Commentary from the Bar

ELIMINATION OR LIMITATION OF DIRECTOR LIABILITY FOR DELAWARE CORPORATIONS

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I. Introduction

On June 18, 1986, the Governor of the State of Delaware signed into law Senate Bill No. 533 which, among other things, amended section 102 of the Delaware General Corporation Law (General Corporation Law) to add a new subsection (b)(7). The amendment, which became effective July 1, 1986, permits a Delaware corporation to include in its original certificate of incorporation (or an amendment thereto) a provision which limits or eliminates a director's personal liability to a corporation or its stockholders for breach of his or her fiduciary duty of care as a director in certain circumstances. The new section 102(b)(7) is intended to assist Delaware corporations attract and retain highly qualified individuals to serve as directors. Many corporations have since taken advantage of this section by adopting amendments which limit or eliminate director liability for breach of fiduciary duty.[1] This article reviews the limited history of section 102(b)(7), evaluates the purposes and effects of charter provisions authorized by that section, and analyzes various alternatives for responding to this recent authorization.[2]

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1. As reported in 1 Corporate Counsel Weekly (BNA) No. 48, at 1 (Dec. 10, 1986) [hereinafter Corporate Counsel Weekly], 75% of Delaware corporations responding to a survey by the American Society of Corporate Secretaries intend to seek stockholder approval for amendments authorized by § 102(b)(7). *See also* Levin, *Board Liability in Delaware*, N.Y. Times, Jan. 15, 1987, at D2, col. 1.

2. Section 145 of the General Corporation law, which permits Delaware corporations to indemnify officers and directors for defending suits arising out of their corporate service, was also amended effective July 1, 1986. Although indemnification of directors and officers, on one hand, and limitation or elimination of director liability as authorized by § 102(b)(7), on the other hand, are often considered in unison, the two aspects of director protection are indeed separate and distinct. Considerations of indemnification of officers and directors and of § 145 generally are beyond the scope of this article. For a further discussion of the relationship between §§ 102(b)(7), 145, and directors' liability insurance, see Veasey, Finkelstein

II. BACKGROUND AND LEGISLATIVE HISTORY

Section 145(g) of the General Corporation Law permits a Delaware corporation to purchase and maintain insurance on behalf of its directors and officers against liability incurred in their corporate capacity, regardless of whether the corporation would have the power to indemnify against such liability under Delaware law.[3] Directors' and officers' insurance could, for example, encompass liability incurred in connection with a stockholder derivative action even though such indemnification is generally limited under Delaware law.[4]

The market for directors' and officers' liability insurance has, however, changed dramatically over the past several years.[5] Despite the statutory authorization for Delaware corporations to purchase and maintain directors' and officers' liability insurance, many corporations have experienced difficulties in obtaining or maintaining sufficient coverage at a reasonable cost. Many insurers offering director and officer liability insurance have withdrawn from that market or have restricted the coverage offered.[6] As a result many corporations have been forced to accept insurance with lower dollar limits of coverage, higher deductible amounts, and broader policy exclusions at a significantly higher cost.[7]

The source of this insurance dilemma has been attributed by various commentators to a number of factors, ranging from market

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& Bigler, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399 (1987).

3. DEL. CODE ANN. tit. 8, § 145(g) (Supp. 1986) (amended 1986). Section 145(g) provides:

> A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the corporation would have the power to indemnify him against such liability under this section.

4. *See id.* § 145(b).

5. *See Corporate Liability Crisis*, Wall St. J., Aug. 21, 1986, at 22 [hereinafter *Corporate Liability Crisis*]; *The D&O Crisis: Corporate Boardroom Woes Grow*, Nat'l L.J., Aug. 4, 1986, at 1 [hereinafter *D&O Crisis*]. *See also* Block, Barton & Garfield, *Advising Directors on the D&O Crisis*, 14 SEC. REG. L.J. 130 (1986).

6. *See* Hilder, *Liability Insurance is Difficult to Find Now for Directors, Officers*, Wall St. J., July 10, 1985, at 1, col. 6.

7. *Id.*

forces within the insurance industry[8] to decisions by various courts.[9] The contraction and restriction in the director and officer liability insurance market has been exacerbated by an increase in the number of corporate mergers, acquisitions, and other extraordinary corporate transactions, as well as the litigation those transactions entail. Traditionally directors' actions in addressing such extraordinary corporate actions are afforded the protection of the business judgment rule.[10] Recent court decisions, however, have made clear that courts will scrutinize the decisions of a director in this context, even where directors can demonstrate that they acted in good faith and not out of self-interest. For example, the Delaware Supreme Court in *Smith v. Van Gorkom*[11] found that the board of directors of Trans Union Corporation breached their fiduciary duty of care in approving a proposed cash merger and held members of the board *personally* liable for the resulting damages.[12] Subsequent court decisions in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[13] *Hanson Trust PLC v. MC*

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8. *See D&O Crisis*, *supra* note 5, at 1.

9. *See Corporate Liability Crisis*, *supra* note 5, at 22.

10. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). In general, the business judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Where the business judgment rule is applicable, the "business decisions" of disinterested directors "will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment." Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). *See* R. BALOTTI & J. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.6 (1986) [hereinafter R. BALOTTI & J. FINKELSTEIN] (further discussion of business judgment rule).

11. 488 A.2d 858 (Del. 1985). The court found the board grossly negligent in that the directors had failed to fully inform themselves of "all material information reasonably available to them," *id.* at 872, and had acted hastily in approving the proposed merger, after two hours' consideration, without reviewing the proposed merger agreement or obtaining documentation to support the adequacy of the merger price. *Id.* at 874. The director defendants ultimately settled the case for $23.5 million, of which only $10 million was covered by directors' and officers' liability insurance. *See* R. BALOTTI & J. FINKELSTEIN, *supra* note 10, § 4.7 (detailed discussion of *Van Gorkom* case).

12. *Van Gorkom*, 488 A.2d at 893.

13. 506 A.2d 173, 182 (Del. 1985). In *Revlon*, the Delaware Supreme Court determined that the directors of Revlon had breached their fiduciary duty of loyalty to the stockholders in entering into "an auction-ending lock-up agreement" granting

SCM Acquisition, Inc.,[14] *Edelman v. Fruehauf Corp.*,[15] and *Dynamics Corporation of America v. CTS, Inc.*,[16]—all arising out of acquisition proposals for various companies—demonstrate the judicial willingness to second-guess directors' decisions and give directors little comfort in their decision-making processes. Accordingly, directors, officers, and insurers have recognized the potential for increased personal liability on the part of corporate directors for damages arising from breach of fiduciary duties as directors.

Against this background, directors and corporations have faced a proliferation of litigation and increased costs in defending such litigation. The expense of defending these lawsuits, the frequency with which unwarranted litigation is brought against directors, and the inevitable uncertainties with respect to application of the business judgment rule in particular situations may impact upon an individual's willingness to serve as a director of a Delaware corporation. Moreover, these factors have contributed to an atmosphere of uncertainty about the protection afforded directors as they act in good faith to meet their responsibilities. Such uncertainty could force directors to act defensively out of concern over costly personal litigation rather than in directing and managing the business of the corporation. In light of this trend, the substantial judgments against directors in recent years,[17] and the ever increasing amount of in-

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a favored purchaser or "white knight" an option to purchase certain corporate assets at prices well below market value and upheld an injunction against consummation of the lock-up agreement. *Id.* at 185.

14. 781 F.2d 264 (2d Cir. 1986). In *Hanson*, the United States Court of Appeals for the Second Circuit found that the board of directors of SCM Corporation had failed to ensure that a lock-up option had been negotiated by those whose only loyalty was to the shareholders. The court also found that the board had breached their fiduciary duty of care in granting a lock-up option to a management-led group sponsoring a leveraged buy-out of the company. The leveraged buy-out had been proposed as an alternative to a hostile tender offer by Hanson Trust PLC and the court, despite the prior approval of the lock-up option, enjoined execution thereof. The court subjected the SCM board's decision-making process to great scrutiny in determining that the board had breached its fiduciary duty. *Id.* at 277-79.

15. 798 F.2d 882 (6th Cir. 1986). In *Fruehauf*, the board of directors of Fruehauf Corporation was found to have breached its fiduciary duty by approving a management-sponsored leveraged buy-out and in not seeking to obtain the best possible price for stockholders, and the court enjoined the use of corporate funds to effectuate the buyout. *Id.* at 886-87.

16. [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,993 (7th Cir. Nov. 3, 1986).

17. *See, e.g.*, National Fire Ins. Co. v. SeaFirst Corp., No. 85-396R (W.D.

formation which must be considered by directors in their corporate roles, directors are demanding increased protection from personal liability.

Availability of directors' liability insurance is a relatively standard condition of service for many directors unaffiliated with management of a corporation. The importance of liability insurance to directors is underscored by their response to the unavailability of such insurance. Many directors have resigned from their positions or have declined to seek to renew their terms as such when liability insurance is unavailable, and many qualified individuals have refused to accept directorships initially.[18] The general result has been that many qualified individuals have refused to serve as directors.[19]

At the same time, courts have noted the importance of outside directors in providing independent and objective oversight of management and in reaching reasoned business decisions.[20] The Council of the Corporation Law Section of the Delaware State Bar Association (the Council) considered several factors when deciding on the 1986 amendments. These included the crucial role of outside directors in general, the importance of directors' and officers' liability insurance in attracting and retaining competent corporate directors, the current crisis in the directors' and officers' liability insurance market, and the overall threat to the quality and stability of corporate governance in Delaware. In response, the Council considered and rejected various solutions to these concerns for several months.[21] In June 1986, the

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Wash. ____. ____, 1985) ($100 million settlement in action against former officers); *Van Gorkom*, 488 A.2d at 893.

18. *See The Job Nobody Wants*, Bus. Wk., Sept. 8, 1986, at 56 [hereinafter Bus. Wk.]; *Business Struggles to Adopt as Insurance Crises Spreads*, Wall St. J., Jan. 21, 1986, at 31, col. 5; Wall St. J., Aug. 26, 1986, at 32 (reporting resignation of directors due to lack of director's liability insurance).

19. *See* Bus. Wk., *supra* note 18.

20. *See Moran*, 500 A.2d at 1356; *Unocal*, 493 A.2d at 954-55; *cf. Revlon*, 506 A.2d at 176.

21. Among the proposals considered and rejected were amending § 145(b) to permit indemnification of judgments or amounts paid in settlement of derivative suits, amending § 145(g) to permit wholly-owned "captive" subsidiaries to provide "insurance" to the parent corporation, providing a statutory "cap" for personal liability of directors, and providing an automatic statutory exemption from certain types of liability. *See* Veasey & Finkelstein, *New Delaware Statute Allows Limits on Director Liability and Modernizes Indemnification Protection*, 6 BUS. LAW. UPDATE 1-3 (1986). The Council was appointed in 1985 to consider amendments to the General Corporation Law which might remedy the crisis in the directors' and officers'

Council submitted proposed legislation to the Delaware General Assembly which is now embodied in section 102(b)(7).[22] As noted in the synopsis accompanying Senate Bill No. 533:

> Section 102(b)(7) and the amendments to Section 145 represent a legislative response to recent changes in the market for directors' liability insurance. Such insurance has become a relatively standard condition of employment for directors. Recent changes in that market, including the unavailability of the traditional policies (and, in many cases, the unavailability of any type of policy from the traditional insurance carriers) have threatened the quality and stability of the governance of Delaware corporations because directors have become unwilling, in many instances, to serve without the protection which such insurance provides and, in other instances, may be deterred by the unavailability of insurance from making entrepreneurial decisions. The amendments are intended to allow Delaware corporations to provide substitute protection, in various forms, to their directors and to limit director liability under certain circumstances.[23]

The concept that a corporation may, through a provision in its certificate of incorporation, protect its directors from monetary liability for a violation of a fiduciary duty is not a novel one. Indeed, some suggested initially that a corporation's certificate of incorporation could be amended to limit or eliminate director liability without section 102(b)(7)'s enabling power. This theory was predicated upon an analogy to trust law (whereby a settlor or beneficiaries can exempt

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liability insurance market. The Council first weighed amendments which would greatly expand the power of corporations to indemnify officers and directors, but ultimately concluded that permitting stockholders to determine whether to limit or eliminate director liability was a more direct approach in addressing the problem. *See also* Sparks, Johnston & Johnston, *Indemnification, Directors and Officers Liability Insurance and Limitations of Director Liability Pursuant to Statutory Authorization: The Legal Framework Under Delaware Law*, SECURITIES ACTIVITIES OF BANKS 545, 571 (1986) [hereinafter Sparks, Johnston & Johnston].

22. In addition, Indiana, Massachusetts, Michigan, Minnesto, New Jersey, Ohio, Pennsylvania, and Virginia have enacted legislation authorizing provisions similar to § 102(b)(7).

23. *See* DEL. CODE ANN. tit. 8, § 102 (amended 1986) (Synopsis).

Chancery decision.[24] Absent an enabling provision, however, it was questionable under Delaware law whether a corporation could so limit director liability.

A. *Technical Analysis of Section 102(b)(7)*

Section 102(b)(7) enables a Delaware corporation to include in its original certificate of incorporation or an amendment thereto a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director.[25] Additionally, section 102(b)(7) provides that no such provision can eliminate or limit a director's liability (i) for breach of the director's duty of loyalty to the corporation or its stockholders;[26] (ii) for acts or omissions not in good faith or involving intentional misconduct or a knowing violation of law; (iii) for willful or negligent conduct in paying dividends or repurchasing stock out of other than lawfully available funds; or (iv) for any transaction from which the director derives an improper personal benefit.[27]

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24. *See In re* Brazilian Rubber Plantations & Estates, Ltd., 1 Ch. 425 (Ch. 1910) (appearing to permit a corporate charter provision limiting liability).

25. DEL. CODE ANN. tit. 8, § 102(b)(7) (as amended 1986).

26. Directors are charged under Delaware law with the fiduciary duties of care and of loyalty. Under § 102(b)(7), liability for a breach of the duty of care may be limited or eliminated while liability for a breach of the duty of loyalty may not. *Id. See infra* text accompanying notes 28-38.

27. The text of the amended portion of § 102(b)(7) is as follows:

> (b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, a certificate of incorporation may also contain any or all of the following matters:
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> . . . .
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> (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under section 174 of this Title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this subsection to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock.

Section 102(b)(7) is an enabling provision only. Consequently, stockholder approval is required to amend a corporation's certificate of incorporation to include a provision authorized by that section after such has been proposed by the board of directors. It can be argued that a board which proposes a charter amendment pursuant to section 102(b)(7) is "interested," since the individual members of the board will benefit from the elimination of monetary liability which they might otherwise be required to pay absent such an amendment.[28] However, obtaining the required stockholder approval of the amendment after full disclosure of all material facts eliminates any conflict of interest which might otherwise arise.[29] Thus, the ultimate determination as to the propriety of limiting the ability of a corporation or its stockholders to seek monetary damages from directors for breach of fiduciary duty rests with stockholders of the corporation.

Section 102(b)(7) permits limitation or elimination of liability only against actions instituted by the stockholders or by or in the right of the corporation. Consequently, section 102(b)(7) charter amendment does not preclude or limit damages in actions instituted by third parties. Nor does it permit elimination or limitation of monetary damages for officers, employees, or agents of a corporation, and thus the standards of care for these individuals remain the same. Moreover, section 102(b)(7) permits limitation or elimination of monetary liability only for directors acting as directors. Thus, it does not permit limitation of liability for acts or omissions of a director in a capacity other than a director. Actions taken by a director-officer in his capacity as an officer cannot be exempted from liability, nor can actions taken by a majority stockholder in his capacity as such.[30]

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28. A monetary judgment in a derivative action against a board of directors may result in liability for the judgment on the part of such directors. *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). An amendment authorized by § 102(b)(7) would shield a director from such monetary liability if such liability were premised upon a violation of the directors' duty of care. *See also supra* note 27.

29. *See* Findanque v. American Maracaibo Co., 92 A.2d 311, 318-21 (Del. Ch. 1952). The court determined that stockholder ratification of a stock exchange proposal which was not an "interested director transaction" validated the plan and immunized it from future stockholder attack. *Accord* DEL. CODE ANN. tit. 8, § 144 (1974).

30. Some commentators have suggested that with the adoption of a charter amendment authorized by § 102(b)(7), officers of a corporation will be more likely to submit controversial business decisions to a board of directors. Such officers would then rely on director approval of the challenged action to shield themselves from

Section 102(b)(7) does not permit limiting or eliminating liability of a director for any act or omission occurring prior to the effective date of the charter amendment. Therefore, any such amendment will have a prospective effect only. Accordingly, adoption of an amendment limiting or eliminating director liability will have no effect upon pending litigation. It also will have no effect in relation to acts or omissions of directors which occur prior to the effective date of such amendment. An amendment becomes effective, after stockholder approval, upon the filing with the Secretary of State of the State of Delaware of a certificate of amendment to the corporation's certificate of incorporation.

Section 102(b)(7) authorizes with a total elimination or a partial limitation (such as a dollar "cap," either for the board collectively, per director or with respect to certain matters but not others) of directors' liability for fiduciary duty violations.[31] Similarly, limitation or elimination of liability could be conditioned upon director action in connection with specific matters. Lastly, section 102(b)(7) does not permit limitation or elimination of liability arising under other laws or regulations. Thus, a director's potential liability under state or federal securities laws is unaffected by section 102(b)(7).[32]

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liability arising from the conduct of their offices. *See, e.g.*, Sparks, Johnston & Johnston, *supra* note 21, at 453.

31. For example, Basic Earth Science Systems, Inc., in its proxy statement dated September 11, 1986, proposed amending its certificate of incorporation to limit "to a maximum of Ten Thousand Dollars ($10,000) the personal liability of a director to the corporation and its stockholders for breach of fiduciary duty as director . . . ."

32. Section 17(h) of the Investment Company Act of 1940, 15 U.S.C. § 80a-17(h) (1981), prohibits any registered investment company from having, in its certificate of incorporation, bylaws, or similar documents,

> any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office.

Id. Accordingly, a company registered under the Investment Company Act of 1940 must, if such company seeks to adopt an amendment to its certificate of incorporation under § 102(b)(7), draft such amendment subject to the limitations of the Investment Company Act of 1940, and the rules and regulations and staff interpretations thereunder.

Moreover, in an analogous context, the Securities and Exchange Commission has determined that indemnification liabilities arising under the Securities Act of 1933 is against public policy regardless of whether the relevant state law standard of conduct is met. *See* 17 C.F.R. § 229.512(i) (1986). *But see id.* § 230.461(c) (insurance to cover such liabilities does not appear to be objectionable).

Section 102(b)(7) affords corporations the needed flexibility in responding to the recent changes in the market for directors' and officers' liability insurance. Charter provisions can be carefully tailored to include such restrictions or conditions as are appropriate in particular circumstances. Because section 102(b)(7) was recently enacted, little judicial guidance exists with respect to its validity or to the scope of the limitations of liability presently authorized.[33]

B. *Fiduciary Duties*

Delaware law places the ultimate responsibility for managing the business and affairs of a corporation on the board of directors.[34] In meeting this responsibility, directors are charged with the fiduciary duties of due care and loyalty. The duty of loyalty to a corporation and its stockholders requires that a director, in making a business decision, act in good faith and in the honest belief that the action taken is in the best interests of the corporation.[35] Directors may be found liable for breaching their duty of loyalty where corporate decisions reflect a kind of self-interest currently referred to as "entrenchment" by many courts.[36] Section 102(b)(7)(i) specifically precludes, however, any limitation or elimination of personal liability of a director for breach of the duty of loyalty to the corporation or its stockholders. Thus, directors may still be found liable for monetary damages for breach of the fiduciary duty of loyalty. As implied from the official legislative synopsis, section 102(b)(7) permits a corporation to protect its directors from monetary liability only from liability for

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33. To date, only one judicial challenge to a proposed § 102(b)(7) amendment has been mounted. *See* Complaint, *Grobow v. Dingman*, No. 565076 (Cal. Super. Ct. filed Oct. 24, 1986), ¶¶ 2, 27, 43, 44, 60, 74. The complaint challenges the design, recommendation, and approval by the board of directors of The Henley Group, Inc. of an amendment authorized by § 102(b)(7) as self-dealing, a breach of the directors' fiduciary duties of care and loyalty to the corporation and its stockholders and as void as against the public policy of California. The stockholders of the Henley Group subsequently approved the amendment by a margin of 94% of the votes cast. The complaint further alleges that the defendant corporation has obtained satisfactory directors' and officers' liability insurance and that the corporation has experienced no difficulties attracting competent executives and management.

34. *See* DEL. CODE ANN. tit. 8, § 141 (1974).

35. *See* Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

36. *Aronson*, 473 A.2d at 812; Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964); Bennett v. Propp, 187 A.2d 405, 408 (Del. 1962).

breach of the fiduciary duty of care, i.e., liability for gross negligence in meeting the duty of care.[37]

The duty of care under Delaware law requires that directors exercise diligence and care in managing the business and affairs of a corporation and exercise an informed business judgment in the discharge of their responsibilities.[38] An informed business judgment means that directors have informed themselves of all material information reasonably available to them and, having become so informed, they then must act with requisite care in the discharge of their duties.[39] The duty of care under Delaware law thus focuses upon the process used by directors in reaching a business decision.[40] Liability of directors to the corporation or its stockholders for breach of the fiduciary duty of care requires a finding by a court that the directors were grossly negligent.[41]

It is important to note that section 102(b)(7) does not alter or eliminate a director's fiduciary duty to act with due care, but merely permits a corporation to insulate directors from personal monetary liability to the corporation or its stockholders for a failure to satisfy that duty. Thus, under Delaware law, directors continue to be charged with the fiduciary duty to act with due care in their corporate oversight responsibilities and in the decision-making process. The duty of care thus remains intact and can be relevant in remedial contexts other than those in which monetary damages are sought against directors.

Directors' conduct in meeting the duty of care under section 102(b)(7) is still subject to equitable remedies, such as injunctive or rescissory relief, and equitable relief may well be relevant in proxy contexts, elections, resignations, and removal contexts. For example, if Revlon, Inc. had a section 102(b)(7) provision contained in its certificate of incorporation, the result in *Revlon* would not have been altered insofar as the decision was premised upon a violation of the duty of care and only injunctive relief was sought.[42] Satisfaction *vel*

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37. This provision enables a corporation in its original certificate of incorporation or an amendment thereto validly approved by stockholders to eliminate or limit personal liability of members of its board of directors or governing body for violations of a director's fiduciary duty of care.

38. *Van Gorkom*, 488 A.2d at 872.

39. *Id.*

40. *Id. See* R. BALOTTI & J. FINKELSTEIN, *supra* note 10, at § 4.6.

41. *Van Gorkom*, 488 A.2d at 873.

42. *See supra* note 13 and accompanying text.

non of the duty of care will still be subject to the same substantive legal standards concerning satisfaction of that duty and the permissibility of corporate action. A stockholder may consequently institute an action to enjoin completion of a board's action or to rescind a completed action if such action involves violations of the duty of care. As a practical matter, however, the unavailability of monetary damages against directors may deprive stockholders or the corporation of any effective remedy when a stockholder is not aware of corporate action by directors until such action is completed. In such instances, stockholders may have no effective remedy for injury occasioned by the directors' action. Section 102(b)(7) may thus limit remedies available to a stockholder who has an otherwise valid claim against a board of directors for violation of its fiduciary duties, even if the directors' conduct involved gross negligence.

Some commentators have suggested that section 102(b)(7) exempts directors from liability for recklessness,[43] i.e., actions that fall somewhere between ordinary negligence and intentional wrongdoing. However, it is unclear whether section 102(b)(7) would protect a director against liability for reckless acts.[44] Accordingly, it could be argued that to the extent recklessness involves conscious disregard of a known risk, such conduct is not taken in good faith and thus would not be a liability subject to limitation or elimination under section 102(b)(7). To the extent recklessness encompasses sustained inattention to duty by directors, however, such conduct could be labeled "grossly negligent" and thus any liability resulting from it would be subject to limitation.[45]

Moreover, some scholars have suggested that courts, faced with the unavailability of monetary damages for breach of the fiduciary

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43. *See* Wiggins, *Delaware D&O Liability Law, a "Windfall" for Directors*, Legal Times, Aug. 18, 1986, at 11 (criticizing § 102(b)(7)); *but see* Sparks, *Delaware's D&O Liability Law, Other States Should Follow Suit*, Legal Times, Aug. 18, 1986, at 10 (supporting § 102(b)(7)).

44. *See* Rabkin v. Hunt, No. 7547 (Del. Ch. Dec. 4, 1986). The chancellor found that in

> [t]he corporate area, gross negligence would appear to mean, "reckless indifference to or a deliberate disregard of the stockholders," *Allaun v. Consolidated Oil Co.*, Del. Ch., 147 A. 257, 261 (1972) or actions which are "without the bounds of reason," *Gimbel v. Signal Companies, Inc.*, Del. Ch., 316 A.2d 599, 615, *aff'd, Gimbel v. Signal Companies, Inc.*, Del. Supr., 316 A.2d 619 (1974).

Id. at 19.

45. *See* Lutz v. Boas, 171 A.2d 381 (Del. Ch. 1961) (equating gross negligence with inattention to judiciary duties); Veasey, *Non-Insurance Alternatives*, in STRATEGIES FOR RESPONDING TO THE D&O INSURANCE CRISIS 167 (1986).

duty of care, could simply expand the scope of the duty of loyalty to encompass the duty of care and that plaintiffs will fashion their complaints to fall within the duty of loyalty contexts.[46] Directors owe a duty of loyalty to the corporation and its stockholders, and such duty mandates that a director not consider or represent interests other than the best interests of the corporation and its stockholders.[47] Accordingly, in light of section 102(b)(7)'s explicit exemption from limitation of liabilities arising from breaches of the duty of loyalty, the precise boundaries of the duty of loyalty are increasingly important.

How a particular director's actions are characterized by a court may be important in defining the scope of section 102(b)(7). At least in the context of management-sponsored leveraged buyouts, courts have implicated violations of the duty of loyalty as well as the duty of care in enjoining such transactions.[48] It is unclear, outside of a leveraged buyout context, whether courts will be receptive to stockholder challenges upon breach of loyalty grounds and how far the scope of directors' duty of loyalty will be expanded.

Liability for a breach of the duty of loyalty traditionally implies that the directors are somehow interested in the transaction they are being asked to approve. Directors are "interested" under Delaware law if they either expect to derive a personal financial benefit from a transaction (as opposed to a benefit which accrues to the corporation or all stockholders generally), or appear on both side of a transaction.[49] Accordingly, under present notions for breach of a director's duty of loyalty, expansion of such duty to encompass duty of care violations would require that the directors, in addition to failing to meet the duty of care, must be "interested" in the traditional sense in the transaction at hand. Absent such "interest," however, a director should be able to rely on traditional concepts of the fiduciary duty

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46. *See* Herzel, Shepro & Katz, Next-to-Last Word on Endangered Directors, HARV. BUS. REV., Jan.-Feb. 1987, at 38.

47. *See Revlon*, 506 A.2d at 182; Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983). *See also* Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939).

48. *See* Edelman v. Fruehauf Corp., 798 F.2d 882, 886-87 (6th Cir. 1986); *Revlon*, 506 A.2d at 182-84 (finding that the board of directors of Revlon breached their duty of loyalty to stockholders by entering into a lock-up agreement); AC Acquisition Corp. v. Anderson, Clayton & Co., No. 8584, slip op. at 30-31 (Del. Ch. Sept. 18, 1986) (finding that the board of directors of Anderson, Clayton breached its "duty of loyalty" by approving a transaction which had an entrenchment effect).

49. *Pogostin*, 480 A.2d at 624; *Aronson*, 473 A.2d at 812.

of care in looking to section 102(b)(7) for protection from monetary damages.

Section 102(b)(7) specifically precludes a corporation from limiting or eliminating personal monetary liability of directors arising under section 174 of the General Corporation Law.[50] Section 174 provides that directors shall, under certain circumstances, be jointly and severally liable for willful or negligent violations of certain requirements concerning stock repurchases and redemptions and the payment of dividends.[51] Section 102(b)(7) also precludes a corporation from eliminating liability for acts not in good faith or which involve intentional misconduct or a knowing violation of law. These categories attempt to distinguish between wrongful conduct which involves director "intent" and conduct which is the result of a director's lack of due care. Lastly, section 102(b)(7) precludes a corporation from limiting or eliminating liability for a transaction from which directors receive an improper personal benefit, e.g., a diversion of corporate opportunity.[52] These exclusions to section 102(b)(7) were the result of obvious public policy considerations.

In the past, many corporations limited directors' liability for monetary damages through insurance. It appears that this protection has not encouraged directors to neglect their duties. Thus, elimination of personal monetary liability should not lead directors to neglect or disregard their fiduciary duties. An amendment under section 102(b)(7) should supplement the protections of directors afforded by director liability insurance and would complement various indemnification rights available to directors. Moreover, while there is no assurance that adoption of such a provision will enable a company more readily to secure directors' liability insurance on a favorable basis, the amendment may have a favorable impact on the availability, cost, and amount and scope of coverage over the long term. Most important, however, such an amendment may assist a corporation in continuing to attract and retain highly qualified individuals to serve as directors. It would also permit directors to make more entrepreneurial decisions in the exercise of their independent business judgment on behalf of the company by reducing undue concern over potential litigation.

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50. DEL. CODE ANN. tit. 8, § 174 (1974).
51. *Id.*
52. *Id.* § 102(b)(7)(ii), (iii), (iv). *See* Sparks & Johnston, *supra* note 21, at 575.

Adoption of a provision authorized by section 102(b)(7) may have the effect of reducing derivative litigation against directors for breach of the fiduciary duty of care. Moreover, such provision may deter company or stockholder actions against directors for breach of such duty even though the action might have otherwise benefitted the corporation or its stockholders if successful. Corporations which are reincorporating in Delaware may seek to avail themselves of section 102(b)(7) and of the exception to the registration requirement in the case of mergers under the Securities Act of 1933 contained in Rule 145(a)(2) (providing that no registration is necessary where the sole purpose of the transaction is to change the issuer's domicile) will be available.[53] In recent no-action letters, the Securities Exchange Commission has taken the position that it will not recommend enforcement action if the company effects the proposed reincorporation merger in Delaware without compliance with the registration requirements of the Securities Act of 1933 in reliance upon an opinion of counsel that the Rule 145(a)(2) exception is available.[54]

C. *Practical Considerations*

A corporation must address a number of factors in considering whether to amend its certificate of incorporation pursuant to section 102(b)(7) and it faces a number of options in drafting such an amendment. A corporation should first make a preliminary assessment, possibly with the assistance of professional proxy solicitors, of the likelihood that an amendment limiting or eliminating director liability for breach of fiduciary duty will muster enough support among stockholders. This assessment is premised upon a review of the corporation's stockholder profile and is particularly important where the corporation's voting stock is closely held or is held in large amounts by institutional investors. Overall, a persuasive argument can be made that an amendment to a certificate of incorporation as authorized by section 102(b)(7) ultimately benefits institutional (and all) stockholders by enabling the corporation to attract and maintain objective, highly qualified outside directors to oversee the business and affairs of the corporation. Moreover ex-

53. *See* 17 C.F.R. § 230.145 (1986).

54. *See* Worthington Indus., Inc. SEC No-Action Letter, Sept. 8, 1986 (LEXIS, FEDSEC Library, NOACT file); Clorox Co. SEC No-Action Letter, Sept. 29, 1986 (LEXIS, FEDSEC Library, NOACT file).

perience demonstrates that although institutional investors are not hesitant to institute actions against a board of directors or a corporation in order to protect their investment in the corporation, such investors are not particularly responsible for the recent proliferation of litigation against directors.[55] Accordingly, although limitation or elimination of liability of directors for a breach of fiduciary duty should be well-received by institutional investors,[56] the sponsoring corporation must make individual assessments as to large stockholders within its stockholder profile.

Once a corporation has assessed the probability of the passage of such an amendment, it must determine the form of such an amendment. Some corporations have adopted an amendment authorized by section 102(b)(7) which essentially tracks, or mirrors the statute.[57] A clear benefit of such an approach is that a provision which tracks section 102(b)(7) is highly likely on its face to withstand judicial scrutiny and, absent some judicial review as to the validity or effect of section 102(b)(7), enhances the stature of such a provision when applied to particular facts. Moreover, this formulation could require less stringent disclosure in a proxy or registration statement.

Other corporations have adopted provisions which attempt to limit or eliminate director liability in a broad fashion by eliminating or limiting such liability "to the fullest extent permitted by law." This formulation attempts to invoke not only the protections of section 102(b)(7) in its present form but also attempts to provide any permissible elimination or limitations upon director liability which may

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55. *See* Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967).

56. As reported in the *Corporate Governance Bulletin*, which is published by the Investor Responsibility Research Center Inc. (1986), many institutional investors are supporting § 102(b)(7) amendments "on a case-by-case basis," finding the "possibility of board resignations to be a serious and credible threat." *Id.* at 96-98. In addition many institutional investors "recognize the legitimacy of the companies' problems because they face the same difficulties obtaining liability insurance for their own directors." *Id.* Institutional opponents of such amendments are characterized as "staunch but few."

57. Such a provision generally provides:

> A Director of the Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a Director except for liability (i) for any breach of the Director's duty of loyalty to the Corporation or its stockholders (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law (iii) under Section 174 of the Delaware General Corporation Law or (iv) for any transaction from which the Director derived any improper personal benefit.

be authorized by future mendments to the General Corporation Law. Thus if future changes in the General Corporation Law or future judicial determinations permit further limitation of directors' liability such limitation would automatically become effective under this formulation. Conversely, if future changes in the General Corporation Law or future judicial determinations permit less limitation of directors' liability the lesser limitation of liability would automatically become effective. Such provisions, of course, remain untested.

In combination with either of the above formulations many corporations may seek to protect directors from the uncertainties of future stockholder action once the directors have relied upon the protections afforded by section 102(b)(7). Accordingly many initial section 102(b)(7) charter amendments include the following provision: "Any repeal or modification of the foregoing paragraph shall not adversely affect any right or protection of a Director of the Corporation existing hereunder with respect to any act or omission occurring prior to or at the time of such repeal or modification."[58]

This provision attempts to shield directors from monetary liability for breach of the duty of care as directors in the event that the section 102(b)(7) amendment is subsequently altered or repealed. A corporation can further protect directors against the uncertainties of future stockholder action by requiring that future charter alterations inconsistent with the section 102(b)(7) amendment be subject to a super-majority voting requirement, e.g., the affirmative vote of eighty percent or more of the voting power of the then outstanding voting stock of the corporation.

Once the form of the amendment has been determined, the corporation must determine when and how to submit the proposed amendment to a vote of its stockholders. A corporation can choose to submit such a proposal for stockholder approval at its annual meeting, or it can call a special meeting of stockholders.[59] Moreover,

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58. Such a provision generally provides:

> A Director of this Corporation shall not be liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a Director except to the extent such exemption from liability or limitation thereof is not permitted under the Delaware General Corporation Law as the same exists or may hereafter be amended.

59. Many corporations, such as American Hoist & Derrick Company and Ocean Drilling and Exploration Company, have proposed adoption of § 102(b)(7) amendments at special meetings of stockholders. As reported in Corporate Counsel

a corporation may alternatively seek to adopt such an amendment by acting by written consent of stockholders pursuant to section 228 of the General Corporation Law.[60]

D. *Required Disclosures*

Practitioners should consider carefully the extent and nature of disclosure required in proxy statements when proposed amendments authorized by section 102(b)(7) are presented to stockholders for approval. Such disclosure will, of course, vary with both the precise form of the proposed amendment and the particular factual setting in which the adoption is proposed. A review of the many proxy statements filed with the Commission since early August concerning charter amendments authorized by section 102(b)(7) suggests that the Commission's examination of the proxy disclosures has become increasingly uniform. Although variations and inconsistencies continue, it appears that the Commission staff now typically looks for certain disclosures, including: (i) a clear explanation of the effect of the amendment on the ability of the corporation or its stockholders to seek monetary damages for directors' negligence or gross negligence; (ii) a statement that, although the availability of equitable remedies remains unimpaired, as a practical matter equitable remedies may not be available in particular circumstances; (iii) a statement that the charter amendment will not limit or eliminate monetary liability for violation of the federal securities laws; (iv) a statement indicating that the board of directors has a personal interest in proposing an amendment to a corporation's certificate of incorporation authorized by section 102(b)(7) in that such amendment would eliminate monetary liability which, under certain circumstances the directors might otherwise be required to pay; and (v) a statement as to the precise scope of the amendment. Undoubtedly more patterns will emerge in the coming months.

Weekly, *supra* note 1, 85% of the Delaware corporations responding to a survey by the American Society of Corporate Secretaries indicating their intent to adopt an amendment authorized by § 102(b)(7) plan to present such amendment at such corporation's upcoming annual meeting, 6% plan to call a special meeting, and 5% plan to seek written consent of shareholders.

60. A number of Delaware corporations, such as Kidde, Inc. and Carter-Wallace, Inc. have proposed adoption of § 102(b)(7) amendments by written consent. Under Rule 14c-(c)(5), promulgated under the Securities Exchange Act of 1934, a company must prepare and distribute a consent statement in connection with proposed corporate action by written consent. *See* 17 C.F.R. § 240.14c-(c)(5) (1986) (amended 1986). *See also* DEL. CODE ANN. tit. 8, § 228 (1974).

These proxy statements also indicate that certificate amendments are often submitted for prior stockholder approval in combination with stockholder ratification of indemnification bylaws or indemnification agreements. To the extent that stockholder ratification of such bylaws and/or indemnification agreements involves different substantive considerations under Delaware law appropriate disclosure in the proxy statement must be considered separately from the required disclosures for a section 102(b)(7) amendment.

III. CONCLUSION

Section 102(b)(7) was prompted by a concern about the directors' and officers' liability insurance crisis, the increase in litigation involving officers and directors and the ability of Delaware corporations to attract and retain high calibre individuals on boards of directors. It also affords corporations flexibility and allows for charter provisions to be carefully tailored to include such conditions and restrictions as might be appropriate in particular circumstances. Section 102(b)(7) will not and was not intended to, remedy all the problems which corporate directors face in meeting their responsibilities as directors. It merely permits a corporation's stockholders to provide directors protection from situations in which a director's personal assets may be at risk. Corporations should continue to seek appropriate liability insurance for their directors and officers to complement the protection afforded by section 102(b)(7). Adoption of a provision authorized by section 102(b)(7) cannot ensure that Delaware corporations will be able to secure directors' and officers' liability insurance providing higher dollar limits of coverage and fewer policy exclusions at a lower cost. Such a provision may, however be viewed favorably by insurers and eventually have a positive effect upon the availability, amount, cost, and scope of coverage of such insurance.

Adoption of an amendment authorized by section 102(b)(7) should assist a corporation in attracting and retaining high-qualified outside directors. Many corporations have adopted charter amendments to take advantage of section 102(b)(7) and many more are considering proposing such amendments. In light of the overall benefit to corporations through limiting director liability, adoption of an amendment authorized by section 102(b)(7) is highly desirable.