

**Analysis of the 1986
Amendments to the Delaware
Corporation Law**

By

Lewis S. Black, Jr., Esq.

and

A. Gilchrist Sparks, III, Esq.

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ANALYSIS OF THE 1986 AMENDMENTS TO THE DELAWARE CORPORATION LAW

By Lewis S. Black, Jr. and A. Gilchrist Sparks, III, of the Delaware Bar, Partners,
Morris, Nichols, Arsht & Tunnell

INTRODUCTION

Amendments to the Delaware General Corporation Law became effective on July 1, 1986. The amendments were prompted by a growing awareness by members of the Corporation Law Section of the Delaware Bar Association that directors' concerns about personal liability were causing Delaware corporations to lose, or to be unable to attract, qualified men and women to serve on their boards. These concerns were heightened by highly publicized lawsuits involving potentially ruinous recoveries against individual directors and were brought to a head by dislocations in the market for directors and officers liability insurance, which saw some corporations' insurance cancelled and almost all corporations experiencing dramatic increases in the cost of insurance coupled with cutbacks in the scope of coverage.

A committee of the Corporation Law Section was appointed in the fall of 1985 to study amendments to the General Corporation Law which might alleviate this problem. The committee at first considered legislation which would greatly expand the power of Delaware corporations to indemnify directors and officers. While certain minor amendments to the indemnification provisions of the statute were retained, the committee ultimately concluded that legislation which would permit stockholders to limit director liability, if they so chose, was a more direct approach which fit well with the traditional enabling character of the statute. The 1986 amendments to the statute were adopted by the Delaware legislature in the form proposed by the Corporation Law Section. This article calls attention to each of the changes made by the legislation and supplements earlier reports published by Prentice-Hall, Inc. on periodic amendments to the Delaware General Corporation Law.*

FORMATION

Certificate of incorporation; contents [§102].—The most significant of the 1986 amendments expands Section 102(b) of the Delaware General Corporation Law, which enumerates the provisions a Delaware corporation may include in its certificate of incorporation, to add a new paragraph (7) authorizing a provision which would, subject to certain limitations, eliminate or limit a director's liability for monetary damages for breaches of his or her fiduciary duty. Such a provision could not eliminate or limit a director's liability

- for breaches of the duty of loyalty to the corporation or its stockholders;
- for acts or omissions not in good faith or involving intentional misconduct or knowing violations of law;
- for the payment of unlawful dividends or unlawful stock repurchases or redemptions; or
- for transactions in which the director received an improper personal benefit.

The amendments provide that liability arising out of acts or omissions which occurred before the enactment of such an exculpatory charter provision cannot be covered by the provision.

* Arsht and Stapleton, *Analysis of the New Delaware Corporation Law*, *Analysis of the 1969 Amendments to the Delaware Corporation Law*, *Analysis of the 1970 Amendments to the Delaware Corporation Law*; Arsht and Black, *Analysis of the 1973 Amendments to the Delaware Corporation Law*, *Analysis of the 1974 Amendments to the Delaware Corporation Law*, *Analysis of the 1976 Amendments to the Delaware Corporation Law*; and Black and Sparks, *Analysis of the 1981 Amendments to the Delaware Corporation Law*, *Analysis of the 1983 Amendments to the Delaware Corporation Law*, *Analysis of the 1984 Amendments to the Delaware Corporation Law*; *Analysis of the 1985 Amendments to the Delaware Corporation Law*; Prentice-Hall, Inc. 1967, 1969, 1970, 1973, 1974, 1976, 1981, 1983, 1984 and 1985, respectively. Copies of these articles are available from Charles Fraser, Prentice-Hall Information Services, 240 Frisch Court, Paramus, NJ 07652, (201) 368-4636.

New Section 102(b)(7) is an enabling provision only. It authorizes a charter provision which relieves directors of personal liability, but it has no effect unless such a provision is adopted by stockholders or is included in the certificate of incorporation of a newly formed Delaware corporation. Hence, if existing corporations want to take advantage of the kind of limitation of liability which Section 102(b)(7) permits, it is necessary to seek stockholder approval. Many Delaware corporations are already taking steps to implement the statutory authority.

Section 102(b)(7) permits an exculpatory provision written broadly so as to relieve directors of all liability to the corporation or its stockholders for breaches of fiduciary duty except as otherwise required by law. It also encompasses provisions which grant directors less relief. Accordingly, the new section would allow the kind of "cap" on director liability which has been proposed by some writers and practitioners. Such a "cap" could take the form of a stated dollar maximum for which directors would be liable, either individually or collectively. Other limitations could also be imposed such as conditioning the grant of relief from liability on directors taking specific action or a limitation on liability in connection with some types of transactions but not others.

Section 102(b)(7) speaks only of directors in authorizing the limitation or elimination of liability. While most derivative litigation names directors as defendants, corporate officers are sometimes charged with liability for negligence in the conduct of their offices. It is probable that, where a corporation has implemented the new statutory authority by an appropriate charter provision, officers will be more likely to take controversial decisions to the board. In such cases, assuming the directors know or are apprised of the material facts concerning the transaction, officers should be able to point to director approval as protecting the officers from liability and directors will, in turn, be protected to the extent they are absolved from liability by contract in the certificate of incorporation.

Section 102(b)(7) is intended only to permit stockholders to offer directors protection against breaches of the directors' duty of care. Charter provisions enacted under the section can, at most, absolve directors of liability for negligence, including gross negligence. Breaches of a director's duty of loyalty to the corporation and its stockholders were not intended to be included within the section and are expressly beyond its scope. Also beyond the scope of Section 102(b)(7), as indicated above, are acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law and transactions from which a director derives an improper personal benefit. In addition, Section 102(b)(7) would expressly prohibit a charter provision which absolves directors of liability under Section 174 of the Delaware General Corporation Law. That section makes directors personally liable for unlawful dividends or unlawful stock repurchases or redemptions and expressly sets forth a negligence standard with respect to such liability.

Moreover, it should be noted that Section 102(b)(7) only provides directors with relief from judgments for monetary damages for breaches of their duty of care. It does not do away with the duty. Accordingly, as the commentary which accompanies the legislation makes clear, the section has no effect on the availability of equitable remedies such as an injunction or rescission based upon a director's breach of the duty of care.

DIRECTORS AND OFFICERS

Indemnification of officers, directors, employees and agents; insurance [§145].—The 1986 amendments also make changes in Section 145 of the Delaware General Corporation Law, which governs indemnification of directors, officers, employees and agents. These changes are relatively minor.

Section 145(b), as in effect prior to the new amendments, required court approval before there could be any indemnification for expenses incurred in derivative actions where the person seeking indemnification had been found liable "for negligence or misconduct in the performance of his duty . . ." The amendments dropped the quoted language in order to make the statute consistent with the decisions of the Delaware Supreme Court in *Smith v. Van Gorkom*, Del. Supr., 488 A.2d 858 (1985) and *Aronson v. Lewis*, Del. Supr., 473 A.2d 805 (1984), to the effect that directors are liable only for gross negligence where violations of their duty of care are alleged. The amendments do not alter the requirement for court approval before indemnification for expenses may be had in derivative suits which have resulted in an adjudication of liability.

Section 145(e) authorizes a corporation to advance litigation expenses to an officer or director prior to the final disposition of an action. That section conditions the making of such advances upon the officer or director giving the corporation an undertaking to repay if it turns out that indemnification is not available. The 1986 amendments change the form of the director's or officer's undertaking from a promise to repay "unless it shall ultimately be determined that he is entitled to be indemnified" to a promise to repay "if it shall ultimately be determined that he is not entitled to be indemnified."

This change shifts the burden of going forward to obtain the required finding as to entitlement to indemnification from the claimant to the corporation. While the amendment may make signing the undertaking more palatable, its effect is more symbolic than real since the statute continues to require, at Section 145(d), that indemnification be authorized pursuant to a finding that the indemnitee has met the statutory standard. Hence, the board, by a majority of disinterested directors, the stockholders, or, as the statute permits, independent legal counsel, will still have to decide whether indemnification is warranted in each case.

A more substantive change in Section 145(e) is reflected in the 1986 amendments' deletion of the requirement that advances of litigation expenses be "as authorized by the board of directors in the specific case." The quoted language, which has been eliminated, suggested that directors must evaluate each request for an advance on an individual basis. This raised questions as to the validity of charter or by-law provisions, or individual contracts of indemnification, which purport to obligate the corporation to make advances whenever an officer or director proffers an undertaking in proper form. The deletion of the quoted language facilitates such a general authorization.

Section 145(f) of the General Corporation Law states that the indemnification authorized by Section 145 is not exclusive of any other rights to indemnification which a director, officer, employee or agent may have under a by-law, agreement, board or stockholder resolution "or otherwise". This non-exclusive feature of the Delaware statute and other state statutes modeled on it contrasts sharply with state indemnification statutes which expressly limit permissible indemnification to that provided in the statute. The scope and intent of the non-exclusive language of Section 145(f) has been much debated. In recent times, because of the shrinking availability and coverage of directors and officers liability insurance, corporations have looked to this provision as a basis for granting more expansive indemnification. Where directors and officers liability coverage has been cancelled or becomes too expensive, or where new exclusions in the insurance contract make its value questionable, corporate lawyers have tried to formulate charter and by-law provisions and individual contracts of indemnification which will substitute for the insurance in whole or in part.

The 1986 amendments do not elucidate the scope of the non-exclusive language of Section 145(f). However, they do make it clear that advances of expenses are meant to be included within the non-exclusivity concept so that a director's or officer's right to have his litigation expenses paid by the corporation in advance of the disposition of the proceeding may be expanded and other rights relating thereto may be granted by a by-law provision, contract or directors' or stockholders' resolution so long as no public policy is offended.

The 1986 amendments also change Section 145(f) by moving to a new Section 145(j) language indicating that the indemnification provided by the statute continues as to a person who ceases to be a director, officer, employee or agent and inures to the benefit of his heirs, executors and administrators. It was thought that this provision should be in a free-standing subsection of Section 145 since it relates to the entire section. No substantive change was intended.

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