M E M O R A N D U M

TO: LSB, AGS

FROM: JFJ

DATE: March 6, 1986

RE: Proposed Amendments to Section 145

Attached is a slightly revised version of the proposed amendments and proposed "synopsis", attaching a form of legislative bill and a form of memo for legislators. As far as my committee is concerned (which, for all practical purposes, now consists of me and Don Bussard), this package is ready to be sent to the Council. You may want to make changes prior to sending it. I recognize, in particular, that you may want to change the comment with respect to "interested" transactions in the commentary on Section 145(g). However, it seemed to me that the case law under Sections 157 and 152 should be addresesd, one way or another.

JFJ/jer
Attachments

PROPOSED AMENDMENTS TO SECTION 145 OF THE DELAWARE GENERAL CORPORATION LAW*

The amendments to Section 145 represent a legislative reponse to recent changes in the market for directors and officers liability insurance. Such insurance has become a relatively standard condition of employment for directors and officers. 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 and officers have become unwilling, in many instances, to serve without the protection which such insurance provides. The amendments are intended to allow Delaware corporations to provide substitute protection, in various forms, to their directors and officers.

The first amendment will require the repayment of litigation expenses advanced to directors and officers in more limited circumstances than under previous law. The second amendment is intended to allow indemnification by the corporation served, or an affiliated corporation, as a partial sub-

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* A form of legislative bill for these proposed amendments with the same commentary except for the omission of citations as set forth herein (to be used as the official "synopsis") is attached as Exhibit A. A draft of a memorandum for legislators and other non-lawyers explaining in more detail than the synopsis the reasons for the proposed legislation is attached hereto as Exhibit B.

stitute for directors and officers liability coverage, in circumstances where such indemnification would previously not have been permitted, or where the power to grant such indemnification was previously unclear. The third amendment is intended to make clear that relatively unconventional forms of directors and officers liability insurance are valid. The fourth amendment merely moves a previously existing provision and is not substantive.

(1) Amend the first sentence of Section 145(e) to read as follows (brackets indicate deletions and underlining indicates additions):

> (e) Expenses incurred by an officer or director in defending a civil or criminal action, suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding as authorized by the board of directors in the specific case upon receipt of an undertaking by or on behalf of such director or officer to repay such amount [unless] <u>if</u> it shall ultimately be determined that he is <u>not</u> entitled to be indemnified by the corporation as authorized in this Section.

COMMENT: The amendment to § 145(e) changes the undertaking required for the advancement of expenses to directors and officers so as not to create an obligation to repay unless a specific determination is made that the director or officer is not entitled to be indemnified as authorized in § 145.

(2) Amend Section 145(f) to read as follows (brackets indicate deletions and underlining indicates additions):

(f) The indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which a person seeking indemnification or advancement of expenses may be entitled under any by-law, agreement, [vote of stockholders or disinterested directors,] resolution of disinterested directors or stockholders, or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office [and shall continue as to a person who has ceased to be a director, officer, employee or agent, and shall inure to the benefit of the heirs, executors and administrators of such a person]. No by-law, agreement or resolution providing for any such other rights shall be void or voidable solely because the indemnification or advancement of expenses provided for therein would not be permitted by any other subsection of this section; provided that no such by-law, agreement or resolution shall permit indemnification of any person for the results of such person's willful or intentional misconduct, other misconduct to the extent such misconduct results in improper personal benefit to such person, or for acts or omissions by such person not in good faith, and provided further that such other rights are

(i) authorized in an original by-law or in a by-law adopted or ratified by vote of disinterested stockholders or in a resolution adopted, before or after the act or omission for which indemnification or advancement of expenses is authorized, by vote of disinterested stockholders and the material facts as to the grant of indemnification or advancement of expenses provided for in such by-law or resolution are disclosed or known to such stockholders; or

(ii) provided for in an agreement authorized by the board of directors of the

indemnifying corporation (including a corporation related in any way to the corporation served by the indemnified party) between such corporation and the indemnified party and:

(A) the agreement is approved or ratified by vote of the disinterested stockholders and the material facts as to the agreement are disclosed or known to such stockholders; or

(B) the agreement is fair to the indemnifying corporation as of the time it is authorized or approved.

COMMENT: No substantive changes in the first sentence of § 145(f) are intended except for the deletion of the phrase in the prior version beginning "and shall continue as to a person who has ceased to be a director, officer, employee or agent", which has been moved to new subsection (j). The addition of the phrase "and advancement of expenses" is intended to make clear that the "other rights" provided for in Section 145(f) may include rights to have expenses advanced on terms other than those provided in Section 145(e). The provisions which have been added after the first sentence are intended to create a safe harbor against invalidation of indemnification, or rights with respect to the advancement of expenses, on the ground that such grant is inconsistent with the public policy limitations expressed, or implicit, in the other subsections of Section 145. In order to rely upon these safe harbor provisions the specified procedural safeguards must be observed, or substantive standards met, and the conduct for which indemnification is provided must be within the public policy limi-

tations specified in this subsection. Those limitations are meant to be generally co-extensive with the public policy limitations on the conduct which can be insured under director and officer liability insurance policies and would, for example, permit indemnification for expenses, judgments or payments in settlement in either third party actions or derivative suits where the conduct of the indemnified director or officer was grossly negligent but not intentional, or in bad faith, and did not result in an improper personal benefit to such person.

Disinterested stockholder approval is required in order for the safe harbor provisions to be applicable, except in the case of an indemnification "agreement" which is "fair to the corporation as of the time it is authorized or approved." In the latter case, Section 145(f)(ii)(B) provides for director-authorized indemnification "agreements" between the corporation and the indemnified party in circumstances in which the other subsections of §145 would not permit indemnification -- the validity of such agreements to be determined according to the "fairness" standard specified therein. This additional basis for relying upon the safe harbor provisions in the case of such an "agreement", but not for other director-authorized grants, is premised upon a reviewing court's capability of determining "fairness" in such a context (i.e. where the corporation receives some form of consideration or benefit to support its agreement), based upon all relevant

circumstances (including, e.g., whether the agreement has been bargained for by the indemnitee and been approved by disinterested directors. [See Weinberger v. UOP, 457 A.2d 701, 709 n.7 (Del. Supr., 1983) (arm's length bargaining provides "strong evidence that the transaction meets the test of fairness"). Compare the stock option cases, wherein the Delaware courts have, even in the case of grants approved by disinterested directors or stockholders, required some form of quid pro quo to avoid a claim of waste. See, e.g., Michelson v. Duncan, 407 A.2d 211 (Del. Supr. 1979).]

The safe harbor provisions are meant only to provide against invalidation "solely" because the indemnification in question is beyond the authority of the corporation provided for in the other subsections of § 145. Except in the case of a director-authorized indemnification agreement (which, as stated above, would be valid if the "fairness" standard is met) the safe harbor provisions are not intended to specify burden of proof and standard of review principles, which will continue to be determined by common law. [Cf. Fliegler v. Lawrence, 361 A.2d 218 (Del. Supr. 1976); Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971).]

(3) Amend Section 145(g) by adding the following sentence at the end of the subsection as presently written:

> In the absence of actual fraud, the judgment of the directors as to the terms and conditions of such insurance, and the identity of the insurer (the stock of which may be owned in whole or in part by the corpo-

ration), as set forth in the resolution or resolutions of the board of directors providing for the purchase and maintenance of such insurance, shall be conclusive.

COMMENT: A sentence has been added at the end of § 145(g) to confirm the validity of insurance contracts entered into between a corporation and a partially or wholly-owned subsidiary, as well as unconventional insurance contracts issued by unaffiliated insurers (such as, for example, contracts requiring the insured corporation to provide security to or otherwise indemnify the insurer). The statute is modeled upon the last sentence of Section 157, and the second sentence of Section 152, which govern the consideration requirements for the issuance of stock options and stock, respectively. As in the cases of those provisions, as interpreted by the Delaware courts, the amendment is not intended to displace common law principles relevant to the burden of proof or standard of review in "interested" transactions. [See generally Folk, The Delaware General Corporation Law (1972) at 121-123, 128, 132-136; Gottlieb v. Haden Chemical Corp., 91 A.2d 57 (Del. Supr. 1952); Lofland v. Cahall, 118 A.1 (Del. Supr. 1922); Maclary v. Pleasant Hills, Inc., 109 A.2d 830 (Del. Ch. 1934).]

(4) Add a new subsection (j) to read as follows:

(j) The indemnification and advancement of expenses provided by, or granted pursuant to, this section shall, unless otherwise provided when authorized or ratified, continue as to a person who has ceased to be a director, officer, employee

or agent and shall inure to the benefit of the heirs, executors and administrators of such a person.

COMMENT: A new subsection has been added to set forth a provision contained in the prior version of Section 145(f).

EXHIBIT A

SPONSOR: _____

_____

HOUSE OF REPRESENTATIVES

_____ GENERAL ASSEMBLY

HOUSE BILL NO. _____

AN ACT TO AMEND TITLE 8 OF THE DELAWARE CODE RELATING TO THE DELAWARE GENERAL CORPORATION LAW.

BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF DELAWARE (TWO-THIRDS OF ALL MEMBERS ELECTED TO EACH HOUSE THEREOF CONCURRING HEREIN):

Section 1. Amend the first sentence of subsection (e) of Section 145, Title 8, Delaware Code, by deleting the word "unless" after the word "amount" and substituting therefor the word "if" and by adding the word "not" after the phrase "determined that he is."

Section 2. Amend subsection (f) of Section 145, Title 8, Delaware Code, by (a) adding to the first sentence thereof the words "and advancement of expenses" after the phrase "the indemnification", (b) adding to that sentence the phrase", or granted pursuant to, the other subsections of" after the words "provided by", (c) adding to that sentence the phrase "or advancement of expenses" after the phrase "seeking indemnification", (d) deleting the words "vote of stockholders or disinterested directors", and substituting therefor the words "resolution of disinterested directors or stockholders," (e) deleting the comma after the word "office" and substi-

tuting therefor a period, (f) deleting from that sentence the phrase "and shall continue as to a person who has ceased to be a director, officer, employee or agent and shall inure to the benefit of the heirs, executors and administrators of such a person" and (g) adding, following the initial sentence thereof, the following:

> No by-law, agreement or resolution providing for any such other rights shall be void or voidable solely because the indemnification or advancement of expenses provided for therein would not be permitted by any other subsection of this section; provided that no such by-law, agreement or resolution shall permit indemnification of any person for the results of such person's willful or intentional misconduct, other misconduct to the extent such misconduct results in improper personal benefit to such person, or for acts or omissions by such person not in good faith, and provided further that such other rights are
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> (i) authorized in an original by-law or in a by-law adopted or ratified by vote of disinterested stockholders or in a resolution adopted, before or after the act or omission for which indemnification or advancement of expenses is authorized, by vote of disinterested stockholders and the material facts as to the grant of indemnification or advancement of expenses provided for in such by-law or resolution are disclosed or known to such stockholders; or
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> (ii) provided for in an agreement authorized by the board of directors of the indemnifying corporation (including a corporation related in any way to the corporation served by the indemnified party) between such corporation and the indemnified party and:
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> (A) the agreement is approved or ratified by vote of the disinterested stockholders and the material facts as to the agreement are disclosed or known to such stockholders; or

(B) the agreement is fair to the indemnifying corporation as of the time it is authorized or approved.

Section 3. Amend subsection (g) of Section 145, Title 8, Delaware Code, by adding, following the initial sentence thereof, the following:

> In the absence of actual fraud, the judgment of the directors as to the terms and conditions of such insurance, and the identity of the insurer (the stock of which may be owned in whole or in part by the corporation), as set forth in the resolution or resolutions of the board of directors providing for the purchase and maintenance of such insurance, shall be conclusive.

Section 4. Amend Section 145, Title 8, Delaware Code, by adding a new subsection (j) to read as follows:

> The indemnification and advancement of expenses provided by, or granted pursuant to, this section shall, unless otherwise provided when authorized or ratified, continue as to a person who has ceased to be a director, officer, employee or agent and shall inure to the benefit of the heirs, executors and administrators of such a person.

SYNOPSIS

The amendments to Section 145 represent a legislative reponse to recent changes in the market for directors and officers liability insurance. Such insurance has become a relatively standard condition of employment for directors and officers. 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 and officers have become unwilling, in many instances, to serve without the protection which such insurance provides. The amendments are intended to allow Delaware corporations to

provide substitute protection, in various forms, to their directors and officers.

The first amendment will require the repayment of litigation expenses advanced to directors and officers in more limited circumstances than under previous law. The second amendment is intended to allow indemnification by the corporation served, or an affiliated corporation, as a partial substitute for directors and officers liability coverage, in circumstances where such indemnification would previously not have been permitted, or where the power to grant such indemnification was previously unclear. The third amendment is intended to make clear that relatively unconventional forms of directors and officers liability insurance are valid. The fourth amendment merely moves a previously existing provision and is not substantive.

Commentary on Section 145(e)

The amendment to § 145(e) changes the undertaking required for the advancement of expenses to directors and officers so as not to create an obligation to repay unless a specific determination is made that the director or officer is not entitled to be indemnified as authorized in § 145.

Commentary on Section 145(f)

No substantive changes in the first sentence of § 145(f) are intended except for the deletion of the phrase in the prior version beginning "and shall continue as to a person who has ceased to be a director, officer, employee or agent", which has been moved to new subsection (j). The addition of the phrase "and advancement of expenses" is intended to make clear that the "other rights" provided for in Section 145(f) may include rights to have expenses advanced on terms other than those provided in Section 145(e). The provisions which have been added after the first sentence are intended to create a safe harbor against invalidation of indemnification, or rights with respect to the advancement of expenses, on the ground that such grant is inconsistent with the public policy limitations expressed, or implicit, in the other subsections of Section 145. In order to rely upon these safe harbor provisions the specified procedural safeguards must be observed, or substantive standards met, and the conduct for which indemnification is provided must be within the public policy limitations specified in this subsection. Those limitations are meant to be generally co-extensive with the public policy limitations on the conduct which can be insured under director and officer liability insurance policies and would, for example, permit indemnification for expenses, judgments or

payments in settlement in either third party actions or derivative suits where the conduct of the indemnified director or officer was grossly negligent but not intentional, or in bad faith, and did not result in an improper personal benefit to such person.

Disinterested stockholder approval is required in order for the safe harbor provisions to be applicable, except in the case of an indemnification "agreement" which is "fair to the corporation as of the time it is authorized or approved." In the latter case, Section 145(f)(ii)(B) provides for director-authorized indemnification "agreements" between the corporation and the indemnified party in circumstances in which the other subsections of §145 would not permit indemnification -- the validity of such agreements to be determined according to the "fairness" standard specified therein. This additional basis for relying upon the safe harbor provisions in the case of such an "agreement", but not for other director-authorized grants, is premised upon a reviewing court's capability of determining "fairness" in such a context (i.e. where the corporation receives some form of consideration or benefit to support its agreement), based upon all relevant circumstances (including, e.g., whether the agreement has been bargained for by the indemnitee and been approved by disinterested directors.

The safe harbor provisions are meant only to provide against invalidation "solely" because the indemnification in question is beyond the authority of the corporation provided for in the other subsections of § 145. Except in the case of a director-authorized indemnification agreement (which, as stated above, would be valid if the "fairness" standard is met) the safe harbor provisions are not intended to specify burden of proof and standard of review principles, which will continue to be determined by common law.

Commentary on Section 145(g)

A sentence has been added at the end of § 145(g) to confirm the validity of insurance contracts entered into between a corporation and a partially or wholly-owned subsidiary, as well as unconventional insurance contracts issued by unaffiliated insurers (such as, for example, contracts requiring the insured corporation to provide security to or otherwise indemnify the insurer). The statute is modeled upon the last sentence of Section 157, and the second sentence of Section 152, which govern the consideration requirements for the issuance of stock options and stock, respectively. As in the cases of those provisions, as interpreted by the Delaware courts, the amendment is not intended to displace common law principles relevant to the burden of proof or standard of review in "interested" transactions.

Commentary on Section 145(j)

A new subsection has been added to set forth a provision contained in the prior version of Section 145(f).

EXHIBIT A

PROPOSED AMENDMENTS TO SECTION 145 OF THE GENERAL CORPORATION LAW OF THE STATE OF DELAWARE

Introduction

The crisis in liability insurance affects virtually all aspects of our economy. Almost daily the media informs us of another casualty. The availability of insurance covering the actions of directors and officers of corporations ("D&O insurance") is also dramatically shrinking. Although little publicity has been given to the D&O insurance crisis, the peril to our economy is monumental. If talented men and women are forced to decline to serve as officers and directors of corporate America because of inadequate D&O insurance, the long-term effect on our economy could be devastating.

The proposed amendments to Section 145 of the General Corporation Law (Title 8) address the D&O insurance crisis by permitting corporations to "self-insure" certain risks which are not permitted under current law. This memorandum discusses the effect that the proposed amendments would have in the context of the crisis in D&O insurance.

Discussion

A. The Need for Indemnification and Insurance.

In order to attract the most talented people to serve as directors and officers of corporations, it is necessary to offer more than salaries and directors' fees. It is also necessary to provide a shield against the threat

of lawsuits that may be filed against an individual as a result of his service to the corporation. This shield is provided through the promise of indemnification and D&O insurance.

This protection is especially needed in order to retain the services of directors who are not otherwise employed by the corporation. Corporations whose stock is publicly traded typically have boards of directors comprising two groups of individuals: (i) those who are major stockholders or are employed by the corporation in high management positions (so-called "inside directors"), and (ii) those who are not major stockholders and not employees of the corporation (so-called "outside directors"). Although outside directors typically receive a stipend for their services, this remuneration is often insufficient to cause qualified individuals to accept the risk of personal liability which may arise from their service on the board.

The risk of "corporate malpractice" lawsuits is real, as evidenced by the fact that premiums for D&O insurance -- when insurance is available at all -- have increased as much as 1200% during the past year. The majority of these suits are filed by stockholders, employees, former employees and customers. Already, directors of some corporations have resigned en masse as D&O coverage has been terminated. A decision handed down by the Delaware Supreme Court last year, Smith v. Van Gorkom, 488 A.2d 858 (Jan. 29, 1985) has

contributed to this panic. In that case the directors of Trans Union Leasing Corp. were held personally liable for rushing into a friendly merger, even though the merger price was $20 per share higher than the recent market price of the company's stock. Since the merger was not the product of a hostile takeover situation and the directors derived no personal gain (such as job security), the ruling has caused considerable fear among honest-minded directors.

B. Indemnification and Insurance Under Current Law.

The crisis in D&O insurance has caused corporations to scramble for alternative or substitute protection. Under present Section 145 insurance and indemnification are interrelated components in a framework of protection.

Section 145, in granting authority to Delaware corporations to indemnify their officers and directors, distinguishes between lawsuits brought by a stockholder in the right of a corporation to recover some debt or liability to the corporation (so-called "stockholder derivative suits") on the one hand, and all other lawsuits (so-called "third party suits") on the other hand.

In the case of third-party suits, a corporation may indemnify an officer or director for all judgments and settlements against him and expenses, including attorney's fees, if he acted in good faith and in a manner he reasonably believed to be in the best interest of the corporation (the so-called "duty of loyalty" standard). Thus, where a

director is held liable for his negligence[1] in a third-party suit, the corporation can indemnify him if his action, although negligent, conformed to the duty of loyalty standard. See Section 145(a).

In the case of stockholder derivative suits, current law permits a corporation only to indemnify an officer or director for his expenses and not for any judgments or settlements against him. Moreover, where the officer or director has been found liable for negligence or misconduct in the performance of his duty, no indemnification is permitted (even though his actions met the duty of loyalty standard) unless a court specifically rules that it is appropriate under the circumstances. See Section 145(b).

Under current Section 145(g) a corporation is permitted to purchase D&O insurance to cover not only those liabilities for which the corporation could indemnify its officers and directors under subsections (a) and (b), but also those liabilities which the corporation is prohibited from indemnifying. Thus, a corporation can purchase insurance to cover judgments and settlements in a stockholder derivative suit against a director or officer whose conduct was negligent.

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[1]There is considerable doubt whether acts of "gross negligence", such as were found in Smith v. Van Gorkum, can be indemnified under present Section 145.

For many years corporations were able to fill the gaps in the scope of indemnification permitted by Section 145(a) and (b) by purchasing D&O insurance under Section 145(g). The present inability of many corporations to procure D&O insurance forces corporations to ask their directors and officers to serve with no protection for these liabilities.

C. The Proposed Amendments to Section 145.

The proposed amendments to Section 145 clarify and expand the extent to which a corporation may indemnify its officers and directors. Under the amendment, corporations would now be permitted to indemnify for (i) acts of gross negligence, and (ii) judgments and settlements in stockholder derivative suits, subject, however, to the protective limitation that indemnification may not be granted for willful or intentional misconduct, other misconduct resulting in improper personal benefit, or acts or omissions not in good faith. As a further public policy safeguard, this expanded scope of indemnification may be granted only through (i) a by-law, resolution or contract authorized by vote of stockholders who do not directly benefit thereby (so-called "disinterested stockholders") or (ii) a contract which is "fair to the indemnifying corporation." See proposed amendments to Section 145(e) and (f).

The proposed amendment to Section 145(g) is a clarification designed, among other things, to authorize a

corporation to procure D&O insurance from a subsidiary or other affiliated company. Under present Section 145(g) there is some question whether a D&O policy purchased from a wholly-owned subsidiary would be deemed true "insurance" in all circumstances. Because of this doubt, corporations have been hesitant to set up captive insurance companies in Delaware under legislation enacted in 1984, 18 Del.C., Chapter 69, to self-insure D&O coverage. The proposed amendment permits the corporation to obtain D&O insurance policies, from a captive insurer or elsewhere, on terms or in form different than conventional D&O policies, in the absence of actual fraud. See amendment to Section 145(g).

It is not anticipated that the proposed amendments would have any material adverse impact on the therapeutic effect of stockholder derivative litigation. Plaintiffs' counsel will still have incentive to bring meritorious suits because they would still be entitled to recover their fees based on the benefits produced to the corporation. Although the corporation would now be permitted to indemnify the individual defendants in a derivative suit, such payment by the corporation is simply a logical extension of the corporation's authority under present law to pay premiums for D&O insurance which in essence indemnify the individual defendants.