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RICHARDS, LAYTON & FINGER
ONE RODNEY SQUARE
P. O. BOX 551
WILMINGTON, DELAWARE 19899
TELEPHONE (302) 658-6541
TELECOPIER (302) 658-6548

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TO: Members of the Corporation Law Section
of the Delaware State Bar Association

FROM: E. Norman Veasey

RE: Proposed Amendment to Section 1.02(b) of the Delaware General Corporation Law

Having had the privilege to participate in several national groups and programs on "corporate governance" and the deliberations of the Council of this Section, I have come to the conclusion that something must be done to address a problem and a perception which is becoming critical.

The problem is the exposure of directors -- particularly outside directors -- to personal liability for monetary damages for "gross negligence", as that term may be interpreted and applied by various courts in a variety of factual settings. The lack of insurance is but a symptom of the disease. When it is available, insurance does not cure the uncertainty and the risks of exposure to personal liability. It serves only to insulate directors from putting their personal assets at risk when they make a decision in good faith. The perception among many directors -- and indeed many respected scholars and practitioners -- is that the courts are increasing their scrutiny of the directors' decisionmaking process to see if it was grossly negligent. The Delaware courts have made it quite clear that liability for failure to exercise due care in decisionmaking is predicated on concepts of gross negligence. Nevertheless, the perception around the nation is that there is little difference in reality between gross negligence and ordinary negligence and that directors are exposed to personal liability on a tort theory.

The concern is that this exposure to liability could happen in many boardrooms on individual transactions, despite careful counseling. This concern is held by honest directors who work hard at being

a director and do not seek to avoid liability for self-dealing, bad faith or other misconduct. The concern is about being second-guessed on the extent of the homework, deliberative process, etc.

As insurance becomes less and less available, qualified outside directors will refuse in increasing numbers to serve without adequate insulation from personal liability. That phenomenon presents the ultimate irony in corporate governance. Our courts have properly paid heightened deference to the decisions of boards where there has been a preponderance of independent directors. If competent directors are not willing to serve because of an unreasonable risk of exposure of their own assets, the policy of having a majority of independent directors as decisionmakers is seriously undermined. That would leave corporate governance either to insiders or to outsiders who are marginally competent to serve. Those who do serve may not be independent or may be timid or risk averse. None of these alternatives is attractive.

In the present situation, many corporations have resorted to some form of "self-help". Some have tried captive subsidiaries as "insurance" companies under §145(g). Others are revising their indemnification by-laws or agreements with a wide variety of techniques. Some of those techniques are very "creative" and "aggressive". Other by-laws and agreements are largely declaratory of §145, except that they strengthen some of the procedures and make indemnification mandatory in some instances. Other techniques employing funding mechanisms to implement indemnification are being attempted. These remedies, taken as a whole, are hardly a satisfactory long-term answer to the problem.

Legislative relief is warranted, not only because insurance is largely drying up (whether or not that is a cyclical phenomenon). There is an underlying substantive need for increased certainty concerning the personal liability limits of outside directors. Insurance (when available) is just the anesthesia -- or perhaps the tranquilizer -- to alleviate the concern of directors over the lack of certainty and exposure to liability.

Various alternative approaches to legislation were considered thoroughly by members of the Council before making the current recommendations. Although I am not a member of the Council, I requested

and was graciously accorded the privilege of expressing my views to the Council. These views are as follows: we should consider only a solution which is intellectually supportable and makes sound public policy. Solutions which do not, in my view, meet these tests are proposals such as the following:

1. Amending §145(b) to allow indemnification of judgments or amounts paid in settlement in derivative suits would be circular, would not benefit the corporation and would be expensive because the corporation would be saddled with both plaintiff's and defendant's attorneys fees.

2. Amending §145(g) expressly to permit wholly-owned captives to provide "insurance" without any genuine risk sharing would also be circular.

3. Providing a "cap" in some arbitrary amount for personal liability of directors found to have been grossly negligent in their decisionmaking, recognizes that there should be liability, but fixes the remedy for that liability in an arbitrary amount which is unrelated to the facts of the case.

A concept was suggested by some scholars that the certificate of incorporation could eliminate or limit liability of directors. In fact, there is some authority to support this concept under existing law by analogy to the Restatement of Trusts and an old English Chancery decision in the corporate area. Although, some corporations may already have taken such steps, many Delaware practitioners are not comfortable giving an opinion that this may be accomplished without an enabling statute.

I think that an enabling statute which is carefully limited is the best solution. The proposed amendment to §102 does just that. We can all argue about the words of that proposal, but the concept is intellectually supportable and makes for sound public policy.

The proposed statute does not eliminate the duty of care for directors. They continue to be charged under Delaware law with

that duty in their decisionmaking processes and in their oversight responsibilities in reacting to "red flag" situations. Not only would the duty of care continue to be present under the amendment as an aspirational matter, it has continuing vitality in remedial contexts other than personal monetary damages against directors as individuals. It will continue to be a vitally important issue in injunction cases. In addition, the duty of care would be a relevant issue in cases involving rescission and in proxy contests. Indeed, it has clear vitality in the process of election, resignation and removal of directors.

Under the proposed amendment to §102, conduct amounting to bad faith or intentional misconduct (among others) may not be excluded from personal liability for monetary damages. Independent directors on whom our corporate governance policy depends should not be concerned that they continue to have potential liability for bad faith or intentional misconduct. Their legitimate concern is eliminating or limiting the risk that their personal assets may be seized as a result of some transactional "glitch" where the decision is made by a process which some court somewhere might later find to have been "grossly negligent".

Liability under the corporation law is not the analogue of the automobile tort doctrine which properly equates an inadvertent running of a red light with the inevitable liability for the resultant crash regardless of the driver's good intentions, previously exemplary driving record, etc. Such tort concepts are of questionable validity in the corporation law. See Manning, The Business Judgment Rule and the Directors Duty of Attention: Time for Reality, 39 Bus. Law. 1477, 1492-98 (1984).

The proposed amendment to §102, along with the amendments to §145 are sound and appropriate. I urge your support of the Council's action in approving them.

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cc: All Members of the Executive Committee
of the Delaware State Bar Association