Case: The Evolution and Adopting of Section 102(b)(7) of the Delaware General Corporation Law
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Interviewer: Edward McNally, Morris James
Interviewee: E Norman Veasey
Gordon, Fournaris & Mammarella, P.A.
(Former Chief Justice, Delaware Supreme Court)

McNally: I'm here with former Chief Justice E Norman Veasey of the Delaware Supreme Court. And we appreciate you taking the time, Justice Vessey, to be with us today.

Veasey: My pleasure, thank you.

McNally: I want to start with a little bit of the background of the subject that we're going to talk about today. In Robert Rice's new book, Saving Capitalism, he points out that in 1970's there were thirteen hostile takeovers. In the 1980's there were a hundred and fifty hostile takeovers. What do you recall were the concerns of directors of public companies in the 1980's?

Veasey: We were all involved in those takeovers that were being litigated in Delaware. And we did triple track depositions, and arguing cases because our court of chancery is able to turn cases around in short period of time. But we had a lot of people involved. And we spent a lot of time talking to the directors about how they really felt about this. And they wanted to spend more time on the governance aspect and worrying about lawsuits. But they had to worry about lawsuits because there were lawsuits going on all over the place, particularly since that is what happens when there's a hostile takeover. Then what's a duty of the director of the target company? There was a lot of angst among directors about that duty. And we all had to go to these boards of directors meetings and tell them what they had to do. And then some of these cases came along, and either clarified that or created more uncertainty about that. And there was a lot of uncertainty.

McNally: Now, I know that for example, in April of 1986, you alerted the then chairman of the corporation law section, Gil Sparks, about the crisis in D&O insurance. What was the crisis in D&O insurance in the early 1980's or mid-1980's?

Veasey: Well I'm sure Gil knew about it. Everybody had an idea that insurance was drying up. [00:02:26] It was more expensive. It was very difficult to get the D&O insurance at that time and directors were under a lot of siege in itigation, and they were worried about their livelihood. Their assets were being put at risk, and they had to be covered by insurance.

But insurance wasn't the only answer. There were a lot of other answers, that I guess we'll go along further into your, into our dialogue.

McNally: Alright. Well I know the Van Gorkom case was decided in 1985, and 1985 was kind of a watershed year for corporate litigation in Delaware. What do you recall about that particular year?

Veasey: Four important cases, you know. In the winter it was Smith V. Van Gorkom. Then it was Unical in the Spring. Maran, the poison pill case in the Summer. And then Revlon in the Fall and into 1986. [00:03:25] So those four cases kind of framed the issues for a lot of these hostile takeovers.

McNally: Now, among the documents that we saw when we went through our files, was a memo from you dated February 24, 1986, to Frank Bilotti, Lou Black, and Gil Sparks. And it talked about amendments to the indemnifications statue. Was there a point in time where the issues, where there were concerns of directors were going to be addressed by changes to the indemnification statute?

Veasey: I was responding to a memo from John Small in which he talked about the indemnification statute and what could be done with indemnification statutory amendments that would alleviate some of the pressures on directors. And as we know, subsequent history, after that time, there was a lot more than just indemnification. But this memo is one in which I was referring only to the issues involved in indemnification in response to John Small's memorandum.

McNally: At that point in time, people were talking about changing the indemnification statute but Van Gorkom had of course, held directors liable for gross negligence. A hard thing to define. I know that in May 13, 1986 you wrote a memo to the members of the Delaware Corporation Law Sanction, where you proposed an amendment to Section 102(b). And we know that the Section 102(b) was subsequently amended. Well, I appreciate you don't want to take the credit for being the only person who thought about that memo. Do you have a copy?

Veasey: [00:05:14] I do. It was a collaborative effort, and I'd be glad to talk at any length you want to talk about it. But the idea of going the route of 102(b)(7) and exonerating directors from liability for negligence or the failure to exercise due care in terms of personal damages against them, was I think, front and center, of what was going on. That was coupled with this insurance crisis, unavailable and high crost of insurance. It was kind of a perfect storm there that was inspired, I guess, by a whole takeover thing that you referenced, and aggravated by the Van Gorkom case, that held directors liable,

personally, for damages in connection with a breach of their duty of care, without any finding about duty of loyalty violations or misconduct. Although that's arguable from the decision. In any event, we reached this point in the Spring, late Winter and early Spring in 1986, wringing our hands about what are we going to do about this? [00:06:33] And at that time, and in previous years and subsequent years, the American Law Institute was studying principles of corporate governance. And it was very controversial. It started out with Professor Kerry's article, and those who wanted to federalize some of the things that directors do internally that is really state law. And the late Ray Garrett said why don't we see if we can get the American Law Institute to make a study of this? I believe, although I don't know, that he might have had some idea that this thing, if it were delayed through a study, might calm down this impotence to go federal. And so that's what happened. We had fifteen years of battle. We, I mean, there were a lot of us that were involved in different entities. There was something called CORPRO, which was primarily American Bar Association, Business Law section effort, fighting what was going on. Because the first thing that came out of this principles of corporate governance was a Draconian thing which was anti-director. We thought. So then when we got to the point that you're focusing on in Delaware in 1986, about what are we going to do about this problem that directors had about liability for negligence, we looked at, I don't know who did it first, but I remember going to the then draft of Section 719 of the American Law Institute. [00:08:13] And while I didn't believe in a lot of things in there, they had an idea in there that why not go get a charter amendment, exonerating the directors or limiting their liability? Now they didn't go as far as we ultimately went. What they were proposing was a charter amendment that would in effect, permit some lessening of the liability exposure of directors. But it didn't go all the way. And I have a copy of what they finally came out with, which I think is basically what was going on then. But it inspired us to go that route, the certificate of incorporation route. That would have to be approved by a stockholder. So we thought that would pass muster as far as the world is concerned. And if it were accompanied by pretty good arguments, that's a good way to go. So we began drafting a statute that would amend Section 102(b) to provide the director shall not be liable in damages personally in an action for breach of their fiduciary duty, except in certain instances, like the duty of loyalty and improper benefit and misconduct and dividends and the like. [00:09:38] But basically it was designed to say that directors should not be personally liable for damages of the violations of the duty of care. But the duty of care was still there. We didn't abolish the duty of care. In fact, it was very important that it was still there, not only because it was the aspirational things that directors should be doing in terms of corporate governance, but also because the lack of due care or the violation of duty of care could be very important in injunction cases, and that was still [00:10:12] - extant. So I remember some of this. It is thirty years ago. These are the things that I remember. And you sent me some minutes of a meeting of the council where that was referenced. And then later this amendment--this memo of mine, in May, came about.

McNally: There are several minutes to back. But I do want to before we turn to those, follow up on what you just mentioned, which is that the amendment to 102(b)(7) dealing with exculpation, had no effect on the court of chancery's ability to block transaction that was in violation of the duty of care.

Veasey: Correct

McNally: Was that important to you?

Veasey: Very important.

McNally: Why?

Veasey: Because it was a selling point. And it was an important point in corporate governance. If you have--if there is a deal being made where the directors of the target company, for example, were negligent in how they considered something, the court could step in upon the application of the plaintiff, and adjoin that transaction. Because, you didn't have to go to duty of loyalty or anything else, just duty of care. [00:11:26] They didn't do their homework in order to make this deal. That was very important. Not only as a matter of principle, but also as an important soundbite.

McNally: Then let's turn to those minutes of the April 17, 1986 Corporate council meeting. In general, what was the role of the council of the corporation law section back in the 1980's?

Veasey: Well that was the then iteration of the governance of the section of business law of the Delaware State Bar Association. Because back in the day when I was the head of that entity, not the Bar Association, but the head of the Corporate Law's committee, it was only a committee. And then we went to sections. And I think council became the governing arm of the section of business law, in particularly, in the area of corporate changes and corporate governance and corporate law. [00:12:31] So it was... I wasn't on the council. I was president of the Bar Association 1982-83. So I wasn't on the council corporation law council in 1986. But I was invited to the meetings [00:12:49 inaudible] and people asked me for my ideas. So as the minutes of this meeting show, April 17, 1986, it says on page 3, "Mr. Sparks, who was the head of the council then, circulated the proposal Mr. Veasey had made at a prior meeting, titled possible amendments to aid Delaware code, Section 102(b)." Now we had talked about a lot of things, putting a cap on damages, having indemnification go around in a circle on derivative suits and the like. And there were problems with all of these. And I don't really know now, 31 years later, the memo that I

circulated, if it was a memo... Mr. Sparks, with whom I was working very closely, and he and I were on the same page, I think, throughout, circulated the proposal. And it goes into some detail about the proposal, which basically was sort of the way it ended up. That was in April. And then you referenced the memo that I wrote on May the 13th. That was after there had been some controversy. And that memo of May 13th was designed... It was the memo to the whole corporation law section of the Delaware State Bar Association. [00:14:17] Designed to sell this.

McNally: Yeah, let's pause just for a moment on that. In connection with the minutes you just referred to, I noted the end of the last page next to the last page, it says each section member was given an opportunity to express his views and preferences. All expressed a preference for the proposed 102 over proposed 146, expect for Mr. McNally.

Veasey: That would be you.

McNally: That would be me. And I was motivated at that point because I had had as you pointed out, Professor Kerry as my corporate law professor. And I was quite concerned that 102(b)(7) would be viewed as Delaware overly favoring directors, protecting directors, even those who had done wrong. Was that a concern of yours as well, that public relations aspect?

Veasey: Yeah, sure, there's a very... there's a big concern about that. That was a concern that we had to deal with with-in the whole corporate law section of Delaware, and in the public generally, and the legislature. And you know we had to sell it. So that's why I wrote the May 13th more comprehensive memo about all the reasons why it would be good.

McNally: [00:15:38] Alright, let's talk a little bit about that May 13th memo. Before we get to that, can you describe for us what you can recall about the controversy within the Bar Association, over the proposed amendments, particularly the views of both Charles Crompton and Bruce Starget? Both of whom, like you, had been president of the Bar Association and both of whom, like you, were extremely well respected lawyers, and both of whom, at some point, as I understand it, were concerned about the proposal to amend 102(b)(7), to exculpate directors?

Veasey: Well I think Bruce was more concerned than Charlie Crompton was. And as I read these minutes, it seemed that Charlie Crompton was more concerned about the cap on liability issue. Because, you know, if you set it at a million dollars, which was what Section 146 would have done, who's to know that a million dollars today is appropriate tomorrow? So that's one thing. The second thing is that it looked more like a race to the bottom than the other things. Because Delaware is being accused of a race to the bottom.

And all of it's a judication of director liability and statutory changes. But that wasn't a fair concern. It was a perception that to be sure. [00:17:11] So when it came to the 102(b)(7), what you can put into your certificate of incorporation, I think the saving grace was that it had to go to the stockholders. It had to be in the certificate of incorporation. And if you're going to get an amendment to the certificate of incorporation, you had to have disclosure of what the effectiveness was. And the arguments were set forth in that, May 13th memorandum, the principal one being that directors should be able to focus on the important stuff. And that they can be held liable under the old rules for lack of homework preparation, if you will. Just gross negligence, which very much, not very much different from ordinary tort law, negligence. So there was a big concern about that and how to change that. So putting a cap didn't solve that problem of what the directors had to do, because, well, for the reasons that I mentioned.

McNally: Well you've come to this discussion with a perspective that's possibly unique, because you then became the Chief Justice of the Delaware Supreme Court and had to deal with the statue that you had created, or participated in creating. And we know that 102(b)(7) has an exception for conduct, for example, it's in bad faith, or not in good faith. Did that become a troublesome issue for you later, after 102(b)(7) was adopted, that is to what constituted, or did not constitute bad faith?

Veasey: [00:18:53] No, not while I was on the court. The Disney case finally clarified that, that good faith was part of the duty of loyalty. But all along, we think we knew what good faith was or lack of good faith. And in these discussions that are in the minutes, there was a discussion, well, does that mean bad faith? Bad faith may or may not be in the mirror image of lack of good faith. And also, lack of good faith or the good faith principle is already in our statute under Section 145 Entitlement to Indemnification. You have to act in good faith, meaning you have to act in the best interest of the corporation and not have a total disregard of your fiduciary duties that you know about. And it was also in Section 141(e) that said a director can be fully protected, is fully protected by good faith reliance on records and experts and the like. And so that became a pretty good thing to put in the statute. We had negotiations.

McNally: We're gonna get to that.

Veasey: I remember Joe Rosenthal, who was a plaintiff lawyer, wonderful lawyer. And we had negotiations with him about this. And he finally approved of the 102(b)(7). And he was the one, I think, don't say bad faith, say not in good faith like these other statutes say. And he was the one who said you gotta put it to the stockholders. And we all thought that was a good idea. And then I believe Joe Rosenthal was responsible for some of those other exceptions, like the duty of loyalty. That became a sticking point because how do

you know what that means in terms of a statute? But we worked around that. And as you fast forwarded to when I was on the Supreme Court, we had to deal with that, and we had to deal with 102(b)(7).

McNally: [00:21:14] Is it fair to say that that kind of statute which leads to the judiciary, the most difficult task of achieving justice under the particular facts of a particular case, it is consistent with the Delaware way of approaching corporate governance?

Veasey: Always has been. It's very hard to write the business judgement rule into a statute. I've been on the corporate law's committee. We tried to do that back in the day. I remember Frank Wheat was on the corporate laws committee when I was there and we were struggling how to articulate it in the model act. And he turned to me and he said, “Norm some things just don't draft.” But the principles of corporate governance put that in, did draft a statute outlining the business judgement rule. But we in Delaware always thought that was best left to our expert judiciary. And it is an expert judiciary that's been doing that for over a hundred years.

McNally: Well as one of the person who is on the judiciary, did you ever wish it was actually in the statute, or did you prefer the way it was?

Veasey: No. I prefered it the way it was. It's common law. And the common law develops and evolves and you look at prior cases and see how your current case fits into that. Justice Scalia, on the Supreme Court, I had dinner with him one time, on one of these meetings, and he said I admire you Chief Justice Veasey. I said you admire me?

McNally: Coming from Scalia that was an unusual statement.

Veasey: But it wasn't me, it was what I do, what I was doing. He said you're a common law judge, you can mold the piece of clay into something. We're constrained by the statute and constitution, the written word. You can deal with current situations as a common law judge. [00:23:16] And that's true. I think being a common law judge is wonderful and I enjoyed my 12 years on the court being a common law judge.

McNally: And we were glad you were there as well.

Veasey: Thank you.

McNally: Now, I know that you did eventually write an article in 1987 called the Delaware Supports Directors with a 3 legged Stool with Limited Liability Indemnification and

Insurance. It was in the Business Lawyer. Was that article well received, you think? It's a good explanation of what we were trying to do, or what you were trying to do at that time?

Veasey: I have no idea how it was received. You run things up the flagpole and you don't know who's going to salute it. But I do think it tend to express what we're trying to do in Delaware, and that is to get directors able to focus on the big things and not be worried about their assets being scooped up for failure to do their homework, for example. And Smith V. Van Gorkom was part of this perfect storm that came at that time that worried people a lot about it. And so when we wrote this article, I wrote it with Jesse Finkelstein and Steve Bigler [00:24:34] about sort of came right after we did 102(b)(7). And we said in that article that the irony of this whole thing is that courts want directors to be free to exercise their business judgement. But prior to this the courts could turn around and fine them, you know, find them liable for damages for not paying attention to their job when they had no intention of doing anything incorrect. And they took no improper benefit, they were loyal to the corporation and so forth.

McNally: Now I'm going to ask you a question, I don't think I've talked to you about before. What you just said really prompted me. In today's world of activist investors, do you think 102(b)(7) still has its place in making sure that directors aren't worried about being sued or somehow being criticized for the tough decisions that they have to make?

Veasey: [00:25:37] There are two parts to that question. Worried about being sued. They're always worried about being sued but they're not worried about being sued for negligence or gross negligence, and that relieves them in part of that concern. But worried about their jobs and worried about other things and worried about being sued, yes, they're worried about being sued. They're worried about corporate takeover or a proxy fight, and they're worried about what's out there and what the activist stockholders are trying to do. And if they exercise their fiduciary duty in the right way and the corporation is being handled correctly, then they have less to worry about. But I don't think 102(b)(7) is a problem, a concern in the current environment.

McNally: The current environment today in some ways reminds me of the environment in 1985 when you had institutional plaintiffs as opposed to today when you have maybe individual stockholder plaintiffs. But institutional plaintiffs were well financed and had able lawyers and presented the best possible case they could against the directors. Today we have activists stockholders. Do you see a similarity between the plaintiffs of the 1985 era and the potential plaintiffs of today?

Veasey: [00:27:00] Yes. And there is, there are institutional plaintiffs today, pension funds, for example, are very active in bringing actions against directors for violations of duty of

good faith or duty of loyalty and the like, and to try to get something done, try to prevent something from happening, suing for damages and so forth. And so their pension funds all over the place trying to do that. They are today's institutional stockholders. There are formidable adversaries for people who are defending those cases. And there are a lot of cases that are brought in Delaware by pension funds and the like, and they are very sophisticated, they're very well financed, they're very well represented. There are firms in Delaware, like the Grant Eisenhower firm [00:27:50] that specialized in bringing actions by these kinds of institutions, stockholders.

McNally: 102(b)(7) is still there to protect the directors--

Veasey: From the negligence piece of it, yes.

McNally: Chief Justice, there's just two areas that I think we didn't touch on. Number one was the process of getting 102(b)(7) approved by the general assembly. Do you recall whether that went smoothly or was it more of a contentious presentation?

Veasey: For the most part these amendments presented to the Delaware General Assembly have gone relatively smoothly because the members of the general assembly who focus on this know that the bar association council corporation council has spent a lot of time in debating these things and examining how they are perceived all over the world. Because Delaware's corporate franchise is one of the most important assets that Delaware has, and it's very important that we keep that ship on an even keel. And they know that and they know that we in the Delaware Bar Association are paying attention to that and that we do a balanced job that's been vetted throughout the country. [00:29:11] So they usually take what we say, you know, as being carefully vetted. In this case, I think they did the same, although I can't remember thirty years ago, whether there was much of a problem. I talked to Richard Himber, who was then a speaker of the house. And I think he was on a committee that considered that. He and I had a lot of dialogue along the way about this 102(b)(7). And I think he was satisfied. I went down to the legislature and talked to a lot of people there and tried to answer their questions. And I think they were satisfied by that. And so I think it went ok. And the members of General Assembly would look at our paperwork, in this case, the statute that was drafted and the synopsis explaining the statute, they looked at that very carefully. And so I think we've had a very responsible legislative reaction to our proposals, including this one.

McNally: There was some concern, I think I recall, that stockholders wouldn't approve a 102(b)(7). How did that work out in the real world?

Veasey: [00:30:26] In the real world they approved it, overwhelmingly. And there was that concern. But I think that stockholders at the end of the day were persuaded that we're freeing the directors to govern these enterprises, and that they shouldn't have to worry about these lawsuits, these nuisance suits, and that they should focus on the important stuff, the big stuff. And I think that, I was surprised at the overwhelming reaction of most of the stockholder base of the Delaware corporations to Section 102(b)(7). And it went through very well. It's been adopted almost universally.

McNally: I recall reading a court decision of a few months ago where the corporation involved did not have a 102(b)(7) revision in their charter, and I was shocked to see that. Is it fair to say that everybody now has adopted a 102(b)(7) for the most part?

Veasey: Everybody but that company, I guess.

McNally: [00:31:35] Is there anything further that you would care to add that I have forgotten to ask about?

Veasey: You sound like the head of an audit committee.

McNally: [laugh]

Veasey: I think we've covered it. And I think what I said in that May 13th memorandum sums up my feelings about it.

McNally: Ok, thank you Justice Veasey.

[00:32:14 end of video]