The Evolution and Adoption of Section 102(b)(7) of the Delaware General Corporation Law

McNally_Lamb

MCNALLY: Steve, thank you for agreeing to do this interview about the history behind and the idea of Section 102(b)(7). Let me start by saying I you were back in the council back in the mid 80's. What were you doing? What law firm were you with and what was your focus at that point?

LAMB: At that point I was a partner Skadden Arps Slate Meagher & Flom, which is a New York headquartered office with a substantial Wilmington presence at the time. And my work mostly involved takeovers.

MCNALLY: And so in the 1980's you were intimately involved with Skadden, one of the biggest firms around dealing with takeover, takeovers in general or take over litigation in particular?

LAMB: [00:01:06] Yes, that is correct.

MCNALLY: Can you tell us how you became involved in considering an amendment to the corporation code that eventually became 102(b)(7)?

LAMB: I was sitting as a member of the corporation law council. I don't remember if it was the first year I had been on the council or not, but it was certainly among the first. And in attending meetings of the council I recall the issue of the D&O crisis coming up. And it came up in conjunction with probably some general unhappiness about the Delaware Supreme Court's recent decision in the VanGorkom case.

MCNALLY: And tell us a little bit more about why this uncertainty or unhappiness was of such concern with board of directors? Was it because it was hard to figure out, for example, gross negligence was, something like that?

LAMB: [00:02:02] Well certainly. And also it was the first case in which any Delaware court had ever, in circumstances like this, held members of a public board of directors liable for the way they conducted themselves in connection with, in this case it was a takeover and the company was sold to one of the Pritzker entities as I recall. And there was a very long litigation that went back and forth in the Supreme Court a couple of times, which ultimately resulted in a finding of liability. And it was substantial. By today's numbers

it doesn't look like much, but it was millions, maybe ten million dollars, something in that magnitude.

MCNALLY: And did you recall whether there were other cases not in Delaware that were also in this period of time that suggest directors could be liable for lack of care?

LAMB: I don't. I imagine it's true but I don't remember that.

MCNALLY: Yeah, I think there were a couple of cases that went in that direction. Alright, you became involved in then now we're in the middle of 1985-1986. What's your first recollection of being specifically focused on what became 102(b)(7)?

LAMB: Well I have looked at minutes of the meetings of the council during this time frame and I noticed in doing that that at the March 10th meeting, this issue was raised and the first time The first thing I saw that about any contribution that I made was a comment at that meeting that I thought the best approach would be a legislative amendment eliminating financial liability for corporate directors in breach of the duty of care. And that was part of a larger discussion about limitations on liability or the changes in the indemnification statutes. It didn't gain support of the council in general.

MCNALLY: Alright. Now in part your ideas evolve a little bit and I think that after... We're talking March of 1986, of course. After that, I think were you, did your thinking process consider the use of such people as the ALI and etc?

LAMB: [00:04:25] I did. I remember or recall from reading this that I referenced a project that Louis Loss was in charge of at the time. Louis Loss was a very famous corporate and securities law professor at Harvard Law School. And at this time he was leading the American Law Institute project on trying to come up with a restatement of the law of corporations. And one of the things I understood it seems from reading the minutes at the time, is that the ALI was at least considering an approach that among other things would cap liability. Of course the problem for a corporate director as opposed to running your own affairs, let's say, is you are often called upon to make decisions that have enormous financial consequences that can dwarf your own net worth. And even for high net worth people can be a proposition in which you're getting paid at this time, 10, 20, 30 thousand dollars a year and you're exposing yourself to potentially tens of millions of dollars of liability. And so it's a little hard to understand why you bother, why you would agree to do it. Although for the obvious reasons, the prestige and so forth, you're certainly, at the time, anyway, you weren't doing it for the money. I think it's also clear at the same time, both the federal government through the SEC and the Delaware Supreme Court were pushing for there to be larger proportions of independent directors on corporate boards. So it's

one thing for the president and the senior executives of a company, and maybe the family member who controls the company to sit on the board. [00:06:21] They're in the position where, very much, all of their interests are at stake. It's something else to get an outsider to come in and expose his or her net worth to liabilities or rising amount of activity. And so when there's this pressure to get more independents on the board, the idea that you're going to get more of them to serve, have what you think is a better boards process and then expose them all to basically unlimited liability, there's some tension.

MCNALLY: I seem to have read in one of the articles in preparation for this that there were in fact people resigning from corporate boards. Was that your experience as well?

LAMB: I recall that.

MCNALLY: And because of this spectrum of potential liability, that's a main reason for doing so, correct?

LAMB: Yes. And I remember people asking advice whether they should serve on boards. And it was very hard to give someone unbiased advice if it's a good idea.

MCNALLY: And I think you mentioned--

LAMB: [00:07:20] Just to make that point, this is in conjunction with this D&O crisis that was going on. If you're fully insured and you're not at bankruptcy risk it's one thing. If you can't get the insurance or if it's too expensive for the corporation to buy the insurance, it's something else.

MCNALLY: And this was what was going on in 1984-1985, etc.

LAMB: It was, and I think for reasons that had nothing to do with the law. I think it was just an insurance market problem at the time.

MCNALLY: It affected other professionals as well, like doctors, for example. That's my understanding as well. So you mentioned that you had a very direct approach to this problem. But I know that later you proposed in April of 1986 in conjunction with other people, that perhaps one way to deal with this problem was a cap on liability. What was your thinking in your April 1986 memo about that issue?

LAMB: I did... and frankly I forgot all about this before I saw it.

MCNALLY: I don't want to bring up ugly memories.

LAMB: But evidently my partners Ed Welch and Tom Allingham and I proposed or drafted this proposed section 146 that would have placed an aggregate cap of a million dollars on the liability of directors as a group for breach of the duty of care in any given transaction. As I read the draft today, or when I read it this morning or last week, it seems to have some real serious problems in the way it was structured.

MCNALLY: Well just as a general idea as a cap, how did that fly or didn't it?

LAMB: The idea of a cap was discussed at council, and I think I know I've heard Mr. Sparks say. And I don't remember this and I may have not really have been very much privy to it at the time because I didn't do any tort work. We weren't doing med mal practice, we weren't doing anything basically other than corporate work. So I don't remember that I was aware at the time or at least at the beginning of this process about the fact that there was this tort reform legislation also working its way through the legislature. That created a real problem for the bar association. For, on the one hand, be supporting a cap for director liability and opposing it for everybody else. So that does seem to be a significant political problem.

MCNALLY: I would think so. Alright, well we know that after the proposal started to circulate through various meetings at the council, you had further involvement. What do you recall is the next involvement that you had with respect to a proposed exculpation statute?

LAMB: [00:10:35] Well I do remember that the... I guess it was Norman Veasey who at the time was at Richard, Layton, and Finger, subsequently became chief justice, who proposed a statute that would amend section 102(b), which I know you've already been through this and I probably shouldn't repeat again.

MCNALLY: No, go ahead.

LAMB: 102(b) is the provision that tells corporations what they can put in their certificates of incorporation. And so this proposal was to permit companies to adopt provisions in either amendments to or original provisions that would exculpate directors essentially for violations of duty of care. So it was not too far off the idea I had in a sense. But instead of legislating it, it would permit companies to choose to put this in their own certificate of incorporation.

MCNALLY: And therefore have the stockholders consent to it?

LAMB: Yes, and then the stockholders either by being in the original certificate or through an amendment process, the shareholders would have consented to including this in this certificate of incorporation. So it has perhaps greater legitimacy than just to do it by legislative act.

MCNALLY: Alright. And do you recall any debates, for example, do you recall any debate about officers being included in the statute?

LAMB: [00:12:10] I do a little bit. It gets mixed up in my mind with debates about officers being subject to long arm jurisdiction, which I think was being also reviewed at the same time. I don't remember that being a big issue because we were there to talk about director liability, there hadn't been any recent case law unexpectedly finding directors or officers liable for violating their duty of care. So that wasn't really the issue of the day, so it wasn't addressed.

MCNALLY: I noticed in the statue that there is a provision in there that talks about not in good faith. Do you recall a discussion about that, who proposed that, why it was proposed and what was said in respect to it?

LAMB: I do. And it goes back to the way that this statute is drawn; it could have been drawn to say you can put in your certificate of incorporation and provision that exculpates directors from financial liability for breach of the duty of care.

MCNALLY: Just that simple?

LAMB: Period. I think that didn't happen because of the sensitivity of [00:13:17] members of the council to be appearing to reverse, even this indirectly, the Van Gorkom decision. So instead of doing that, it's drafted the other way around. So it's you can exculpate for everything other than the breach of the duty of care. I don't know, I probably just said that backwards.

MCNALLY: Yes

LAMB: You can exculpate everything in the world except the whole list of things, which when you put it all together adds up to everything other than the breach of the duty of care. So it's a more difficult drafting process, I think, because you had to include the duty of loyalty, can't exculpate the duty of loyalty. And then you had to include all these statutory provisions, like dividends and surplus and things like that. You can exculpate those because they're in the statute. And then I do remember, to get back to your question, a meeting at Morris Nichols office, which at the time was over in the IM Pei

building, at which maybe it was the final meeting to consider this, in which Mr. Rosenthal said that he believed the statute should include as one of the things that you cannot exculpate was a breach of the duty of any action not taken in good faith. And I remember that discussion because it was... Couple reasons, I mean my view of it was things that are not in good faith violate the duty of loyalty. And so it was, to me, surplusage, didn't need to say that. I thought since it was in my mind surplusage, it created some risk of--

MCNALLY: Ambiguity?

LAMB: Ambiguity and hazard in putting it in the statute because it meant there was going to be an argument, or a long, you know, having to go through some process of deciding what this duty of good faith became. And it was presented in the negative as actually it's not in good faith. There even became a question whether there was a difference between bad faith and a lack of good faith. As you know, I later became a member of the Court of Chancery and had a lot of cases dealing with these problems over the years. That was '97 to 2009.

MCNALLY: Yeah, I want to get into that. But first I want to finish up with just talking about that.

LAMB: Ok, back to that meeting. Mr. Rosenthal was quite insistent that it needed to be in there to gain his support. I think there was a lot of unease among all the other members of the council in the room. But in the end people agreed to it, to put it in there.

MCNALLY: And then of course subsequently the statute was enacted and you had the fortune or misfortune of having to deal with it as a member of the judiciary.

LAMB: [00:16:08] I don't have much recollection up to the enactment. I don't really remember the section meeting, and I had nothing to do with the general assembly.

MCNALLY: Well that was over 30 years ago.

LAMB: I don't remember. I remember Bruce Stargatt's objection and it causing real consternation in the council. But it got resolved.

MCNALLY: Alright, I think the, for me at least, valuable and interesting perspective is yours as a member of the Court of Chancery, having to deal with that statute. Can you tell us a little bit about how the court dealt with it initially and how that evolved over time? Cause I think that's a real interesting story.

LAMB: I'm only going to tell you in generalities because the brief didn't really talk about cases. But to my mind, Ed, as much as the statute went down smoothly every other way, when it got into the courts, there were a couple of problems. [00:17:06] The first problem was how the statute would be invoked in a lawsuit procedurally. And I think when it was adopted it was everyone's expectation that it would cut off at the beginning litigation that only involved issues of care. Litigation that was seeking money damages and not some other form of relief and only involved issues of care.

MCNALLY: I agree with that.

LAMB: Everyone thought that was going to happen.

MCNALLY: But that didn't happen.

LAMB: And it didn't happen.

MCNALLY: [laughter] What did happen?

LAMB: What happened was I believe the Supreme Court held, in the case I can't remember the name of, that this was in the nature of an affirmative defense. And not an affirmative defense like an immunity, because that's an affirmative defense, but one that can be raised at the threshold of the litigation. An affirmative defense that you had to go through discovery, get to the end, and get sort of ready for trial when you could presented as a summary judgment motion. And that undermines [00:18:21] I mean, for some period of time, undermined the utility of 102(b)(7) as a device to protect against directors and their insurance companies, because this was largely designed to make sure that insurance people would be in the market. That they basically had to pay a lot of money to get to the point where they could say wait a minute this is a 102(b)(7) issue. So, generally speaking, that did eventually get resolved. But it took a long time.

MCNALLY: And how was it resolved?

LAMB: The Supreme Court eventually said that you could, if a complaint is filed that only alleges things that are fairly read or duty of care issues, and is only seeking money damages, that it can be dismissed at that point. The other thing that happened was, and to the point of the Joe Rosenthal language, we went through a period of timing in the jurisprudence where it was suggested by a number of cases that the fiduciary duty directors owed really, was in three parts, not two parts. It was the triad of duties. And it was loyalty, care, and good faith. [00:19:43] Good faith was quite hard to define, not surprisingly. If it isn't just loyalty, what is it? And it became at least in public statements

by members of the court and in some opinions, it became very much like the duty of care. And so it seemed as though it, 102(b)(7) was not fulfilling everything it was supposed to do. That finally was put to rest. But I don't think that happened until ten years ago.

MCNALLY: The Disney case you think brought it to a rest or not?

LAMB: I don't remember. I remember finally we got rid of the triad of duties and people came back to realize we're just dealing with two, not three.

MCNALLY: And is your thinking as it is mine that that's basically where we are today?

LAMB: Yes. I should add, I think it's in England there's really only one duty of law, of fiduciary duty. And it's essentially the duty of loyalty.

MCNALLY: Well we don't want to be English, do we? [laugh]

LAMB: And they never understood what we were doing in all of this. [laugh]

MCNALLY: That's way above my pay grade, I can tell you that much. Alright, well that's very helpful. Do you have any other recollections that you'd like to share with us in respect to 102(b)(7)? Even not so much the drafting, but even as your role as vice chancellor?

LAMB: No, I think we've covered that. [00:21:24] Like I said, I didn't brief it, so I can't give you the case citations. But it was both as a vice chancellor. And it was a pretty good time in the early 2000's when I was teaching this law at NYU, and I've lectured on it in other places. It was always an issue that I had been asked to address. In fact, Gil and I a couple years ago were asked to do something like this at Penn Law. And I was again taking the position that we should just have eliminated liability for the duty of care and saved ourselves a lot of trouble.

MCNALLY: Well it looks like you've been vindicated, buddy. [laugh] Good for you. Alright, thank you so much.

[00:22:08 end of video]