped counts under section 145(c). Merritt-Chapman & Scott argued that the statute and sound public policy permit indemnification only where the person has been vindicated, not where some of the charges were dropped for practical reasons. The court, however, granted indemnification for the four counts which were dropped, stating: "Success is vindication. In a criminal action, any result other than conviction must be

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82. Id.
83. Id. at 701.
84. E. Folk, supra note 10, at 98.
85. 359 F. Supp. at 702.
86. Id. The indemnification claim was dismissed without prejudice pending the outcome of the other litigation.
89. United States v. Wolfson, 437 F.2d 862 (2d Cir. 1970).
90. 321 A.2d at 140.
91. Id.
92. Id.
93. Id. Charges against the other two claimants in the case had also been dropped as a part of the agreement.
94. Id.
95. Id. at 141.
considered success. Going beyond the result . . . is neither authorized by subsection (c) nor consistent with the presumption of innocence."96 The Delaware court thus interpreted the success standard to include any result other than conviction. This result constituted a broad extension of the meaning of "success" and a seeming departure from the Wolfson and Galdi decisions.

An alternate approach to the "success" question would have been a restrictive interpretation of the term supported by the reference to vindication in earlier Delaware cases,97 Professor Folk's report,98 and the published explanations of the Revision Committee members.99 The Delaware superior court, however, typically does not interpret the state's corporation laws in a manner unfavorable or restrictive to management.100 The court gave lip service to the legislative history of the section by equating success with vindication,101 but this interpretation of vindication would only seem to distort the ordinary meaning of the word.102 The statute clearly authorizes indemnification for technical defenses which do not fit within the vindication category, so it is arguable that the requirement of vindication should not be engrafted onto the statutory criteria of "success." Unfortunately, the statute does not distinguish between defenses based on the running of the statute of limitations, which the drafters intended to cover,103 and dismissals less deserving of indemnification.104

Nolo Contendere Pleas. Among the problems involved in interpreting "successful defense" is determining the appropriate treatment of a plea of nolo contendere upon which a suit demanding indemnification as of right is based. The courts and commentators are not in full accord as to the effect of a nolo contendere plea on indemnification rights;105 however, two separate issues generally arise: (1) the effect of a nolo contendere plea on the right to indemnification for the count on which the plea is entered, and (2) the effect of an agreement in a plea bargaining context whereby the defendant pleads nolo contendere to some counts and others are dropped. The permissive sections of the Delaware and New York statutes explicitly provide that a plea of nolo contendere is not presumptive evidence of an adjudication of

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96. Id.
98. E. FOLK, supra note 10, at 85, 89, 96 n.15.
99. See, e.g., articles cited supra note 48.
100. See Cary, supra note 51.
101. 321 A.2d at 141.
102. WEBSTER'S NEW WORLD DICTIONARY OF THE AMERICAN LANGUAGE (College ed. 1962) defines "vindicate" thus: "(1) to clear from criticism, censure, suspicion, etc.; uphold by evidence or argument."
103. See note 36 supra and accompanying text.
104. See note 70 supra.
misconduct. However, the mandatory provisions are silent as to the effect of a nolo contendere plea. The California statute does not mention the effect of a nolo contendere plea on a suit for indemnification.

Count on Which the Plea is Entered. The question of the effect of a nolo contendere plea on a claim for mandatory indemnification arose under a former New York statute in Schwarz v. General Aniline & Film Corp. Schwarz, a director who had pleaded nolo contendere to a criminal antitrust prosecution under the Clayton Act, sought indemnification for the expenses of his defense. The court denied indemnification, finding the nolo contendere plea to be “an adjudication that petitioner was liable for ‘misconduct in the performance of his duties’ within the meaning of section 64 . . . .” The New York court of appeals, in a 4-3 decision, affirmed the denial of indemnification on the ground that the statute was not intended to cover criminal proceedings. Under the present New York statute, a defendant who has pleaded nolo contendere would not meet the “wholly successful” standard of mandatory section 724. If his corporation refused to indemnify him, he could seek a court order for indemnification under section 725, which empowers the court to order indemnification to the extent the corporation could have granted it. In a third-party context the statute explicitly states that a nolo contendere plea does not in itself create a presumption that the applicable standards of conduct were not met. Therefore, the New York court could examine the underlying facts in any mandatory indemnification proceedings involving a plea of nolo contendere.

In Delaware the question of a nolo contendere plea was raised in Merritt-
In addition to seeking indemnification for the counts which had been dropped, Wolfson and Gerbert sought indemnification for expenses incurred in defense of the unsuccessful counts, contending that a bylaw of the corporation effectively made mandatory the permissive indemnification in section 145(a). The pertinent bylaw provided that a director or officer "shall be indemnified . . . except in relation to matters as to which he shall finally be adjudged in such action, suit or proceeding . . . to have been derelict in the performance of his duty as such director or officer." The court recognized a right of indemnification that may exist apart from the statute under section 145(f), the "nonexclusive" provision, and treated the bylaw as granting such a right apart from the statute. However, acknowledging that "[a]lthough a plea of nolo contendere may not be used as an admission in another action, upon acceptance by the court and imposition of sentence there is a judgment of conviction against the defendant," the court held that the "[c]onviction of these offenses" established that the directors had been adjudged derelict in the performance of their duties, and, thus, under the corporation's bylaw they were not entitled to indemnification. Under section 145(a), which authorizes the corporation to indemnify, a nolo contendere plea is not presumptive evidence of breach of duty. By treating the bylaw as independent of the statute the court avoided the necessity of an inquiry of whether the defendant had breached a duty to the corporation. The court said the bylaw, unlike the statute, did not require an inquiry into the circumstances behind the judgment, as the bylaw's standard was adjudication of misconduct.

The position of the dissent in Schwarz seems much more sustainable than the Delaware superior court's, since a nolo contendere plea is not an admission of guilt for purposes other than the criminal prosecution itself, and the indemnification proceeding is a collateral proceeding. A nolo contendere plea might not automatically satisfy a statutory requirement of success, but the holding in Wolfson dealt with a bylaw standard of adjudication of misconduct, rather than a statutory requirement of success. To sustain a finding of misconduct, an inquiry into the circumstances which prompted the plea of nolo contendere is necessary, since factors other than guilt may have been the motivation.

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115. 321 A.2d 138 (Del. Super. Ct. 1974), discussed supra at notes 72-80 and accompanying text. This was the second Wolfson case.
116. Id. at 142.
117. Id. Since the bylaw was worded similarly to the former indemnification statute, in effect when the bylaw was adopted, the bylaw came closer to making mandatory the permissive indemnification of that section, but did not do so as to section 145, the court said. The former statute was Law of April 15, 1943, ch. 125, § 1, [1943] Del. Laws 422 (repealed 1967).
118. 321 A.2d at 143.
119. Id.
120. See note 106 supra.
121. 321 A.2d at 142.
122. See note 111 supra.
123. Note, supra note 105.
124. Id.
under the permissive sections; \textsuperscript{126} common law principles should compel a similar result without the statute. In Delaware, as a result of \textit{Wolfson}, the net result of a nolo contendere plea is that the corporation in a permissive indemnification proceeding may look at the circumstances behind the plea, but a court in a mandatory proceeding may not. The ultimate effect in Delaware may be that the most extensive use of the mandatory section will be by corporations, not in court proceedings. By noting that the success standard of subsection (c) has been met, such as by dismissal of some charges, a corporation could avoid making the determination as to whether the fiduciary standard of (a) and (b) had been satisfied. \textsuperscript{126} Such a use completely thwarts the protective measures set up in the permissive sections. \textsuperscript{127} The California indemnification proceeding provides for an inquiry into the underlying circumstances in every case of indemnification, either by the court, or, in third-party suits, by the corporation. \textsuperscript{128} It is questionable what effect a nolo contendere plea would have under the California statute, where the standard is success in whole or in part or settlement with court approval. \textsuperscript{129} The court could conceivably treat a nolo contendere plea as a settlement with court approval, since the court is not required to accept a plea of nolo contendere.

\textit{The Plea Bargaining Context.} Different considerations are involved when indemnification is sought for those counts which have been dropped as part of an agreement with the prosecution. In the second \textit{Wolfson} case, \textsuperscript{130} a nolo contendere plea to one count was entered following an agreement with the prosecution by which the other four counts were dropped. \textsuperscript{131} On the four counts which were dropped, the Delaware court found itself bound by the

\begin{enumerate}
\item \textit{Del. Code Ann. tit. 8, § 145(a) (1974).}
\item The corporation could reason that it was required to indemnify by the mandatory section. Interview with Alan Bromberg, Professor of Law at Southern Methodist University, in Dallas, Texas, Oct. 31, 1974.
\item It appears at first glance that in Delaware, only the court has the power, and moreover is required, to indemnify where good faith standards are not met but some charges have been dropped; a corporate charter or bylaw that agreed to indemnify in a nolo contendere plea bargaining situation could not be permitted under section 145(a) unless the fiduciary standard had been met. However, the \textit{Wolfson} court recognized that a right to indemnification could exist apart from the statute. It can be argued that if the court can grant indemnification under a given set of circumstances, such indemnification is not beyond the limits of public policy, and could be written into the corporate charter under the authority of the nonexclusive provision in § 145(f). The Delaware court in \textit{Wolfson} discovered no public policy of the state which would prohibit such a result. Furthermore, as indicated earlier, the corporation, by taking notice that a court would be required to indemnify under the circumstances, could avoid making its determination that a good faith standard of conduct had been met. If the court could award indemnification, it should not be without the bounds of public policy for the corporation to voluntarily indemnify under the same circumstances. However, the corporation would probably construe the success standard much more loosely than would a court. The corporation might ask its legal counsel, or the legal counsel of the person seeking indemnification, to stipulate that he had been successful.
\item \textit{Id.} § 830(a).
\item \textit{Id.} at 140.
\end{enumerate}
statutory criteria of success on "any claim, issue, or matter," and held that success had to be inferred where charges were dismissed. The Delaware court's holding seems consistent with the statutory treatment of technical defenses. Under the Delaware statute, a successful technical defense to a single count clearly requires the court to grant partial indemnification, and dropped counts in this context are similar to defenses based on the bar of the statute of limitations, or other technical defenses. The New York and California partial indemnification provisions seem preferable to Delaware's in this respect because under the New York and California statutes a court faced with the Wolfson fact situation could inquire into the merits of the defendant's claim.

III. FEDERAL POLICY LIMITS ON MANDATORY INDEMNIFICATION

The effect of indemnification against legal expenses of an unsuccessful defense on the interests of the shareholders of a corporation is a question of state corporation law. However, the policies embodied in federal securities law may conflict with the indemnification permitted by state corporation law. The SEC's rule indicates disapproval of indemnification of expenses incurred in unsuccessful defenses. Statutes which authorize corporations to purchase indemnification insurance for executives, to cover situations which the corporation would not be permitted to indemnify directly, have been heavily criticized as undermining the policy of the federal statutes. Mandatory indemnification as authorized in the Delaware statute and as awarded in Wolfson may also conflict with such policies.

Since only expenses are reimbursable under section 145(c), the problem of reimbursement of fines incurred by the insider is not squarely presented by the Delaware mandatory indemnification statute. It can be argued that

133. Id.
134. One possible treatment of the nolo contendere plea is Judge Fuld's idea that such a plea is a settlement agreement with the state, rather than a conviction. The dropped counts could then be treated as part of the settlement agreement. However, this approach would probably not change the result in either New York, California, or Delaware. In California, settlement with court approval, plus a finding that indemnification is merited, entitles one to indemnification. In New York indemnification is possible following settlement of a suit if the requisite standards of conduct have been met. But in Delaware the mandatory indemnification section does not refer to settlement as a circumstance under which indemnification can be obtained.
136. See note 144 and accompanying text.
138. See notes 87-96 supra and accompanying text.
the federal statutory policy is not thwarted by the reimbursement of legal expenses alone. Even where liability was incurred under a statute whose policy is deterrence, disallowing reimbursement of legal expenses may not be an appropriate way to enforce compliance with the law. A penalty or fine is assessed in proportion to the severity of the offense. Forcing the insider to bear his own legal expenses increases the penalty, not in proportion to culpability, but in relation to the quality of the defense and the difficulty of defending against the charge. It can also be argued that the ends of criminal justice are served when a person vigorously defends a charge leveled against him. The arguments supporting denial of indemnification of expenses of unsuccessful litigation are the additional deterrence provided and the reality that legal expenses often far exceed the fines levied, so that indemnification would take most of the "sting" from a conviction.

Where the defense is successful, certainly no federal policy is thwarted by reimbursement of expenses. If expenses for an unsuccessful defense are not to be reimbursed because clearly defined federal policy is undermined thereby, then the definition of success assumes great importance. The Securities and Exchange Commission may not agree with the type of definition of success the Delaware courts have given the partial indemnification statute. The Commission has taken the position that it is against public policy to indemnify a director or officer against "liabilities incurred" in connection with the issuance of a prospectus under the Securities Act of 1933. Under the SEC's rule 460, a condition to acceleration under section 8(a) is that claims to indemnification arising out of the issuance of a prospectus must be waived, or a printed statement must appear on the registration statement that claims for indemnification will be submitted to a court for approval. However, the rule does not clearly prohibit indemnification.

140. Note, supra note 139, at 1411-12; Note, supra note 137, at 660-61; cf. Commissioner v. Tellier, 383 U.S. 687 (1966), where the Supreme Court held that legal expenses incurred in the unsuccessful defense of a criminal securities charge were deductible as ordinary and necessary business expenses for federal income tax purposes. The Court said that no public policy is violated when a person hires a lawyer to defend against a criminal charge, and that deductions for legal expenses would be permitted unless allowance of the deduction frustrated some sharply defined public policy.

141. Section 11 of the Securities Act was intended to deter negligence in the preparation of registration statements. See 3 L. Loss, SECURITIES REGULATION 1831 (1961). If one of the purposes of the statute is compensation to the plaintiff, the argument for indemnification becomes stronger. Reimbursement for liability for non-willful violations of rule 10b-5, for example, should not offend public policy. See Bishop, New Problems in Indemnifying and Insuring Directors: Protection Against Liability Under the Federal Securities Laws, 1972 DUKE L.J. 1153, 1165.

142. Note, supra note 139, at 1411-12.

143. In the Wolfson case the fines incurred by Wolfson and Gerbert were $10,000 and $2,000, respectively. The legal fees charged were $250,000 per trial, and there had been three trials. The law firm attributed 10% of its fee to the defense of the unsuccessful counts. 321 A.2d at 143.

144. 17 C.F.R. § 230.460, note (a) (1975).

145. Acceleration is a discretionary process whereby the SEC can allow amendments to a registration statement to become effective before expiration of the normal twenty-day waiting period. It is essential that acceleration of the price amendment be allowed because the price must be listed in the statement and it is almost impossible to set it twenty days before sale. See 1 L. Loss, supra note 141, at 277.

146. 17 C.F.R. § 230.460, note (a) (1975).
against expenses. The rule does except from its prohibition "payment by the registrant of expenses incurred or paid by a director, officer or controlling person of the registrant in the successful defense of any action, suit or proceeding," thus seeming to indicate SEC disapproval of reimbursement of legal expenses in an unsuccessful defense. The SEC's approval of indemnification for expenses in a "successful defense of any action" may not extend to partial indemnification or indemnification for expenses where success was based on technical grounds. The SEC's position, however, is inconsistent to the extent that it permits indemnification insurance to be purchased by the corporation.

The first case declaring an indemnification agreement invalid due to a conflict with federal securities laws was *Globus v. Law Research Service, Inc.* The trial judge in this case struck down the jury's award of indemnification because enforcement of an indemnification agreement between an issuer and an underwriter, where the underwriter had been found guilty of misconduct, would have violated the public policy embodied in the federal securities legislation. Both the district court and the Second Circuit limited their holdings, however, to the situation where the underwriter had been found guilty of misconduct involving omissions, false and misleading statements, and wanton indifference to its obligations and the rights of others. The indemnification agreement struck down provided for reimbursement of legal expenses as well as for other liabilities, but neither the district court nor the Second Circuit mentioned the possibility of allowing reimbursement of legal expenses; the entire agreement was held unenforceable.

The possibility seems remote that a statute permitting indemnification for partial success or success on technical grounds will be held by a court to be violative of policies of federal securities law. First, *Globus* struck down an indemnification agreement because the indemnitee was guilty of gross negligence, and no case has yet extended that holding to the situation of a merely negligent violation of the securities laws. Second, since reimbursement of legal fees of a successful defendant would not thwart any federal policy, striking down an indemnification statute such as Delaware's would involve quibbling over the definition of success, a fairly refined distinction. As noted earlier, rule 460 is not clear on this point, so no definitive policy of the Securities and Exchange Commission exists at present on the subject.

147. *Id.*
149. *Kroll, supra* note 137, at 689, suggests that the SEC's position on insurance reflects a balancing consideration between the need to compensate the victim and the need to deter.
151. 287 F. Supp. at 199.
152. 418 F.2d at 1287 n.14.
153. *See* text accompanying notes 151-52 *supra*.
154. *See* notes 140-42 *supra* and accompanying text.
155. *See* text accompanying note 149 *supra*. 
Third, even if the SEC took a firm position against reimbursement of expenses of an unsuccessful defendant, carefully defined, the question remains whether reimbursement of legal expenses can constitutionally be denied an unsuccessful litigant.\textsuperscript{156} Furthermore, if the Securities and Exchange Commission begins acting to strike down indemnification agreements, more companies will turn to indemnification insurance, which has the approval of the SEC.\textsuperscript{157}

IV. CONCLUSION

The mandatory indemnification statutes of Delaware, and the similar Model Act provisions in effect in many states, give persons who have breached their fiduciary duty to the corporation an enforceable right to indemnification in some instances. The Delaware statute’s inflexible standard of success is inadequate in a situation like that presented in \textit{Wolfson}. Corporate management as well as the courts seem to be needlessly restricted by the Delaware court’s treatment of the nolo contendere plea. Where the executive has pleaded nolo contendere for reasons other than guilt, he has no recourse if his corporation unjustly refuses to indemnify him. If an undeserving director or officer negotiates an agreement with the prosecution whereby some counts are dropped, the corporation will be powerless to prevent the \textit{Wolfson} result. The New York indemnification provision is superior to Delaware’s in this respect, in that it allows a corporation to change the mandatory result by express charter provision. For states whose policy is to protect the interests of the shareholders of a corporation, the New York and California statutes seem preferable to that of Delaware. Giving a court

\textsuperscript{156} See note 140 supra.

\textsuperscript{157} The Securities and Exchange Commission might intervene to oppose an indemnification agreement. In \textit{Feit} v. \textit{Leasco Data Processing Equipment Corp.}, 332 F. Supp. 544 (E.D.N.Y. 1971), the SEC intervened to oppose a proposal by Leasco to pay a judgment and plaintiff’s legal fees totalling $330,000 without seeking contribution from the three directors found jointly liable with Leasco under a section of the 1933 Securities Act for negligently failing to include material information in the registration statement filed in connection with the exchange offer. The court eventually approved an agreement whereby each director paid Leasco $5,000 “in satisfaction of any claims that Leasco may have against said defendants for contribution.” Order, Civil No. 69-1329 (E.D.N.Y., July 31, 1972). The SEC could seek an injunction against an indemnification agreement under its power to obtain injunctive relief against violations of the Securities Acts. Securities Act of 1933, \S\ 20(b), 15 U.S.C. \S\ 77(t) (1970); Securities Exchange Act of 1934, \S\ 21(e), 15 U.S.C. \S\ 78(u) (1970). However, this possibility seems remote due to the narrowness of the issue—the definition of success—and the fact that there presently is no definitive SEC position on the subject. If the mandatory indemnification had been sought by someone who had agreed to operate under the restrictions of rule 460, the SEC could oppose indemnification as a matter of breach of agreement, and the agreement to be interpreted would be the terms of rule 460. If that rule were not involved, the SEC might seek to enjoin the indemnification merely on the basis of the policy of the Act.

Shareholders of the defendant corporation might intervene in a suit for indemnification if they knew about the suit, which is unlikely under the Delaware statute. However, shareholders may not have standing to raise the issue of the SEC policy. If the corporation had made indemnification a matter of contract with the officer or director, it might be estopped from raising the defense. Even if standing were not a problem, the unclear position of the SEC would make difficult an argument that the policy of the SEC was being violated.
discretion to deny or award indemnification based on the underlying circumstances of the case, at least when the defense is only partially successful, may prevent undeserving executives from receiving indemnification as a matter of statutory right. The strained arguments that the nolo contendere plea is a settlement, and that the statutory standard of success should be limited by the word "vindication," would be unnecessary if the court had discretion to look into the circumstances behind the nolo contendere plea both on the count in which entered and on the counts dropped. Unless prosecutors refuse to bargain, the Wolfson formula will be very attractive to indicted management where Delaware law applies. Because the conflict with securities law is a refined and narrow conflict, the chance of its litigation by the SEC is remote at the present time, and the probability of a corporation's successfully raising the issue is small. Thus, the matter at the present time remains largely a problem of state corporation law.

APPENDIX

Indemnification Provisions

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