



Hercules Incorporated
Hercules Plaza
Wilmington, DE 19894
(302) 594-5000
Telex: 83-5479

LAW DEPARTMENT

Writer's direct dial
number (302) 594-7024

March 17, 1986

John H. Small, Esquire
Prickett, Jones, Elliott,
Kristol & Schnee
1310 King Street
P. O. Box 1328
Wilmington, Delaware 19899

✓ Donald A. Bussard, Esquire
Richards, Layton & Finger
One Rodney Square
P. O. Box 551
Wilmington, Delaware 19899

Re: D&O Subcommittee

Dear John and Don:

I thought you might be interested in the enclosed memorandum.

Very truly yours,

Kevin E. Walsh

cc: John F. Johnston, Esquire (w/enc.)
Edward P. Welch, Esquire (w/enc.)
Donald J. Wolfe, Jr., Esquire (w/enc.)

5370K

March 6, 1986

To Our Clients:

Director and Officer Liability Insurance

Effective liability insurance coverage for directors and officers is becoming very difficult for public companies to obtain, and even when available its cost is usually very high.

Current D&O policies do not properly address the areas where coverage is most needed. For example, D&O policies being offered today do not adequately insure against liabilities arising from directors' and officers' activities in response to tender offers and other attempts to take over a company. Also, many policies no longer indemnify directors or officers personally but only indemnify the company in the event that the company pays an indemnity to a director or officer. These limitations on the scope of coverage, along with high deductibles and low limits of liability, have undermined meaningful D&O insurance coverage.

We believe that in some states companies could achieve reasonable limitation of director and officer liability exposure through contract. However, this is an untried area and subject to question and litigation. Therefore, we recommend that companies undertake to deal with the problem by seeking the enactment of new legislation. A suggested form of legislation is attached. This legislation would supplement existing statutory provisions on indemnification and insurance. The basic scope of the proposed legislation is to limit director and officer liability to an amount which is significant, yet would not threaten them with catastrophic loss for their actions.

Pending the enactment of corrective legislation, we recommend that companies carefully examine their by-law provisions relating to indemnification. The by-laws should be drafted to provide for indemnification to the fullest extent permitted by the state statute. Also, in order to protect directors and officers in the event of a change of control, the by-laws should provide that the indemnification continues in effect for ten years following the termination of the director's or officer's relationship with the company.

M. Lipton
I. Reich

Proposed Legislation Regarding the Scope of Liability of Directors, Officers and Employees of Public Corporations

I. Introduction and Purpose

Public corporations are today faced with a liability insurance crisis. The rising tide of litigation against directors, officers and employees of public corporations has led to dramatically higher liability insurance rates and significantly greater limitations on coverage. Small corporations have an even greater problem than large corporations. In many instances, no coverage can be obtained.

In the absence of adequate coverage, a real risk is created that a director or officer can be held personally liable for millions of dollars in damages, even where he has acted entirely in good faith. As a result, public corporations are finding it increasingly difficult to attract and retain qualified and experienced individuals to serve in those capacities. In several instances, individuals have either resigned existing positions or refused to accept new positions rather than serve without adequate liability insurance coverage.

The purpose of the proposed legislation is to create a logical framework for the determination of personal liability for those persons serving public corporations. It is only through a framework where the potential liability is commensurate with the benefits received from service to the corporation that public corporations will continue to be able to attract and retain well-qualified individuals.

A wide range of constituencies suffer when public corporations cannot attract and retain the best people to serve as directors, officers and employees. It is not just stockholders and the public securities markets that suffer when less qualified and less experienced individuals are responsible for the operation of public corporations. Without qualified leadership, the welfare of the thousands of employees, suppliers and customers of those corporations, as well as the communities in which they work and live, may be jeopardized.

The proposed legislation would allow for sufficiently high potential awards to encourage the commencement of suits to redress real breaches of duty. On the

other hand, it should have the effect of reducing the amount and frequency of frivolous suits. The current proliferation of frivolous suits has contributed to the increase in liability insurance rates and the greater limitations on coverage. The reduction in the number of frivolous suits will moderate the costs of defending litigation in this context and thereby moderate liability insurance rates.

The proposed legislation is comparable to the limitation on liability for certain violations of the federal securities laws proposed by the American Law Institute. The Institute's proposed Federal Securities Code also adopts a \$100,000 limitation. It states, "there must be some maximum [on the amount recoverable for civil violations] [However, unless] the potential liability is high enough to attract able lawyers who are willing to undertake class actions on a contingency basis, there may not be any practical enforcement The answer suggested is basically an arbitrary maximum of \$100,000 per individual defendant...." Comments to §1708(c), ALI Federal Securities Code, 1980, at pp. 731-2.

II. Proposed Legislation

The proposed legislation would limit civil liabilities of directors, officers and employees of public corporations arising out of the performance or non-performance of their duties to the corporation, to an amount equal to the "actual benefit received" by such person or \$100,000, whichever is greater.

"Actual benefit received" is defined to mean the direct or indirect monetary benefit received by such person in either a transaction between the corporation and such person, if the performance or non-performance arose out of that transaction or a transaction in which such person misappropriated a corporate benefit or opportunity. Thus, if a covered person engages in an improper transaction with the corporation and receives a benefit of \$2,000,000, the limit on recovery is \$2,000,000, not \$100,000.

If the breach of duty did not relate to a transaction in which a person received a benefit, the "actual benefit received" by such person would be determined by reference to the compensation received by such person from the corporation during the twelve months immediately prior to the transaction in question. With respect to a non-officer director, such amount is deemed to be three times

the amount of his fees received from the corporation as a director during that period. With respect to an officer or other employee of the corporation, such amount is deemed to be the total compensation earned by such person through his employment during that period.

The proposed legislation would not apply to litigation related to criminal violations or suits for personal injury or wrongful death. The proposed limitation on liability would not apply to any claims or causes of action relating to the performance or non-performance of duties to the corporation for which the person sued has been convicted of a criminal offense (other than a traffic violation or similar offense) for which the time for appeal has expired or an appeal has been taken and the conviction has been affirmed or upheld. Similarly, the proposed limitation on liability also would not apply to actions, suits or proceedings seeking recovery of monetary damages for personal injury or wrongful death.

The proposed legislation would not limit a corporation's liability to third parties nor would it limit the liability of any person not a director, officer or employee who has acted in concert with, or benefited from, a breach of duty by a director, officer or employee.

The proposed legislation would add a new section to the state's corporation law. It would be applicable only to domestic corporations. It would not affect any right to indemnification or insurance already contained in the corporation law. It would not create any additional right to bring a cause of action, affect actions commenced prior to its effective date or diminish any existing causes of action. Furthermore, it would not limit the liability of any person under any applicable federal statute.

III. Text of Proposed Legislation

"§ ____ . Limitation of Liability.

(a) No director, officer or employee of a corporation that is subject to the registration or reporting requirements of Section 12 or Section 15(d) of the Exchange Act, shall be held liable in any civil action, suit or proceeding by or in the right of the corporation or otherwise on behalf of the stockholders of the corporation, for money damages for the performance or non-performance of such person's duties to the corporation, in an amount exceeding the greater of (1) the actual benefit received by such person or (2) \$100,000.

(b) For purposes of this section, the following terms shall have the following meanings:

(1) "actual benefit received" means either:

(A) the direct or indirect monetary benefit received by such director, officer or employee in a transaction (i) between such person and the corporation in connection with which the performance or non-performance of such person's duties shall have occurred or (ii) in which such person shall have misappropriated a benefit or opportunity of the corporation; or

(B) in instances where the performance or non-performance shall not have occurred in connection with a transaction set forth in subparagraph (b)(1)(A) above:

(i) if such person was a director, but not an officer, at the time the performance or non-performance shall have occurred, an amount equal to three times the fees received from the corporation by such director, as a director, during the twelve months immediately preceding the transaction in connection with which the performance or non-performance shall have occurred, or

(ii) if such person was an officer or employee at the time the performance or non-performance shall have occurred, an amount equal to the total compensation earned by such officer or employee with respect to his employment with the corporation during the twelve months immediately preceding the transaction in connection with which the performance or non-performance shall have occurred.

(2) "Exchange Act" means the Act of Congress known as the Securities Exchange Act of 1934, as the same has been or hereafter may be amended from time to time, or any successor legislation thereto.

(3) "corporation" includes its subsidiaries and affiliated entities.

Lipton Smith

Any other

(b) ~~The provisions of this section shall not~~ apply to any claim or cause of action

(1) with respect to any performance or non-performance for which a director, officer, ~~or employee~~ has been convicted by a court of competent jurisdiction in a criminal action, suit or proceeding (other than a conviction for a traffic violation or similar offense) under the applicable penal laws of any state, federal or local jurisdiction and for which the time for appeal has expired or an appeal has been taken and the conviction affirmed or upheld; or

(2) seeking recovery for personal injury or wrongful death.

(c) Nothing contained in this section shall affect any rights to indemnification or insurance contained elsewhere [in the corporation law].

(d) Nothing contained in this section shall be construed to create a new cause of action, diminish an existing cause of action or affect or limit the liability of any person other than a director, officer, ~~or employee~~.

(e) Nothing contained in this section shall limit the liability of any person under any applicable laws of the United States of America.

(f) This section shall be effective only with respect to actions, suits or proceedings commenced after _____, 1986."

Handwritten notes and scribbles on the right side of the page, including a large bracket and illegible text.