TO: Members of the Corporation Law Section

FROM: Subcommittee on Director Liability
(John H. Small and Donald A. Bussard (co-chairman)
and Donald J. Wolfe, Jr., Kevin E. Walsh, John Johnston
and Edward P. Welch)

DATE: May 9, 1986

RE: Proposed Amendments to DGCL§102 and 145:
A Response to Bruce M. Stargatt, Esquire

As you know, the Council of the Corporation Law Section has in the last few years submitted to the Delaware State Bar Association Executive Committee and then to the Delaware General Assembly certain amendments to the Delaware General Corporation Law. Typically, those amendments were drafted by various subcommittees of the Section and were not controversial. This year, when that same procedure was about to be employed for proposed amendments to Sections 102 and 145 of the DGCL, it became apparent that at least one highly-respected member of our Section, Bruce Stargatt, was "in strong disagreement" with those parts of the proposed legislation dealing with Section 102. To permit all views to be aired, a meeting of the Corporation Law Section will be held on Wednesday, May 14, 1986 in City/County Council chambers.

In his usual thoughtful and well-stated way, Bruce has set out his concerns in his May 7 memorandum. This is in response to that memorandum. We disagree with Bruce's reasoning and conclusions and urge the Bar to support this proposed legislation. The reason for our views require first some background information.

The Background

It has long been recognized that caution must be exercised before personal liability is imposed on the members of a board of directors for a good faith mistake in judgment. The business judgment rule and the gross negligence standard against which

directors' conduct is measured[1] are both reflections of this concern. As a result, it has been suggested, money judgments against directors for violations of their duty of care are very rare.[2]

Nonetheless, in the last general revision of the DGCL in 1967 it was thought appropriate to permit corporations, if they found it desirable in their individual circumstances, to provide further protection to their directors. Thus, the DGCL was amended to broadly permit D&O insurance, by adding what is now Section 145(g) that authorizes insurance covering claims for which indemnification is not provided by the balance of Section 145.

Just as with the present proposal, this authorization of broad D&O coverage was initially controversial and occasionally misunderstood.[3] However, it is now generally accepted as appropriate legislation and has been widely adopted elsewhere and by the MBCA.[4] In short, at least since 1967 Delaware law has recognized that it is entirely proper to protect directors' personal assets from execution on judgments arising out of good faith mistakes on their part that constitute breaches of the duty of care. D&O insurance was the solution then available.

---

[1] See, e.g., Smith v. Van Gorkom, Del. Supr., 488 A.2d 858 (1985) and Aronson v. Lewis, Del. Supr., 473 A.2d 805 (1984).

[2] Bishop, Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 Yale L.J. 1078, 1099-1100 (1968).

[3] See, e.g., Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 664, 686 (1974) (claiming Delaware sanctions insurance "in any and all circumstances") and Arsht, Reply To Professor Cary, 31 Bus. Law. 1113, 1120 (1976) (pointing out that because D&O insurance is not available for breaches of loyalty, criminal acts, etc., Section 145 only really permits insurance for duty of care claims).

[4] Id.

The Present Problem and The Subcommittee/Council's Role

For whatever reason (and we certainly carry no brief for the insurance industry), the fact today is that standard D&O insurance is almost unavailable. This protection that has worked since at least 1967 to protect directors in appropriate circumstances is not working today. The result has been an unwillingness of some directors to continue to serve their corporations without D&O coverage or equivalent protection.[5]

Faced with this problem, the Council of the Section in October 1985 appointed this subcommittee to study what could be done. Over the next 6 months, the Subcommittee on Director Liability and, beginning in February of 1986, the Council met frequently to focus on this problem, often on a weekly basis.

Numerous alternatives were considered. For example, both New York and the A.L.I. have considered placing a statutory limit or "cap" on a director's individual liability for a duty of care violation. The Council ultimately rejected that suggestion because any "cap" is arbitrary and because it was concluded that stockholders themselves should be permitted to limit director liability for duty of care violations to the extent they deem appropriate. Broadening indemnification rights under Section 145 to permit indemnification for judgments in derivative actions arising out of duty of care claims was also considered and rejected as circular. It seemed illogical to provide a statutory scheme whereby the corporation would, in effect, pay off the very liability asserted by it or on its behalf against the directors.

---

[5] See, e.g., Business Struggles To Adopt as Insurance Crisis Spreads, Wall St. J., January 21, 1986, at 31.

The Merits of the Proposal

Eventually, as a result of their study of the various alternatives, the Subcommittee and Council agreed upon the proposal to amend Section 102 of the DGCL to permit the stockholders to decide the extent, if any, to which directors should not be subjected to personal liability for their honest mistakes of judgment that violate their duty of care.

At the outset and before discussing why we favor this proposal, it is important to stress what the statute would and would not permit. Specifically, the proposal does not permit any director to avoid personal 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 . . . or (iv) for any transaction from which the director derived an improper personal benefit.

Therefore, the vast majority of actionable conduct that exists under present law would still be actionable and subject the directors to personal liability. Accordingly, Bruce is not correct in claiming "only venality" would remain as a ground for director liability.[6]

Moreover, the proposed legislation does not eliminate the duty of care owed by directors of Delaware corporations. The proposal will only enable stockholders to limit or eliminate a director's personal liability for money damages for violations of that duty of care. The director's duty of care remains unchanged and will be enforceable through such equitable remedies as injunctive relief, rescission, etc., even if the stockholder should approve the elimination of personal liability. The proposal simply

---

6 Even the example Bruce cites from Tentative Draft No. 4 of the Principles of Corporate Governance appears to us to present litigable issues, depending upon the specific facts involved and whether the director acted in good faith.

gives stockholders the choice to limit or eliminate one of the remedies for breach of the duty of care.

With this clarification of what the proposed legislation will or will not permit, the reasons for our views include the following:

First, the proposal is consistent with the rationale underlying Section 145 and the long-standing rule of Delaware law which permits Delaware corporations to purchase insurance for their directors. Notwithstanding Bruce's suggestion to the contrary, there has been no effective personal economic pressure on directors of most publicly-held corporations at least since 1967 because those directors have been protected by insurance. Delaware recognized then that there is nothing to be gained by requiring directors to post their personal assets as security to ensure that their business decisions are made with due care.

Now, without such insurance, directors are increasingly asked to decide complex issues that present the possibility they will be subjected to personal ruin if they are later judged to have been grossly negligent. Thus, directors who act in good faith are being forced to incur the risk that later someone else will decide their conduct was "grossly negligent," whatever that may mean.

Second, a number of other states have already acted on this problem. Indiana recently passed a statute providing that a director is not liable for any action taken, or failure to take action, unless the breach or failure to perform constitutes willful misconduct or recklessness. We are informed that the governor of Missouri has just signed new legislation permitting corporations to indemnify directors except where the director's conduct was "finally adjudged" to have been knowingly fraudulent, deliberately dishonest or an act of willful misconduct. Virginia has passed a statute which appears to permit indemnification under certain circumstances for amounts paid

for judgments or settlements in derivative actions. Utah and New York are also considering other legislative solutions. There is also substantial academic support for limiting directors' liability for due care violations.[7]

This prompt action by other states is being viewed with favor by many corporations. The Council's proposal, which appears to offer a better, more balanced solution to this important problem, deserves consideration by the General Assembly.

Finally, the benefits to be gained by the proposed legislation outweigh any potential detriments. We all agree that the public good is best advanced by having the most qualified and capable persons serve as directors. Bruce shares this view and agrees that the present threat of personal liability is causing such persons to decline to serve as directors. Thus, advancing this goal of obtaining the best directors will be furthered by this legislation.[8]

In contrast to this benefit, only two adverse consequences are suggested by Bruce. He is concerned that such legislation will encourage less desirable persons to serve as directors because they will have little to fear if they neglect their duty of care. This fear seems farfetched. Certainly, the paucity of judgments for pure duty of care violations argues persuasively that gross negligence is a rare occurrence. We doubt the type of person who actually plans to abdicate his responsibility will be motivated to serve on, let alone dominate, a corporate board.[9]

---

[7] See Coffee and Schwartz, The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform, 81 Colum. L. Rev. 261 (1981).

[8] Bruce states that he "believes" directors care only if they are insured, not if they are subject to any liability. We question the logic of this view. Surely people will feel more secure if they are not liable at all than if they have indemnity by insurance in a limited amount. In any case, if there is some doubt on this point, why not let the stockholders decide, as the proposed Section 102 amendments would permit.

[9] Under the law governing trusts it has long been permissible to contractually limit a trustees' liability for lack of care. Yet, there is no evidence that trustees' have been encouraged to act improperly.

Bruce also suggests that the potential criticism of those who have attacked Delaware's position as a corporate law leader should deter us now. This too we reject as an excuse for failing to do what we believe is legally and philosophically correct. Just as we should never adopt legislation only because it is the fad of the moment, we should not be deterred by the criticism of those who often are only motivated by a desire to federalize all state corporate law.

In short, we recommend the adoption of the proposed amendment to Section 102. It will permit the stockholders to decide what, if any, limits should be placed on director's personal liability for good faith mistakes that violate their duty of care. As the owners of their corporation, that decision should be for the stockholders to make.

EM60508A