

# INSIGHTS

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## DELAWARE LAW

### Amendments to the DGCL Permit Officer Exculpation

**By John Mark Zeberkiewicz and Robert B. Greco**

On August 1, 2022, Section 102(b)(7) of the Delaware General Corporation Law (the DGCL) was amended to permit a corporation to include in its certificate of incorporation a provision to eliminate or limit the monetary liability of certain corporate officers for breach of the duty of care.<sup>1</sup> Previously, the protection afforded by a so-called exculpatory provision was limited to directors. Although for years there did not appear to be a compelling reason to consider extending the availability of such protection to officers, recent case law and other developments in the case law highlighted the need for the statutory change.

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#### Background

Section 102(b)(7) was originally adopted in 1986, largely in response to the crisis in directors' and officers' insurance that followed the Delaware Supreme Court's landmark decision in *Smith v. Van Gorkom*,<sup>2</sup> where it found that the directors had acted with haste in approving a merger and failed to consider all material information available to them, thereby breaching their duty of care.

At the time, Delaware's Corporation Law Council, which is responsible for proposing amendments to the DGCL, considered several alternatives to address the issue, including amending Section 145(b) of the DGCL to allow the corporation to indemnify directors for judgments and amounts paid in settlement of claims brought by or in the right of the corporation, amending Section 145(g) to allow for captive insurance, and imposing statutory limits on liability.<sup>3</sup>

Those alternatives were rejected at the time (although Section 145(g) was recently amended to allow for captive insurance, subject to certain limitations), as the Council "ultimately concluded that permitting stockholders to determine whether to limit or eliminate director liability was a more direct approach in addressing the problem."<sup>4</sup>

By its terms, Section 102(b)(7), as originally adopted, applied only to directors. The original omission of officers was deliberate. A contemporaneous exegesis of the statute stated:

While most derivative litigation names directors as defendants, corporate officers are sometimes charged with liability for negligence in the conduct of their offices. It is probable that, where a corporation has implemented the new statutory authority by an appropriate charter provision, officers will be more likely to take controversial decisions to the board [and] should be able to point to direct approval as protecting the officers from liability.<sup>5</sup>

In addition, at the time Section 102(b)(7) was adopted, there was little practical risk of officer liability, as Delaware's consent-to-jurisdiction statute, which provided that directors were deemed to consent to service of process in the State of Delaware, did not apply to officers. In 2003, however, in the wake of a series of corporate scandals involving Enron, Worldcom and others—and that animated the adoption of the Sarbanes-Oxley Act—Delaware's consent-to-jurisdiction statute was amended to cover “C-suite” officers.<sup>6</sup> A contemporaneous summary of the amendment to the consent-to-jurisdiction statute observed:

Because of enhanced requirements for independent director representation on public company boards of directors, it is likely that fewer senior officers will also serve as directors. Therefore, had Section 3114 not been amended, the ability to obtain personal jurisdiction in Delaware over some of the most significant participants in corporate governance would have been impaired.<sup>7</sup>

In the years that followed the amendment to Section 3114, fiduciary litigation involving officer defendants remained relatively rare. Indeed, it was

not until 2009 that the Delaware Supreme Court explicitly confirmed that officers owe the same fiduciary duties as directors.<sup>8</sup> Despite the Supreme Court's express ruling that officers owe the same fiduciary duties as directors, claims against officers did not become a focus of fiduciary litigation until relatively recently, when changes in the M&A litigation landscape imposed new hurdles on stockholder plaintiffs seeking to extract settlement payments or secure judgments when mounting claims that the directors breached their duties in approving mergers.

The two cases that precipitated the change in the landscape were *In re Trulia, Inc. Stockholder Litigation*,<sup>9</sup> where the Court of Chancery effectively shut down the practice of so-called “disclosure only” settlements (which would occur where the stockholder plaintiffs would obtain a relatively nominal settlement payment in exchange for the securing revisions to the proxy statement to correct quibble-style alleged omissions and would grant a blanket release for those claims),<sup>10</sup> and *Corwin v. KKR Financial Holdings LLC*,<sup>11</sup> where the Delaware Supreme Court affirmed the Court of Chancery's holding that a fully-informed vote of disinterested stockholders had the effect of restoring the presumption of the business judgment rule to the board's decision to approve a merger, thereby resulting in the dismissal of so-called *Revlon* claims tested under the standard of enhanced scrutiny.<sup>12</sup>

Although the Supreme Court's opinion in *Corwin* gave boards a potent weapon with which to dismiss merger litigation, it also provided stockholder plaintiffs a roadmap for pursuing claims beyond the stockholder vote. The Court stated that “the [*Corwin*] doctrine applies only to fully informed, uncoerced stockholder votes, and if troubling facts regarding director behavior were not disclosed that would have been material to a voting stockholder, then the business judgment rule is not invoked.”<sup>13</sup> In the years following *Corwin*, stockholder plaintiffs not only began to use the so-called tools at hand to bring books and records demands and litigation under Section 220 of the DGCL, but also began to make appraisal demands and utilize Delaware's appraisal statute as

a means to attempt to obtain full-blown discovery before commencing a fiduciary action act.<sup>14</sup>

With reference to the documents produced in the litigation, the plaintiffs would seek to overcome a *Corwin*-based defense by alleging that the disclosure document seeking the stockholder vote or tender was materially misleading. In a pair of opinions from 2018, the Delaware Supreme Court reversed the Court of Chancery's *Corwin*-based dismissals of claims challenging mergers on the grounds that the disclosure documents were materially misleading.<sup>15</sup>

### The Reason for the Amendments

In the late 2010s, stockholder plaintiffs, in pursuing merger litigation, began naming officers as defendants for their role in preparing the allegedly deficient disclosure documents. In *Morrison v. Berry*, for example, the Court of Chancery dismissed claims against a company's directors that had approved the company's acquisition by a private equity firm, but allowed the claims against the company's general counsel and president and CEO to proceed on the basis that, in light of the plaintiff-friendly pleading standard, it would reasonably infer that the officers were grossly negligent in preparing the disclosure document.<sup>16</sup>

Although the *Morrison* Court's opinion seemed to indicate that an ultimate finding of gross negligence would be unlikely, it essentially held that, once a disclosure violation had been found, allegations against officers who prepared the disclosure document could effectively proceed.<sup>17</sup> Subsequent opinions of the Court of Chancery followed the same pattern.<sup>18</sup>

This perverse outcome led to calls from prominent corporate practitioners and commentators, including highly regarded members of the Delaware courts, to call for amendments to Section 102(b)(7).<sup>19</sup> In large part, the amendments to Section 102(b)(7) were enacted in response to the perceived fundamental unfairness that directors—upon whom the obligation to ensure that stockholders are given all information material to any decision they are being

asked to make—could be dismissed from the litigation, while the officers, not entitled to the same level of exculpatory protection, would be required to continue in the litigation to demonstrate that their conduct in preparing the disclosure document was not grossly negligent.

Given corporate law's stringent construction of "gross negligence," it is difficult to conceive of a fact pattern in which an officer of a public company that, with the assistance of outside counsel, prepared a disclosure document that was in fact "grossly negligent" in doing so.<sup>20</sup> Nevertheless, the lack of exculpation for officers gives plaintiffs the ability to continue to exert litigation pressure to drive a settlement. Despite the difficulty plaintiffs would face in proving, after trial, that an officer was grossly negligent, defendants rationally may wish to settle the claims to avoid the costs and distraction of litigation.

### Operation of the Amendments

The amendments to Section 102(b)(7) are designed primarily to correct the dynamic that arises in the context where stockholders are able to pursue direct claims (as is frequently the case in M&A litigation) against officers that would be dismissed if brought against exculpated directors. An exculpatory provision covering officers would not, however, prevent the board of directors from pursuing duty of care claims against officers in the name of the corporation, nor would it prevent stockholders from bringing derivative claims in which officers are alleged to have breached their duty of care.

Thus, Section 102(b)(7), as amended, recognizes the basic structure of the Delaware corporation—that directors are principally responsible for oversight of the corporation and the long-term best interests of stockholders, while officers are responsible for management of the corporation's day-to-day affairs. Given that basic design, directors must have the ability to rely on officers, and should have the opportunity to pursue claims for breach of the duty of care where directors fall short of their obligations.

In terms of derivative litigation, the board of directors will in most cases retain the ability to determine whether to pursue claims for breach of the duty of care against officers, given that stockholders would have to either make a demand on the board to pursue litigation or demonstrate that such a demand would be futile,<sup>21</sup> which, based on a recent opinion from the Delaware Supreme Court, would prove difficult in most settings where the board is composed of a majority of disinterested, independent directors.<sup>22</sup> As with directors, an exculpatory provision may not exculpate officers from liability for breach of the duty of loyalty, for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, for illegal stock redemptions or repurchases and dividends, or for any transaction in which the officer derived an improper personal benefit.<sup>23</sup>

The protection available under Section 102(b)(7), whether for directors or officers, does not apply by default. To the extent any such protection is provided, it must be granted through the certificate of incorporation and will apply only from and after the effectiveness of the provision granting such protection. If the provision were subsequently amended to eliminate the exculpatory protection to officers, the exculpatory protection would continue to apply with respect to acts or omissions taken while the provision was in effect.

Given that exculpatory provisions for officers must be included in the certificate of incorporation, it is likely that newly formed corporations, as well as corporations that are pursuing an initial public offering, should consider including provisions in their certificates of incorporation that exculpate officers to the fullest extent permitted by law. For existing public companies, it remains to be seen how institutional investors and proxy advisors will react to proposals to amend the certificate of incorporation to provide exculpation to officers.

In light of structure of the proposed amendments to Section 102(b)(7), which would not exculpate officers against claims brought by or in the right of the corporation and would principally protect them

for a narrow class of direct claims in which officers are alleged to have breached their duty of care, there would not seem to be a principled objection to the provision.

## Notes

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1. 83 Del. Laws ch. 377, § 1.
2. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).
3. See R. Franklin Balotti and Mark J. Gentile, "Elimination or Limitation of Director Liability for Delaware Corporations," 12 *Del. J. Corp. L.* 5, 9, n.21 (1987).
4. *Id.*
5. Lewis S. Black, Jr. and A. Gilchrist Sparks, II, *Analysis of the 1986 Amendments to the Delaware Corporation Law*, at 313 (Prentice Hall 1986), available at <https://www.law.upenn.edu/live/files/6618-1986-dgcl-article>.
6. The amendment to Section 3114 of Title 10 of the Delaware Code was as follows: "Every nonresident of this State who after January 1, 2004, accepts election or appointment as an officer of a corporation organized under the laws of this State, or who after such date serves in such capacity, and every resident of this State who so accepts election or appointment or serves in such capacity and thereafter removes residence from this State shall, by such acceptance or by such service, be deemed thereby to have consented to the appointment of the registered agent of such corporation (or, if there is none, the Secretary of State) as an agent upon whom service of process may be made in all civil actions or proceedings brought in this State, by or on behalf of, or against such corporation, in which such officer is a necessary or proper party, or in any action or proceeding against such officer for violation of a duty in such capacity, whether or not the person continues to serve as such officer at the time suit is commenced. Such acceptance or service as such officer shall be a signification of the consent of such officer that any process when so served shall be of the same legal force and validity as if served upon such officer within this State and such appointment of the registered agent (or, if there is none, the Secretary of State) shall be irrevocable. As used in this section, the word 'officer' means an officer of the corporation who (i) is or was the president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer

or chief accounting officer of the corporation at any time during the course of conduct alleged in the action or proceeding to be wrongful, (ii) is or was identified in the corporation's public filings with the United States Securities and Exchange Commission because such person is or was one of the most highly compensated executive officers of the corporation at any time during the course of conduct alleged in the action or proceeding to be wrongful, or (iii) has, by written agreement with the corporation, consented to be identified as an officer for purposes of this section." Del. S.B. 126, 142nd Gen. Assem. (2003).

7. Delaware Division of Corporations, Amendments to Corporate Law 2003, June 30, 2003, available at <https://corp.delaware.gov/decodeamend/2003amend/>.
8. *Gantler v. Stephens*, 965 A.2d 695, 708–09 (Del. 2009) (“In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold.”).
9. *In re Trulia, Inc. Stockholder Litigation*, 129 A.3d 884 (Del. Ch. 2016).
10. *Id.* at 898–99. The Court stated: “Returning to the historically trodden but suboptimal path of seeking to resolve disclosure claims in deal litigation through a Court-approved settlement, practitioners should expect that the Court will continue to be increasingly vigilant in applying its independent judgment to its case-by-case assessment of the reasonableness of the ‘give’ and ‘get’ of such settlements in light of the concerns discussed above. To be more specific, practitioners should expect that disclosure settlements are likely to be met with continued disfavor in the future unless the supplemental disclosures address a plainly material misrepresentation or omission, and the subject matter of the proposed release is narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process, if the record shows that such claims have been investigated sufficiently. In using the term ‘plainly material,’ I mean that it should not be a close call that the supplemental information is material as that term is defined under Delaware law. Where the supplemental information is not plainly material, it may be appropriate for the Court to appoint an *amicus curiae* to assist the Court in its evaluation of the alleged benefits of the supplemental disclosures, given the challenges posed by the non-adversarial nature of the typical disclosure settlement hearing.” *Id.*
11. *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015). Roughly two years later, the Delaware Supreme Court confirmed that the *Corwin* doctrine also applies to an “intermediate-form merger” under Section 251(h) of the DGCL, which generally provides that no vote of stockholders is required to approve a merger if a number of shares that would be sufficient to approve the merger are irrevocably tendered to the purchase. *In re Volcano Corp. S’holder Litig.*, 156 A.3d 697 (Del. 2017) (TABLE).
12. *Corwin*, 125 A.3d. at 306. The Court stated that “the Chancellor was correct in finding that the voluntary judgment of the disinterested stockholders to approve the merger invoked the business judgment rule standard of review and that the plaintiffs’ complaint should be dismissed.” *Id.* In articulating the rationale for its holding, the Supreme Court in *Corwin* explained how the initial application of enhanced scrutiny squared with the restoration of the presumption of the business judgment rule following a fully informed vote of the disinterested stockholders, stating that “although the plaintiffs argue that adhering to the proposition that a fully informed, uncoerced stockholder vote invokes the business judgment rule would impair the operation of *Unocal* and *Revlon*, or expose stockholders to unfair action by directors without protection, the plaintiffs ignore several factors[, including that] *Unocal* and *Revlon* are primarily designed to give stockholders and the Court of Chancery the tool of injunctive relief to address important M & A decisions in real time, before closing.” *Id.* at 312.
13. *Id.*
14. *See, e.g., Wei v. Zoox, Inc.*, 268 A.3d 1207 (Del. Ch. 2022).
15. *Appel v. Berkman*, 180 A.3d 1055 (Del. 2018); *Morrison v. Berry*, 191 A.3d 268 (Del. 2018).
16. *Morrison v. Berry*, 2019 WL 7369431 (Del. Ch. Dec. 31, 2019).
17. *Id.* at \*24. (“Drawing all reasonable inferences for the Plaintiff, I find the allegations conceivably support such a claim here. Our Supreme Court held that as offered, the 14D-9 ‘presents a distorted narrative.’ For reasons already explained, I do not find that the omissions support an inference of a subsequent concealment of misconduct or

a bad faith intent to harm the Company. Given the omissions, however, the 14D-9 offers stockholders a version of events that, as our Supreme Court found, left them lacking information material to a decision. Such a distortion of events creates a reasonable inference for the Plaintiff at this stage that [the officer] conceivably acted with gross negligence in his role as [the company]’s General Counsel with regard to the 14D-9.”).

18. *See, e.g.*, *City of Warren Gen. Emps.’ Ret. Sys. v. Roche*, 2020 WL 7023896 (Del. Ch. Nov. 30, 2020); *In re Baker Hughes Inc. Merger Litig.*, 2020 WL 6281427 (Del. Ch. Oct. 27, 2020); *In re Pattern Energy Grp. Inc. S’holders Litig.*, 2021 WL 1812674, at \*69–70 (May 6, 2021).
19. *See* Lawrence A. Hamermesh, Jack B. Jacobs & Leo E. Strine, Jr., “Optimizing the World’s Leading Corporate Law: A Twenty-Year Retrospective and Look Ahead,” 77 *Bus. Law.* 321 (2022).
20. *See generally* *Tomczak v. Morton Thiokol, Inc.*, 1990 WL 42607 (Del. Ch. Apr. 5, 1990) (“In the corporate context, gross negligence means reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.”); *Albert v. Alex. Brown Mgmt. Servs., Inc.*, 2005 WL 2130607, at \*4 (Del. Ch. Aug. 26, 2005) (“Gross negligence has a stringent meaning under Delaware corporate (and partnership) law, one which involves a devil-may-care attitude or indifference to duty amounting to recklessness.”).
21. Court of Chancery Rule 23.1.
22. *United Food & Comm. Workers Union & Participating Food Indus. Emps. Tri-State Pension Fund v. Zuckerberg*, 262 A.3d 1034, 1059 (Del. 2021) (stating that “courts should ask the following three questions on a director-by-director basis when evaluating allegations of demand futility: (i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand; (ii) whether the director faces a substantial likelihood of liability on any of the claims that would be the subject of the litigation demand; and (iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that would be the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand”).
23. 8 *Del. C.* § 102(b)(7).

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