

Chapter 9

Director Liability and Indemnification

WILLIAM D. JOHNSTON

JOHN J. PASCHETTO

Young Conaway Stargatt & Taylor, LLP

The Brandywine Building

1000 West Street, 17th Floor

Wilmington, Delaware 19801

302-571-6679

wjohnston@ycst.com

jpaschetto@ycst.com

Chapter 9

Chapter Summary

9.1 Introduction.....	260
9.2 Statutory Immunity from Personal Liability -- 8 Del. C. § 102(b)(7)	260
9.2.1 Legislative Developments / Model Business Corporation Act Developments	261
9.2.2 Caselaw Developments.....	262
9.2.3 Articles.....	276
9.3 Indemnification and Advancement -- 8 Del. C. § 145.....	278
9.3.1 Legislative Developments / Model Business Corporation Act Developments	278
9.3.2 Caselaw Developments.....	278

9.1 Introduction

This outline summarizes key caselaw developments, and a noteworthy article, from 2001 with respect to charter provisions which, pursuant to § 102(b)(7) of the Delaware General Corporation Law (the “DGCL”), serve to insulate corporate directors from certain types of personal liability. The outline also addresses cases concerning the indemnification or “advance indemnification” of directors and officers through charter provisions, bylaw provisions or otherwise pursuant to § 145 of the DGCL.

We focus on Delaware law in light of the State’s preeminence in matters affecting corporate governance. Nonetheless, decisions from courts outside of Delaware also are considered insofar as they interpret Delaware law or provide additional learning on the subjects of director liability or indemnification. We also note the status of related provisions of the Model Business Corporation Act.

9.2 Statutory Immunity from Personal Liability -- 8 Del. C. § 102(b)(7)

Section 102(b)(7) of the DGCL¹ provides that a corporate charter may eliminate or limit the personal liability of a director for monetary damages from certain types of claims on the part of a corporation or its stockholders. Exculpatory charter provisions adopted pursuant to § 102(b)(7) continued to be frequently litigated in 2001, particularly on pre-trial motions by director defendants attempting to defeat suits or at least limit the triable issues.

Two decisions of the Delaware Supreme Court have particular significance for practitioners who seek to raise, or to overcome, defenses based on § 102(b)(7)-authorized charter provisions. In *Malpiede v. Townson*, Del. Supr., 780 A.2d 1075 (2001), the Court revisited its holding in *Emerald Partners v. Berlin*, Del. Supr., 726 A.2d 1215 (1999) (*Emerald Partners I*), to the effect that the protection afforded by an exculpatory charter provision “is in the nature of an affirmative defense” to be established “normally” by defendants. *Id.* at 1223-24. The *Malpiede* Court clarified that holding, offering several procedurally proper ways in which a trial court, on a motion to dismiss, may take into account an exculpatory charter provision that is outside the pleadings. In addition, the Court affirmed the Chancery Court’s dismissal of the shareholder complaint where no well-pleaded allegations of director disloyalty or bad faith were made and the company’s exculpatory charter provision barred recovery based on the directors’ breaches (if any) of the duty of care.

The import of *Malpiede* cannot be gauged, however, without examining the second of the past year’s Supreme Court decisions alluded to above, *Emerald Partners v. Berlin*, Del. Supr., No. 96, 2001, 2001 Del. LEXIS 525, Holland, J. (Nov. 28, 2001) (*Emerald Partners II*). By the time of the latter decision, the Court had already reversed the Chancery

¹ Section 102(b)(7) of the DGCL provides, in pertinent part, that a certificate of incorporation may contain “[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (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 § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.”

Court's grant of summary judgment for defendants and remanded the case for further proceedings. *See Emerald Partners I, supra*. The case was then appealed from the post-trial decision, in which the trial court had found that plaintiff failed to produce sufficient evidence to place defendants' alleged breaches of duty outside the applicable exculpatory charter provision. Again reversing and remanding, the Supreme Court in *Emerald Partners II* held that the trial court should have examined defendants' conduct pursuant to the entire-fairness standard and should have applied the exculpatory charter provision only after the entire-fairness issue had been decided. The Supreme Court reconciled its holding in *Emerald Partners II* with its affirmance in *Malpiede* on the grounds that, in *Malpiede*, the only colorable basis for invoking the entire-fairness standard was the breach of the duty of care, whereas, in *Emerald Partners*, the entire-fairness standard was invoked by a sufficient showing of disloyalty or bad faith. Some of the issues raised by *Emerald Partners II* are discussed in the "Comment" portion of this outline, below.²

Other decisions in 2001 similarly focused on the minimum showing a plaintiff must make in order to survive a motion to dismiss or a motion for summary judgment based on the protections afforded by a § 102(b)(7)-authorized charter provision. Plaintiffs most often have sought to neutralize exculpatory charter provisions by alleging facts that imply "disloyalty" or "bad faith." *See, e.g., In re New Valley Corp. Derivative Litigation, In re Abbott Laboratories Derivative Shareholder Litigation, In re Reliance Securities Litigation, Clements v. Rogers*. In addition, several federal cases in the bankruptcy context explored the outer boundaries of the protection furnished by exculpatory charter provisions. *See, e.g., Pereira, Official Committee of the Unsecured Creditors of Color Tile, Inc.*

Finally, we commend to the reader's attention the thought-provoking article by former Chancellor William T. Allen and Vice Chancellors Jack B. Jacobs and Leo E. Strine, Jr., reexamining "from the ground up" the judicial standards applied under Delaware law to the review of director conduct.

9.2.1 Legislative Developments / Model Business Corporation Act Developments

The Delaware legislature did not enact any amendments to 8 *Del. C.* § 102(b)(7) in 2001. There also were no amendments to the related provision of the Model Business Corporation Act, § 2.02(b)(4).

9.2.2 Caselaw Developments

In re Freeport-McMoRan Sulphur, Inc. Shareholders Litigation, Del. Ch., Consol. C.A. No. 16729, 2001 Del. Ch. LEXIS 5, Jacobs, V.C. (Jan. 5, 2001).

Background: Shareholders of Freeport-McMoRan Sulphur, Inc. brought a class action against the Freeport board, alleging that the directors had breached their duty of loyalty in

² While it is beyond the scope of this outline, a second holding in *Emerald Partners II* with respect to the entire-fairness standard is likely to have an equally significant impact on litigation regarding directors' fiduciary duties. The Supreme Court appears to have held that any self-dealing transaction is subject to the entire-fairness standard, regardless of whether a majority of the board approving the transaction was disinterested and independent. *See Emerald Partners II, supra*, at *25.

approving the company's merger with McMoRan Oil & Gas Co. The Court grants the defendants' motion to dismiss pursuant to Rule 12(b)(6), finding that plaintiffs failed to allege adequately that more than three of the company's seven directors were not disinterested and independent regarding the transaction. The Court notes, but does not directly address, the defendants' argument that Freeport's exculpatory charter provision also compels dismissal.

Comment: Note that the Court focuses its attention on whether a majority of the directors were disinterested and independent and does not reach the Section 102(b)(7)-based defense on the Rule 12(b)(6) motion.

In re New Valley Corp. Derivative Litigation, Del. Ch., Consol. C.A. No. 17649, 2001 Del. Ch. LEXIS 13, Chandler, C. (Jan. 11, 2001).

Background: The plaintiffs, minority shareholders of New Valley Corporation, claimed that the director defendants and the controlling shareholder's parent, Brooke Group, Ltd., had breached their fiduciary duties by causing New Valley to purchase stock from Brooke Group at an unfair price.

The Court denies the defendants' motion to dismiss for failure to state a claim and failure to plead adequately that demand on the New Valley board was excused. Despite the defendants' urging, the Court first declines to consider allegedly exculpatory board minutes and other documents produced in a prior "books-and-records" action, on the grounds that they are outside the complaint and, unlike "a disclosure statement, a contract, or an allegedly libelous publication[,] are offered for the truth of the matters they assert. *Id.* at *18. Focusing solely on the complaint, the Court then holds that the transaction must satisfy the entire fairness standard and defers until a later stage the allocation of the burden on that issue.

Turning to the question of whether demand was excused, the Court rejects the defendants' challenge because the complaint sufficiently alleges that all of New Valley's current directors "have current or past business, personal, and employment relationships with each other and with the entities involved[,] even though "the actual extent of these relationships is not altogether clear at this point[.]" *Id.* at *25-*26. For the same reasons, the Court then holds that New Valley's exculpatory charter provision does not bar claims against four directors who (according to the defendants) were disinterested, three of whom having acted as a special committee regarding the transaction. Rather, the complaint's allegations of disloyalty and bad faith are found to be sufficient, at the pleading stage, to place the claims against all defendants outside the exculpatory provision.

Comment: While the Court recognizes a lack of clarity in the complaint, and acknowledges that "some of the allegations of interestedness appear innocuous on the surface" (*id.* at *26 n.24), the complaint's depiction of the directors' "intertwining relationships" is nonetheless "enough to defeat a motion to dismiss." *Id.* at *3, *26. Those allegations are also enough to cause the Court to defer its allocation of the burden of proving entire fairness (or its absence), despite the board's use of a special committee that, if "truly independent," would normally have burden-shifting effect. *Id.* at *22. Given the Court's refusal to credit the special committee until the record is better developed, it is unsurprising (albeit not doctrinally necessary) that the Court refuses as well at this juncture to find that the exculpatory charter provision bars claims against the assertedly independent directors who made up the committee.

***McCall v. Scott*, 239 F.3d 808 (6th Cir. [Feb. 13] 2001). *McCall v. Scott*, 250 F.3d 997 (6th Cir. 2001) (amending Section II.C of the previous opinion).**

Background: The plaintiff shareholders brought a derivative action against directors and officers of Columbia/HCA Healthcare Corporation, alleging that the defendants had breached their fiduciary duties by permitting Columbia's management to commit fraud and securities violations. The trial court dismissed the complaint for failure to allege sufficiently that demand was excused, and the plaintiffs appealed.

The Sixth Circuit reverses. While it agrees with the trial court's finding that the alleged breaches of the duty of loyalty were not adequately pled to excuse demand, it nevertheless holds, contrary to the trial court, that demand is excused on the basis of the nature of plaintiffs' duty-of-care allegations. Those allegations support demand excusal despite Columbia's exculpatory charter provision because, in substance, they amount to allegations of bad faith:

Here, Plaintiffs accuse the directors not merely of "sustained inattention" to their management obligations, but rather of "intentional ignorance of" and "willful blindness" to "red flags" signaling fraudulent practices throughout Columbia. Accordingly, regardless of how plaintiffs style their duty of care claims, we find that they have alleged a conscious disregard of known risks, which conduct, if proven, cannot have been undertaken in good faith. Thus, we hold that plaintiffs' claims are not precluded by Columbia's § 102(b)(7) waiver provision.

McCall, 250 F.3d at 1001.

Comment: The Court's and the parties' apparent struggle with characterizing the directors' conduct is perhaps reflected in the later amendment to the opinion, revising the Court's discussion of the effect of Columbia's exculpatory charter provision to explain precisely how alleged duty-of-care breaches could be outside the exculpatory provision. The same result could presumably have been reached by viewing the directors' "intentional ignorance" and "willful blindness" as falling within the "intentional misconduct" exception under Section 102(b)(7).

***McMichael v. United States Filter Corp.*, Consol. Case No. EDCV 99-182 VAP (Mx), 2001 U.S. Dist. LEXIS 3918, Phillips, J. (C.D. Cal. Feb. 23, 2001).**

Background: Following the acquisition of United States Filter by Vivendi S.A., shareholders of Filter brought this action against, among other defendants, Filter's directors. The complaint alleged violations of federal securities laws and state-law fiduciary breaches, based primarily on the board's purported failure to ascertain Filter's "true market value" before agreeing to the transaction, and on the inside directors' purported acceptance of side payments and other special treatment from Vivendi. *Id.* at *6.

The Court grants the directors' motion to dismiss for failure to state a claim. At defendants' urging, the Court finds that it may take judicial notice of the corporation's charter, since "[t]he certificate of incorporation of a Delaware corporation is a publicly filed document." *Id.* at *27. The Court then holds that the charter's exculpatory provision bars plaintiffs' state-law claim "insofar as it is based on the duty of care." *Id.* at *29. Turning

next to an analysis under the business judgment rule, the Court makes an extended examination of the directors' conduct in light of both the duty of loyalty and the duty of care. All of the fiduciary-breach claims are ultimately held to be barred by the business judgment rule's presumption, in that the complaint failed to allege sufficiently that a majority of the board was interested or not independent, that the side payments were material, or that the directors did not "adequately inform[] themselves of the value of the company." *Id.* at *43.

Comment: Notably, the Court analyzes plaintiffs' duty-of-care claim as possible grounds for rebutting the presumption of the business judgment rule, notwithstanding its holding, earlier in the opinion, that any care-based claims are barred by Filter's exculpatory charter provision. In contrast, Delaware courts have typically reasoned (most often *sub silentio*) that, where an exculpatory charter provision bars care-based claims, it is unnecessary to determine whether the allegations of a duty-of-care breach are sufficient to rebut the business judgment rule and require a different standard of review; the plaintiff will not be able to recover in any event. *See, e.g., Malpiede v. Townson*, Del. Supr., 780 A.2d 1075 (2001) (discussed below); *In re Lukens, Inc. Shareholders Litigation*, Del. Ch., Consol. C.A. No. 16102, 1999 Del. Ch. LEXIS 233, Lamb, V.C. (Dec. 1, 1999), *aff'd sub nom. Walker v. Lukens, Inc., et al.*, Del. Supr., 757 A.2d 1278 (2000). *But see Leung v. Schuler*, Del. Ch., C.A. No. 17089, 2000 Del. Ch. LEXIS 41, Jacobs, V.C. (Feb. 29, 2000) (where director-defendants moved to dismiss for failure to state a claim and for failure adequately to plead demand excusal, the Court finds that the complaint fails to state a claim (and thus fails to show that demand is excused), and that as a result the Court need not decide whether the company's exculpatory charter provision may serve to bar the claims).

In addition, the Court's taking of judicial notice of Filter's charter is consistent with Delaware Chancery Court practice and with the recommendations made recently by the Delaware Supreme Court in *Malpiede, infra*, regarding procedurally proper ways in which a trial court may consider an exculpatory charter provision on a motion to dismiss, when the charter is outside the pleadings.

***Pereira v. Cogan*, No. 00 Civ. 619 (RWS), 2001 U.S. Dist. LEXIS 2461, Sweet, J. (S.D.N.Y. March 13, 2001).**

Background: The bankruptcy trustee of Trace International Holdings brought suit against the company's former directors for, among other things, breaching their fiduciary duties by permitting the chairman, CEO, and majority shareholder to, in sum, treat the company "as his personal bank[.]" *Id.* at *8. The directors invoked the company's exculpatory charter provision in a motion to dismiss for failure to state a claim.

The Court denies the defendants' motion, holding that an exculpatory provision cannot apply to claims brought by creditors as opposed to shareholders. Expressly relying on *In re Ben Franklin Retail Stores, Inc.*, Nos. 97C7934, 97C6043, 2000 U.S. Dist. LEXIS 276 (N.D. Ill. Jan. 11, 2000), the Court reasons that charter provisions adopted pursuant to 8 *Del. C.* § 102(b)(7) are intended to allocate risk only as between "the parties to the articles of incorporation, *i.e.*, the shareholders and directors. The clause does not allocate this risk with respect to third parties, such as the creditors for whose benefit the Trustee has brought the instant suit." *Pereira, supra*, at *34-*35.

The Court cites the same authority in rejecting defendants' argument that "the Trustee cannot escape the Exculpatory Provision because he stands in the shoes of the corporation[.]" *Id.* at *35. Rather, the settled law is that "where the injury is to all creditors as a class, it is . . .

. the Trustee who may bring a claim based on that generalized injury” (*id.*), and the fact that the creditors in *In re Ben Franklin*, unlike the Trace creditors, “had specifically assigned their claims to the trustee” does not affect the analysis (*id.* at *36 n.14).

Comment: The opinion points up the potential exposure of directors of financially troubled companies to suits by creditors, notwithstanding the presence of an exculpatory charter provision. In addition, the Court’s distinction between creditor and shareholder on the basis of who is a “party” to the corporate charter is founded on the Court’s implicit acceptance of the “modern” theory of charter-as-contract. See, e.g., William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 *Stan. L. Rev.* 1471 (1989).

***In re Abbott Laboratories Derivative Shareholder Litigation*, 141 F. Supp. 2d 946 (N.D. Ill. [Mar. 28] 2001).**

Background: In this derivative lawsuit, shareholders claimed that an alleged lack of oversight by the directors of Abbott Laboratories was a fiduciary breach that had resulted in a costly consent decree between Abbott and the FDA. A series of regulatory violations by one of Abbott’s divisions had culminated in the decree, which required Abbott to pay a fine of \$100 million, destroy certain inventory, and take other corrective actions. The defendants moved to dismiss on the grounds that the complaint did not adequately plead that demand on the board was excused.

The Court grants the motion to dismiss. In analyzing the demand issue, the Court examines the complaint to determine whether the directors’ risk of liability for the claimed fiduciary breach was sufficiently high for demand to be futile. Taking note of Abbott’s exculpatory charter provision, the Court articulates the showing that plaintiffs must make in terms of conduct outside the provision:

Absent non-exempt behavior that could give rise to liability, there would be no reason the directors could not impartially evaluate plaintiffs’ demand. Consequently, plaintiffs must plead facts showing a substantial likelihood that [the] directors engaged in non-exempt behavior.

Id. at 949. The Court then puts to rest the parties’ dispute over whether reckless conduct constitutes “non-exempt behavior” under the exculpatory provision, concluding that bad faith, not recklessness, is the operative concept, and that recklessness may or may not amount to bad faith.

After weighing the complaint’s factual allegations, the Court finds that no “non-exempt behavior” has been pled. First, the violations were “not so widespread and egregious” that knowledge of them could be imputed to the directors on that basis alone. *Id.* at 950. Second, the correspondence between Abbott and the FDA, even assuming the directors did know or should have known about it, would have reasonably suggested that “Abbott’s management was making a good faith effort to address the violations.” *Id.* at 951. The defendants’ alleged inaction “could, at most, be considered negligent. The complaint . . . does nothing to suggest a majority of the directors were complicit in any scheme to stonewall the FDA[.]” *Id.*

Comment: The Court’s analysis is consistent with Delaware law, requiring that, in view of the type of conduct alleged and the exculpatory charter provision, the complaint’s factual

allegations must establish a substantial likelihood that the directors breached a duty other than the duty of care. See *In re Baxter International, Inc. Shareholders Litig.*, Del. Ch., 654 A.2d 1268, 1269 (1995) (cited by the *Abbott Laboratories* Court at p. 948).

***In re Reliance Securities Litigation*, 135 F. Supp. 2d 480 (D. Del. [Mar. 29] 2001).**

Background: In this action alleging breaches of federal- and Delaware-law disclosure duties in the context of a spin-off transaction, the Court previously (at 91 F. Supp. 2d 706 (2000)) denied the director-defendants' motion to dismiss, ruling that the plaintiffs had alleged sufficient facts indicative of disloyalty to overcome the protections of the corporation's exculpatory charter provision. Certain defendants subsequently reasserted the exculpatory provision on a motion for summary judgment.

The Court grants the motion:

After taking discovery, plaintiffs have not identified facts to support their allegation that defendants acted intentionally or with knowledge. At most, plaintiffs have identified facts which suggest that [the movants] may have recklessly approved certain SEC documents. Further, plaintiffs have not identified facts that demonstrate that defendants breached their duty to disclose in bad faith.

Id. at 520.

Comment: Query whether a Delaware court, given the recent holding of *Emerald Partners v. Berlin* (discussed *infra*), could have decided this case in an equally streamlined manner. Since the trial court had already held that the allegations of director disloyalty were sufficient to survive a motion to dismiss, then, under one possible reading of *Emerald Partners*, the court would be required to conduct a full-blown entire fairness analysis before it could consider whether, and to what extent, the exculpatory provision insulates the directors.

***Malpiede v. Townson*, Del. Supr., 780 A.2d 1075 ([April 3] 2001).**

Background: The shareholder plaintiffs alleged in this action that the directors of Frederick's of Hollywood had violated their fiduciary duties in the sale of Frederick's to Knightsbridge Capital. Following the Chancery Court's dismissal of the complaint for failure to state a claim, plaintiffs appealed.

Plaintiffs asserted a variety of grounds for placing the directors' conduct outside the protection of the Frederick's exculpatory charter provision: (i) the directors acted disloyally because they feared a suit by Knightsbridge if they repudiated its embrace in favor of a higher offer; (ii) the directors' alleged violations of their so-called *Revlon*³ and disclosure duties could not be divided into separate breaches of loyalty and care; (iii) in general, the plaintiffs' duty-of-care claims were so "inextricably intertwined" with their duty-of-loyalty claims that such claims could not be barred by the exculpatory provision (*Malpiede*, 780 A.2d at 1093); and (iv) the Court of Chancery impermissibly shifted to the plaintiffs the burden of proving that the exculpatory provision did not apply to the alleged conduct.

³ *Revlon v. MacAndrews & Forbes Holdings, Inc.*, Del. Supr., 506 A.2d 173 (1986).

The Court, sitting *en banc*, rejects each argument and affirms: fear of being sued upon the sale of a company, it holds, is not sufficient to create a conflict of interest; the so-called *Revlon* and disclosure “duties” are simply “contexts” in which the traditional duties of loyalty, care, and good faith are applied (*Malpiede*, 780 A.2d at 1083); and, if the plaintiffs fail to make well-pleaded allegations of disloyalty or bad faith, the trial court is justified in dismissing any remaining claims where an exculpatory charter provision is in effect.

Comment: The Delaware Supreme Court addresses in *Malpiede* a procedural question that has concerned practitioners since the Court’s 1999 opinion in *Emerald Partners v. Berlin*, 726 A.2d 1215 (*Emerald Partners I*). The Court in *Emerald Partners I* held that the protection afforded by an exculpatory charter provision “is in the nature of an affirmative defense,” and that therefore the court below (the Court of Chancery) improperly placed on the plaintiffs the burden of showing that their claims were not within the exculpatory provision’s reach. Though taking note of this holding, judges in the Chancery Court subsequently continued to grant motions to dismiss where an exculpatory charter provision was in place and the complaint’s allegations supported solely duty-of-care claims. (See, e.g., *In re General Motors*, Del. Ch., 734 A.2d 611 (1999); *In re Lukens Inc. Shareholders Litigation*, Del. Ch., 757 A.2d 720 (1999), *aff’d sub nom. Walker v. Lukens, Inc.*, Del. Supr., 757 A.2d 1278 (2000).) Questions nonetheless remained as to (1) how an exculpatory charter provision could best be put before a court on a motion to dismiss where the complaint did not at least incorporate by reference the subject corporation’s charter, (2) whether a motion to dismiss continued to be a viable means with which to present a Section 102(b)(7)-based defense, and (3) which party should have the burden of proof regarding the applicability of the exculpatory provision to the plaintiff’s claims.

In *Malpiede*, the Supreme Court appears to resolve all three concerns. With respect to the first two questions, the Court squarely holds that, if the corporate charter is first referenced in a defendant’s motion to dismiss and is thus a matter outside the pleading, then the court must convert the motion to one for summary judgment.⁴ This would seem to permit discovery by the plaintiff before the court could decide the motion. However, any such discovery, the Court instructs, should be “carefully limit[ed] . . . to a scope that is coextensive with the issue necessary to resolve the motion.” *Malpiede*, 780 A.2d at 1091. In addition, the Court notes that defendants could try to avoid having their dismissal motions converted by either seeking judicial notice of the exculpatory provision (since the charters of Delaware corporations are publicly filed with the Secretary of State) or moving for judgment on the pleadings after an answer is filed. The Court opines that the latter procedure “would probably be the best practice to employ in these situations. But in some cases, filing an answer to a long and prolix complaint might be onerous.” *Id.* at 1092.

With respect to the burden-of-proof issue, the *Malpiede* Court seems to limit the significance of *Emerald Partners I*. The Court’s basis for distinguishing the earlier case is perhaps expressed most clearly in a footnote:

Although an exculpatory charter provision “is in the nature of an affirmative defense” under *Emerald Partners*, the board is not required to disprove claims

⁴ The *Malpiede* Court nonetheless affirms the Chancery Court’s dismissal of the case under Rule 12(b)(6). The Supreme Court held that the Chancery Court’s failure to convert the defendants’ motion to one for summary judgment was not reversible error, because “the plaintiffs [did] not contest the existence, terms, validity or authenticity of the [corporation’s] exculpatory charter provision[.]” *Id.* at 1079.

based on alleged breaches of the duty of loyalty to gain the protection of the provision with respect to due care claims. Rather, proving the existence of a valid exculpatory provision in the corporate charter entitles directors to dismissal of any claims for money damages against them that are based solely on alleged breaches of the board's duty of care.

Id. at 1096 n.70. However, the Supreme Court's subsequent opinion on the second appeal in *Emerald Partners* (discussed *infra*) indicates that the holding of *Malpiede* likely should not be pushed too far. Indeed, the continuing vigor of *Emerald Partners I* was perhaps foreshadowed by the *Malpiede* Court, which implied that *Emerald Partners I* continues to stand for the proposition that a defendant who relies on an exculpatory charter provision will have the burden of proving his or her good faith at trial (and thus invoking the defense afforded by the provision) if, as in *Emerald Partners*, the plaintiff has succeeded in placing good faith in issue. *Malpiede*, 780 A.2d at 1094.

***Official Committee of the Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A.*, 137 F. Supp. 2d 502 (S.D.N.Y. [April 20] 2001).**

Background: The plaintiff Creditors Committee brought suit on behalf of Color Tile, Inc. (pursuant to a Bankruptcy Court order) against, among others, Color Tile's directors and certain shareholders. The complaint alleged in relevant part that the directors and defendant shareholders had breached their fiduciary duties by causing Color Tile to acquire American Blind Factory at an allegedly excessive price.

The Court grants the defendants' motion for summary judgment as to the claims of fiduciary breach. The Court first holds that the plaintiff failed to present sufficient evidence for a reasonable jury to find the defendants liable for loyalty breaches. The Court then addresses the plaintiff's duty-of-care claim. Against the backdrop of an exculpatory charter provision, the plaintiff attempted to extend liability to the shareholder defendants by arguing (1) that they constituted a controlling group such that they owed fiduciary duties to the shareholders, (2) that among those duties was the duty of care, and (3) that the exculpatory charter provision could not insulate a shareholder. The Court, assuming *arguendo* that the shareholder defendants were a control group, notes the plaintiff's inability to cite "a single instance in which a shareholder's duty of care was recognized in the absence of a breach of the duty of loyalty." *Id.* at *31-*34. Finally, pointing out that plaintiff's claim against the shareholders is based on an agency theory rather than any specific acts by the shareholders, the Court looks to both agency law and common sense in finding for the defendant shareholders:

Plaintiff's agency theory leads to an anomalous result in this case. Each of the Color Tile directors was shielded from personal liability by the inclusion of the Delaware General Corporation Law's exculpation provision in Color Tile's certificate of incorporation. Enabling plaintiff to sue the shareholder defendants for acts of [their director designee] for which [he] personally cannot be held liable would prove an illogical end-run around the protections of § 102(b)(7). Ordinarily, a principal cannot be sued for acts of an agent for which the agent cannot be sued.

Id. at 515.

Comment: The Court’s decision highlights the scope of the protection afforded by a Section 102(b)(7)-authorized charter provision.

In re BHC Communications, Inc. Shareholder Litigation; In re United Television, Inc. Shareholder Litigation, Del. Ch., Consol. C.A. Nos. 18209 & 18218, 2001 Del. Ch. LEXIS 78, Lamb, V.C. (June 4, 2001).

Background: In the transaction under attack, Chris-Craft Industries, Inc., its subsidiary, and the subsidiary’s subsidiary were all acquired by a third party. The plaintiffs, minority shareholders of the first- and second-tier subsidiaries, brought claims against the parent and the directors of both subsidiaries, alleging that the parent had controlled the merger negotiations to its own benefit and to the detriment of the subsidiaries and their shareholders. The defendants moved to dismiss for failure to state a claim.

The Court denies the motion with respect to those directors who were affiliated with the parent corporation. Taking judicial notice of both subsidiaries’ exculpatory charter provisions, the Court holds that the provisions fully bar claims only against the independent directors, as to whom plaintiffs alleged no conflicts of interest. The Court notes that plaintiffs’ naked assertion of fiduciary breach in a *Revlon* situation, without some additional facts to show disloyalty or bad faith, is a duty-of-care claim. However, with respect to the inside directors, the Court is unable to grant dismissal:

I am led to conclude, from a careful reading of the complaints and briefs, that plaintiffs’ counsel mean to allege as fact that Chris-Craft took “exclusive control of the negotiations with News Corporation,” “allocated” the consideration to be received in the three mergers, and “dictated” the terms of those transactions. If these facts are taken as true, it follows that the complaints adequately state a claim for relief against Chris-Craft.

Id. at *32-*33. The Court nonetheless “harbor[s] serious reservations about the basis for these allegations” (*id.* at *33) and, as a result, permits discovery to go forward on the very limited basis set forth in its order, which is appended to the opinion.

Comment: The Court’s order permitting limited discovery may be a useful reference in instances where a motion to dismiss is expected to be a close call.

Telxon Corp. v. Meyerson, Del. Ch., C.A. No. 13139, 2001 Del. Ch. LEXIS 77, Jacobs, V.C. (June 11, 2001).

Background: In an earlier opinion, the Chancery Court had granted summary judgment for the defendants on all but the plaintiff’s duty-of-care claims, which survived for trial. The plaintiff then employed Delaware’s interlocutory appeal procedure in an effort to seek review of the partial grant of summary judgment for defendants. Both the Chancery Court and the Supreme Court refused to certify the interlocutory appeal, the Supreme Court noting that the plaintiff should instead have had final judgment entered on the “non-care” claims under Rule 54(b) (which provides for entry of judgment on fewer than all of multiple claims). The plaintiff accordingly moved in Chancery Court for a final judgment on the non-care claims.

The Chancery Court denies the motion. Noting that plaintiff resists entry of final judgment on its duty-of-care claims even though plaintiff concedes that an exculpatory charter provision renders such claims worthless, the Court refuses to rescue plaintiff from what the Court characterizes as a self-imposed dilemma. Instead, plaintiff will have its appeal as of right if and when final judgment is entered on all claims.

Comment: It is not clear from the decision why the plaintiff was unwilling to allow entry of final judgment on duty-of-care claims that were indisputably barred by an exculpatory charter provision. The Court expresses a similar perplexity: “The plaintiff’s argument appears to be that dismissing the duty of care claims could somehow hamper its effort to establish its entitlement to judicial review under the entire fairness standard. The logic advanced to support that view continues to elude the Court.” *Id.* at *6. In hindsight, the plaintiff’s position now seems to be consistent with the Delaware Supreme Court’s later decision in *Emerald Partners II*, discussed *infra*.

In re Ply Gem Industries, Inc., Shareholders Litigation, Del. Ch., Consol. C.A. No. 15779, 2001 Del. Ch. LEXIS 84, Noble, V.C. (June 26, 2001).

Background: Shareholders of Ply Gem Industries, Inc. brought a direct action against the company’s directors, charging them with breaches of fiduciary duty in approving the acquisition of the company by Nortek, Inc. The defendants moved to dismiss for lack of standing (based on plaintiffs’ failure to make demand or plead demand excusal) and for failure to state a claim.

The Court denies the motion with respect to all but one director. Applying *Parnes v. Bally Entertainment Corp.*, Del. Supr., 722 A.2d 1243 (1999), the Court first holds that the complaint asserts a direct, rather than a derivative, claim, and that therefore the demand requirement is irrelevant. Turning to the failure-to-state-a-claim portion of defendants’ motion, the Court is able to find only one director disinterested and independent as a matter of law. Of the remaining six directors, the Court finds that one is sufficiently alleged to have stood on both sides of the transaction, while the others are sufficiently alleged not to have been independent of that one.

In dismissing claims against the sole disinterested, independent director, the Court takes judicial notice of the corporation’s exculpatory charter provision. However, the Court refuses, at the present stage, to separate any (alleged) care breaches from loyalty breaches with respect to the defendants remaining in the case.

The defendants’ subsequent motion for reargument is denied. *See In re Ply Gem Industries, Inc., Shareholders Litigation, Del. Ch., Consol. C.A. No. 15779, 2001 Del. Ch. LEXIS 123, Noble, V.C. (Sept. 28, 2001).* In their motion, the defendants asserted that the Court had erred by examining their defense based on the exculpatory charter provision without first determining whether any breach of the duty of care was adequately pled. The Court holds that such a breach was in fact adequately pled.

Comment: In its holding with respect to the duty-of-loyalty claims, the Court takes care to limit the implications of its decision:

Because Plaintiffs have been successful in alleging the necessary factual basis for a reasonable doubt as to the disinterestedness or independence of six of the seven directors, Defendants’ Motion to Dismiss the Complaint, except as to [the one independent director], as to the duty of loyalty claims must be denied.

This result does not reflect any judgment on the ultimate merits of these claims. . . . The Court's scope of inquiry is also limited because, subject to certain exceptions not relevant here, it may not look beyond the Complaint. For example, I cannot consider Defendants' assertion that [the interested director to whom others were allegedly beholden] abstained from voting on the Nortek transaction and that the outside directors all lost their legal or consulting fees as a result of the Nortek merger. These issues, and others, can all be addressed on a more complete factual record and must wait for another day.

In re Ply Gem, 2001 Del. Ch. LEXIS 84, at *35 (footnotes omitted). Query whether, in light of the Court's finding that disloyalty was adequately pled, the Supreme Court's subsequent ruling in *Emerald Partners II* (see *infra*) will require a comprehensive entire fairness review at, for example, the summary judgment stage, even if the defendants' contrary assertions -- that the interested director abstained and the other directors acted contrary to their private economic interests -- turn out to be well founded.

***Clements v. Rogers*, Del. Ch., C.A. No. 15711, 2001 Del. Ch. LEXIS 105, Strine, V.C. (Aug. 14, 2001).**

Background: A shareholder of Chaparral Steel Company brought this action based on a 1997 merger in which Chaparral's majority shareholder, Texas Industries, Inc., cashed out the minority. The defendant directors moved for summary judgment, arguing (1) that the plaintiff had acquiesced in the merger by accepting consideration for her shares at a time when she had sufficient information to decide whether the transaction was unfair, and (2) that the directors were insulated from liability by Chaparral's exculpatory charter provision.

The Court denies the motion as to all but two directors. Focusing first on defendants' acquiescence argument, the Court concludes, in line with Chancery Court precedent, that the plaintiff's action is not barred by her acceptance of the merger consideration "so long as the defendants fail to show that she was aware of all the material facts, not simply that she was aware of some of the material facts that buttress her claims." *Id.* at *39. Since the Court then finds that at least some of the plaintiff's disclosure claims have merit, the acquiescence argument fails. Nonetheless, the Court acknowledges that the plaintiff's disclosure claims could have had much more social utility if they had been pressed prior to the shareholder vote on the merger (since one remedy available to the Court is ordering a company to make corrective disclosures):

While there may well be other judicial tools that can be used to create incentives for potential class plaintiffs to litigate disclosure claims more promptly and thus more usefully, the defendants have not persuaded me that the doctrine of acquiescence is one of them in the particular circumstances of this case.

Id. at *44.

Addressing the defense based on the exculpatory charter provision, the Court holds that the inherent self-dealing nature of the transaction, combined with the "buy-side" interests of a majority of the Chaparral board, necessarily implicates the majority's duty of

loyalty: “As traditionally conceived, the duty of loyalty is implicated when conflicted directors propose a self-dealing transaction. It is odd, I think, to posit that the [Chaparral] directors could have discharged their duty of loyalty if [Texas Industries] is found, after trial, not to have paid a fair price.” *Id.* at *68. Furthermore, the Court rejects defendants’ argument that certain of the disclosure claims cannot result in liability because the board did not have access to the undisclosed information:

There is some logical force to this argument, but I do not embrace it (at least, at this stage) for at least two reasons. First, this problem afflicts all disclosure claims, which are often based on information that only a subset of the board may have been aware of. Our law, however, seems to impose a board-wide duty on the directors to take steps to assure that all material facts are disclosed. More important, the ultimate liability, if any, in this case will hinge on whether, at bottom, [Texas Industries] treated the Chaparral public stockholders fairly. . . . [A] damage award will result if this conflict transaction was effected at a price unduly favorable to [Texas Industries], a company in which the [Chaparral] directors held key positions and owned a considerable amount of stock. Their role in bringing about an unfair result implicates their duty of loyalty, not simply their duty of care.

Id. at *69 n.69. By contrast, the two directors who served on the special committee that recommended the transaction are held to be entitled to summary judgment. The Court finds no evidence indicating they acted in bad faith or disloyally; rather, “[a]ny lack of effectiveness on their part emerges as a consequence of misunderstanding their duties or failing to apply adequate time and attention to the assignment given to them. That is, their conduct can at most be ascribed to a breach of the duty of care[.]” *Id.* at *70.

Comment: The case exemplifies the rigor of the Chancery Court’s inquiry when certain objective circumstances indicating director disloyalty are demonstrated by the record, regardless of the directors’ subjective culpability or lack thereof. Specifically, because (1) the cash-out merger was clearly a self-dealing transaction, and (2) other objective factors (*i.e.*, employment by and/or significant ownership interests in Texas Industries) indicated that a majority of the directors were materially conflicted, their professed lack of actual complicity in the company’s non-disclosures not only fails to deflect application of the entire-fairness standard, but is in fact irrelevant as a matter of law to the Court’s decision.

In addition, of note is that one of the Supreme Court’s subsequent holdings in *Emerald Partners* would appear to require application of the entire-fairness standard to a self-dealing transaction even if a majority of the directors are disinterested and independent. *Emerald Partners v. Berlin*, Del. Supr., No. 96, 2001, 2001 Del. LEXIS 525, at *25-*26, Holland, J. (Nov. 28, 2001) (*Emerald Partners II*) (holding that the law of the case, pursuant to the Court’s holding in *Emerald Partners I*, was that a director’s “stance on both sides as a corporate fiduciary, alone, is sufficient to require the demonstration of entire fairness,” and that “independent director approval or fully informed shareholder approval” of the transaction (if proven) would at best shift the burden on the entire-fairness question to plaintiffs (emphasis in original)).

***Leonard Loventhal Account v. Hilton Hotels Corp.*, Del. Supr., 780 A.2d 245 ([Sept. 6] 2001) (per Walsh, J.).**

Background: The shareholder plaintiff had claimed below, in the Court of Chancery, that a poison pill adopted by the defendant's board was invalid because its terms "purport[ed] to relieve directors of 'any liability' for implementing [it]." *Id.* at *5. Such a provision, the plaintiff argued, violated Section 102(b)(7) by attempting to limit the directors' liability for breaches other than those of the duty of care. However, during oral argument below on defendant's motion to dismiss, the defendant represented that the provision would apply only to "the Company, the Rights Agent, 'the holders of the rights, as such' and other 'parties' to the agreement." *Id.* at *16 (quoting from the transcript). The Chancery Court therefore (1) held that the defendant's representation mooted the relevant portion of the complaint, and (2) nonetheless required that the defendant's representation be memorialized in the order of dismissal.

On appeal, the plaintiff argued that the Chancery Court's order amounted to judgment in its favor, not a dismissal for mootness. The Supreme Court, however, declined the plaintiff's invitation to decide that issue, instead affirming the dismissal and expressly leaving for the Court of Chancery (in subsequent proceedings on counts that were not dismissed) the question of what effect, if any, the dismissal will have on the plaintiff's application for fees.

Comment: The case appears to present, without deciding, the question of whether Section 102(b)(7)'s grant of authority to adopt an exculpatory charter provision can be a basis for invalidating a separate contractual provision that purports to bar director liability for any type of fiduciary breach -- in essence, whether the statute may be used as a "sword" rather than a "shield."

***Emerald Partners v. Berlin*, Del. Supr., No. 96, 2001, 2001 Del. LEXIS 525, Holland, J. (Nov. 28, 2001).**

Background: Following the appeal and reversal of summary judgment for the defendants, and after a trial on the merits, the plaintiff appealed the Chancery Court's post-trial ruling for the defendants (*Emerald Partners v. Berlin*, Del. Ch., C.A. No. 9700, 2001 Del. Ch. LEXIS 20, Jacobs, V.C. (Feb. 7, 2001)). The Court of Chancery had begun its post-trial analysis with the corporation's exculpatory charter provision and had then tested the plaintiff's evidence for proof of conduct outside the provision. The plaintiff's claims of disloyalty and bad faith by the directors -- that they unlawfully delegated decisions to a financial advisor and/or were faithless by virtue of their indifference -- were all found to be unsupported by the evidence.

The Supreme Court vacates the judgment and remands the matter for a second time. The Court holds that, as a general proposition,

when entire fairness is the applicable standard of judicial review, . . . injury or damages becomes a proper focus only after a transaction is determined not to be entirely fair. *A fortiori*, the exculpatory effect of a Section 102(b)(7) provision only becomes a proper focus of judicial scrutiny after the directors' potential personal liability for the payment of monetary damages has been established.

Id. at *21-*22 (emphasis in original). This order of analysis -- determining entire fairness or lack thereof before determining whether an exculpatory charter provision will afford any protection to the director defendants -- is required, the Court reasons, because an exculpatory charter provision does not go to the merits of a duty-of-care claim, but only to the recoverability of money damages flowing from such a claim.

Applying the foregoing rule, the Court holds that the Court of Chancery was “premature” in looking to the exculpatory charter provision. *Id.* at *2. Instead, the trial court first should have scrutinized the challenged transaction for entire fairness, decided whether it was entirely fair, and only then (assuming it was found to be less than entirely fair) decided whether such lack of entire fairness was traceable to duty-of-care breaches and thus within the protection afforded by the exculpatory charter provision.

Comment: The Supreme Court’s effort to reconcile its holding with its still-recent holding in *Malpiede v. Townson* (see above) prompts several questions. As discussed above, in *Malpiede* the Court affirmed the Court of Chancery’s dismissal of a shareholder action for failure to state a claim, pursuant to Rule 12(b)(6), where the complaint alleged at most duty-of-care violations and the corporation’s charter included an exculpatory provision. Thus, in *Malpiede* the Court approved of dismissal, on the basis of an exculpatory charter provision, prior to any determination of liability, whereas in *Emerald Partners* the Court requires (or appears to require) that the trial court ignore an exculpatory charter provision until after the issue of liability has been decided. The two cases should not be seen as inconsistent, the Court explains, because in *Malpiede* “the applicable pretrial standard for judicial review of the directors’ actions *ab initio* was the business judgment rule[,]” while in *Emerald Partners* the standard that applied “*ab initio*” was entire fairness. *Emerald Partners, supra*, at *18-*19. Where the entire fairness standard applies *ab initio*, the Court continues, liability can be determined only by “examining and balancing the nature of the duty or duties that the board breached in a contextual comparison to how the board otherwise properly discharged its fiduciary responsibilities.” *Id.* at *20-*21. If the Court finds a lack of entire fairness, it should set forth “in the *ratio decidendi*” which duty or duties were breached such that unfairness resulted. *Id.* at *23 (citation and internal quotation marks omitted). If one of those duties is the duty of care, then, finally, the exculpatory charter provision may be considered as a bar to damages.

But, if a complaint is dismissible under business judgment review *ab initio*, why then consider (*i.e.*, reach the effect of) an exculpatory charter provision in such a context at all? Conversely, if, as the *Emerald Partners II* opinion notes (and as the caselaw of the last decade has indicated⁵), a showing of a duty-of-care breach, without more, is sufficient to rebut the business judgment rule and to invoke the entire-fairness standard, how can it be possible for a case to be both outside the business judgment rule and not subject to the entire-fairness standard? Or must every transaction as to which a duty-of-care breach is adequately alleged be henceforth scrutinized for entire fairness (or pursuant to one of the intermediate standards applied in special contexts) before an exculpatory charter provision can come into play?

It would seem that, by asserting the consistency between *Malpiede* and *Emerald Partners II*, the Supreme Court does not intend its holdings in *Emerald Partners II* to foreclose completely the possibility of dismissal at the pleading stage on the basis of an

⁵ See William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 Bus. Law. 1287, 1302 (2001) (discussed *infra*).

applicable exculpatory charter provision. Accordingly, one could read *Emerald Partners II* to mean that the decisive difference between it and *Malpiede* is that in *Emerald Partners* the exculpation issue was first raised on a motion for summary judgment, while in *Malpiede* the exculpation issue was raised on a motion to dismiss. This reading would suggest the rule that, if a complaint alleges sufficient facts to survive a motion to dismiss under the business judgment rule (or if no motion to dismiss is pursued), then the case cannot be disposed of on the merits until the court has first scrutinized the challenged transaction for entire fairness -- regardless of the type of duty breached and the existence of an exculpatory charter provision.

A better reading of *Emerald Partners II*, however, would have it enunciating the following rule: When a complaint alleges sufficient facts to survive a motion to dismiss under the business judgment rule, the complaint may nonetheless be dismissed for failure to state a claim, on the basis of an exculpatory charter provision, if the only (alleged) fiduciary breach that sufficed to rebut the business judgment rule was a breach of the duty of care. If, on the other hand, the (alleged) fiduciary breach that sufficed to rebut the business judgment rule was a breach of the duty of loyalty or good faith (or was such that its precise nature could not be determined), then the complaint cannot be disposed of on the merits until after the court decides whether a lack of entire fairness has been shown and, if so, whether such lack stemmed in fact from a duty-of-care breach or from breaches of other duties. The Supreme Court seems to say as much in *Emerald Partners II*, when it recounts the holding of *Malpiede*:

[U]nder those specific circumstances, when the presumption of the business judgment rule has been rebutted in the shareholder complaint solely by successfully alleging a duty of care violation, the director defendants do not have to prove entire fairness to the trier of fact, because of the exculpation afforded to the directors by the Section 102(b)(7) provision inserted by the shareholders into the corporation's charter.

Emerald Partners II, *supra*, at *16 (emphasis added).

Such a reading of the Court's opinion in *Emerald Partners II* would serve judicial efficiency by continuing to allow the trial court to dismiss a complaint when, given the existence of an exculpatory charter provision, no breach has been pled that could possibly result in money damages (a policy concern mentioned in *Emerald Partners II*); at the same time, this reading would preserve what seems to be the core concern of the opinion, that the trial court conduct an unconstrained examination of the challenged transaction for entire fairness when the circumstances warrant such an approach, *i.e.*, when the complaint (or a fuller record, as on a motion for judgment on the pleadings or for summary judgment) has adequately shown evidence of disloyalty or bad faith.⁶ However, it must be acknowledged that the reliability of the preceding as suggesting the "ruling" of *Emerald Partners II* is perhaps called into question by certain statements, later in the Court's opinion, that do not distinguish between cases where a duty-of-care breach invokes the entire-fairness test and those where disloyalty or bad faith invokes the entire-fairness test. *See, e.g., id.* at *23 ("we

⁶ It is possible, moreover, that *Emerald Partners* signals a return to the state of the law before *Cede & Co. v. Technicolor Inc.*, Del. Supr., 634 A.2d 345 (1993), when a duty-of-care breach, without more, did not invoke the entire-fairness test, but instead was examined under conventional tort principles, the entire-fairness test being reserved for breaches of the duty of loyalty. *See* Allen et al., *infra*, at 1299-1305.

hold that when entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only after the basis for their liability has been decided” (emphasis in original)).

Finally, note that the requirement imposed on the trial court by *Emerald Partners II* -- that it examine the challenged transaction for entire fairness before determining whether, and to what extent, an exculpatory charter provision may bar an award of damages -- will likely present difficult questions of allocation of liability and causation of damages.

9.2.3 Articles

William T. Allen, Jack B. Jacobs, and Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 *Bus. Law.* 1287 (2001).

One former chancellor (Prof. Allen) and two sitting vice chancellors of the Delaware Court of Chancery provide a thoughtful and incisive appraisal of the legal standards under which Delaware courts review director conduct. Evaluating the current standards in terms of their practical usefulness in deciding cases, the authors point out what they view to be various sources of confusion and theoretical “dead-ends,” and recommend ways in which the existing standards may be revised so as to “clarify their application, reduce their number, and facilitate the task of corporate advisors and courts.” *Id.* at 1292.

The authors initially contend that a rapid transformation of Delaware corporate law occurred between the mid-1980s and the mid-1990s, leading from “the older body of law, developed during the 1920-1980 period, to the current design[.]” *Id.* at 1293. The flurry of M&A activity within a short span, employing ever-novel techniques, “inspired the courts to innovate,” and “[t]he end result was the articulation by Delaware courts of new standards of review in cases such as *Unocal*, *Revlon*, and *Blasius Industries, Inc. v. Atlas Corp.*” *Id.* at 1294. At the same time, in the interest of overall coherence, the courts “attempted to link all the disparate review standards together by using the business judgment rule as the medium.” *Id.* The result “turned out to be less than optimal.” *Id.* at 1295.

Proceeding to a review of the current state of the law and what they view as its trouble spots, the authors articulate as their “fundamental guidepost . . . an emphasis on functionality.” *Id.* at 1297. They then examine in depth (1) the duty of care and its current “linkage” with the entire fairness standard, a development that the authors seek to unwind (*id.* at 1299-1309); (2) the “intermediate” standard for the review of defensive measures by the board, which, the authors argue, should also be “decoupled” from the entire fairness standard (*id.* at 1309-1311); and (3) a second “intermediate” standard for the review of board action that “purposely intrude[s] on the shareholders’ right to select a new board[.]” which is in practice unnecessary and, the authors argue, should be discarded (*id.* at 1311-16).

The discussion of the standard for establishing a breach of the duty of care describes the significance of the 1985 decision *Smith v. Van Gorkom*, Del. Supr., 488 A.2d 858, and (as an aside) its indirect role in the adoption of Section 102(b)(7). According to the authors, *Smith* defied practitioners’ expectations because the Court, imposing liability for duty-of-care breaches on outside directors, “purport[ed] to apply the gross negligence standard of review, [but] in reality applied an ordinary negligence standard.” *Id.* at 1299. The *Smith* Court thus “withdrew much of the comfort and greater incentive for risk-taking promised by [the] more

lenient standard” of gross negligence. *Id.* at 1300. Far-reaching effects of the Court’s “withdrawal of comfort” were soon felt:

No one was misled by the *Van Gorkom* court’s *de facto* application of the simple negligence review standard dressed up as “gross negligence,” as evidenced by the fact that shortly after *Van Gorkom*, the Directors’ and Officers’ (D&O) insurance industry sharply increased their premiums, and in some cases threatened to stop writing D&O insurance policies. This crisis required a legislative solution, i.e., the adoption of [8 *Del. C.* § 102(b)(7)].

Id. at 1300 n.49.

Exculpatory charter provisions are implicated also in the authors’ recommended reforms. One proposal is that, where a transaction found to be unfair has closed and plaintiffs are seeking damages, a court’s inquiry should be less strict than in those cases where enjoining or rescinding the unfair transaction is a realistic option:

In cases where the transaction cannot be undone, the court must conduct a director-by-director inquiry into which specific directors actually engaged in a breach of fiduciary duty sufficient to justify monetary liability. The fact that a transaction is found to be “unfair” does not necessarily mean that all the directors have the same exposure to liability. Where the corporation has a charter provision that exculpates directors from monetary liability for breaching their duty of care, the plaintiff must establish that a director who had no conflicting self-interest in the transaction nonetheless acted in bad faith. If a director did not benefit from the unfair transaction, the plaintiff who seeks to subject that director to money damages liability should have the burden to prove that the director consciously breached his duties to the corporation.

Id. at 1318.

In addition, the authors conclude that the standard for duty-of-care breaches, as noted above, should be “unlinked” from the entire fairness standard and returned to its earlier moorings in traditional tort law. The judicial inquiry “should be straightforward and direct: did the plaintiff prove that the board’s conduct was grossly negligent and caused injury? If so, then in the absence of an exculpatory charter provision, liability should follow. Otherwise, there should be no liability.” *Id.* at 1318-19.

Comment: The authors’ recommendations, if adopted, would give greater force to an exculpatory charter provision where a transaction has been found unfair, since the plaintiff would then have to show that any unconflicted directors acted in bad faith before liability could be imposed on them. It appears, however, that Delaware law may be moving farther from, rather than closer to, the authors’ regime, as evidenced by the Supreme Court’s seeming instruction in *Emerald Partners, supra*, that self-dealing transactions must be subjected to entire-fairness analysis, regardless of the number of disinterested directors present and the sanitizing measures employed. *Emerald Partners v. Berlin*, Del. Supr., No. 96, 2001, 2001 Del. LEXIS 525, at *25-*26, Holland, J. (Nov. 28, 2001).

9.3 Indemnification and Advancement -- 8 Del. C. § 145

Section 145 of the DGCL contains numerous provisions with respect to the indemnification and “advance indemnification” of directors, officers, employees, and agents. In 2001, fewer cases than in previous years addressed director indemnification and advancement under Delaware law. Several cases addressed the availability of advancement where the director/indemnitee acted as a plaintiff, and where the company’s advancement provision by its terms applied only to expenses incurred by those acting as defendants. *See Gentile, Pearson*. Other issues addressed by the cases include defenses to enforcement of a settlement agreement which provided for indemnification to the fullest extent authorized by Delaware law (*Manley*); objections to court approval of a shareholder class-action settlement on the grounds of “impermissible indemnification” (*In re Cendant Corp. Litigation*); and a D&O insurer’s efforts to avoid reimbursement of amounts paid by way of indemnification, on the grounds that the indemnification was not permissible under Delaware law (*Owens Corning*).

9.3.1 Legislative Developments / Model Business Corporation Act Developments

The Delaware legislature did not enact any amendments to 8 Del. C. § 145 in 2001. There also were no amendments to the related provisions of the Model Business Corporation Act, §§ 8.50-8.59.

9.3.2 Caselaw Developments

***Gentile v. SinglePoint Financial, Inc.*, Del. Ch., C.A. No. 17755, 2001 Del. Ch. LEXIS 4, Lamb, V.C. (Jan. 5, 2001), *aff’d*, Del. Supr., No. 339, 2001, 2001 Del. Ch. LEXIS 577 (Dec. 26, 2001) (per curiam).**

Background: John A. Gentile, a former officer and director of SinglePoint Financial, Inc., brought a claim against the company seeking mandatory advancement of the expenses he had incurred in four proceedings: an internal corporate investigation; a suit against him by SinglePoint for breach of fiduciary duty; a suit between SinglePoint and Relevant Information and Training Systems, Inc., in which Gentile tried unsuccessfully to intervene; and a suit by Gentile against SinglePoint to recover stock of Relevant Information held by SinglePoint and allegedly due him. While SinglePoint conceded that Gentile was entitled to advancement, pursuant to the company’s bylaws, in the suit it had brought against him, it moved for summary judgment with respect to his expenses in the other proceedings. Gentile also moved for summary judgment.

The Court grants both motions in part, holding that Gentile is entitled to advancement of his expenses in only the internal investigation and the suit against him by SinglePoint. The Court first finds that all four of the proceedings for which Gentile seeks advancement, including the internal corporate investigation, easily fit within the bylaw’s definition of “Proceeding.” Next addressed are the two defenses raised by SinglePoint: that Gentile is not entitled to advancement because (1) “all of his efforts [in the SinglePoint-Relevant Information suit and in his suit against SinglePoint] have been directed at vindicating his

personal property rights in the [Relevant Information] shares -- not rights or interests of the corporation” (*id.* at *14), and (2) SinglePoint’s applicable bylaw limits advancement to “an Indemnitee who was or is a witness or was or is threatened to be made a named defendant or respondent in a Proceeding” (*id.* at *12).

With respect to SinglePoint’s first defense, Gentile argued that his efforts as a plaintiff and (potential) intervenor were subject to advancement because “all of his litigation efforts were necessary to uphold his honesty and integrity as a director” (*id.* at *19 (internal quotation marks omitted)), relying on *Hibbert v. Hollywood Park, Inc.*, Del. Supr., 457 A.2d 339 (1983). The Court rejects this argument, finding that (unlike the underlying claims in *Hibbert*) Gentile’s actions involved solely his asserted right to the Relevant Information stock held by SinglePoint, not any duty he had as an officer or director. In support of its conclusion, the Court notes:

In his motion to intervene in the SinglePoint/[Relevant Information] action, Gentile states, “Gentile seeks to intervene . . . solely for the limited purpose of protecting his interest in the [Relevant Information] stock.” In his federal action against SinglePoint, all five counts relate to the disputed [Relevant Information] stock. . . . Finally, it is obvious from a review of the undisputed record that Gentile’s proactive litigation efforts are the result of developments in the SinglePoint/[Relevant Information] litigation, not the November 18, 1999 disclosure of the internal corporate investigation.

Id. at *21. The Court further observes, in a footnote, that its findings are unrelated to “the separate question of whether Gentile may be entitled to advancement of expenses in connection with any fiduciary duty-based counterclaims” that may be brought against him. *Id.* at *21 n.25.

The Court next rejects Gentile’s argument that the holding of *Citadel Holding Corp. v. Roven*, Del. Supr., 603 A.2d 818 (1992), provides grounds for advancement. In *Citadel*, the Court explained, the indemnitee’s counterclaim expenses in an action brought by the company were held to fall within its advancement provision -- which referred only to expenses incurred “in defending” an action -- because the counterclaims were “necessarily part of the same dispute” under the applicable rules of civil procedure. *Gentile, supra*, at *22-*23 (quoting *Citadel*, 603 A.2d at 824). By contrast, “Gentile was not faced with a ‘use-it-or-lose-it’ scenario that was the logical underpinning of *Citadel*.” *Gentile, supra*, at *24. Finally, the Court holds that the language of SinglePoint’s advancement bylaw “plainly and simply means that Gentile has no right to mandatory advancement of his expenses when he acts as a plaintiff in initiating an action.” *Id.* at *25.

On a motion for reargument, Gentile asserted that the Court had misapprehended the nature of the connection between SinglePoint’s allegations of fiduciary breach and Gentile’s attempted intervention (and subsequent suit) to obtain the Relevant Information stock he alleged was owed to him. *Gentile v. SinglePoint Financial, Inc.*, Del. Ch., C.A. No. 17755, 2001 Del. Ch. LEXIS 15, Lamb, V.C. (Feb. 9, 2001). The Court remains unpersuaded: “Gentile’s argument fails because there simply is no basis in the record to infer that the issue of Gentile’s alleged breach of fiduciary duty was ever injected into the SinglePoint/[Relevant Information] litigation.” *Id.* at *4.

Comment: It is not clear why the Court does not discuss (and/or Gentile did not advance) the possibility that his expenses as a plaintiff and potential intervenor could be covered by

Singlepoint's bylaw provision requiring advancement to "an Indemnitee who was or is a witness . . . in a proceeding." *Id.* at *12 (emphasis added). In addition, note that the Court, relying on Gentile's representations in the underlying actions, determines his motives therein without a hearing. See also the discussion, *infra*, of the Supreme Court's affirmance of Chancery's summary judgment decision.

***Manley v. AmBase Corp.*, 126 F. Supp. 2d 743 (S.D.N.Y. [Jan. 8] 2001).**

Background: A former officer and director of AmBase Corporation sued the company to enforce a settlement agreement that provided for indemnification, and the company brought counterclaims of reformation and fraudulent concealment regarding the same agreement. Plaintiff won a jury verdict in his favor. See *Manley v. AmBase Corp.*, 121 F. Supp. 2d 758 (S.D.N.Y. 2000) (denying in part AmBase's motion to set aside the verdict). AmBase's counterclaims were tried to the Court, which rules for plaintiff.

AmBase's bylaws created broad indemnification rights in directors and officers, and its employment agreement with plaintiff likewise had provided that he would be indemnified "to the fullest extent authorized by Delaware law[.]" *Manley v. AmBase Corp.*, 126 F. Supp. 2d at 748. Those rights were incorporated in a severance agreement entered into by plaintiff and AmBase when he left the company. Both during and after plaintiff's service on the AmBase board, he was involved in various legal proceedings, including the bankruptcy of a law firm with which he was associated. Although he had informed other directors of the bankruptcy action when it commenced, and the company had arranged for his representation in that action, he did not list the pending bankruptcy settlement payments in a complaint he later filed against AmBase seeking to enforce his indemnification rights. When that action settled, plaintiff and AmBase entered into a settlement agreement that, again, provided him with indemnification "to the fullest extent authorized by Delaware law[.]" *Id.* at 752. Plaintiff then requested that AmBase reimburse him for payments associated with the bankruptcy action, and AmBase refused.

In response to plaintiff's suit to enforce the indemnification provision of the settlement agreement, AmBase counterclaimed that the agreement should be reformed and that plaintiff should be held liable for fraudulent concealment. Applying New York law to those claims, the Court holds, first, that AmBase failed to present clear and convincing evidence that the settlement agreement, as written, did not represent the parties' intention. The Court then holds that AmBase's fraudulent concealment claim is also not proven, since AmBase failed to show (1) that plaintiff, as a former director, had a duty to disclose his intention to seek advancement regarding the bankruptcy action; (2) that, even assuming he had such a duty, he had acted knowingly or recklessly; and (3) that AmBase had reasonably relied on any such omissions.

Comment: In rejecting AmBase's arguments, the Court charges AmBase with an "institutional memory" of the various actions in which plaintiff was involved:

[T]he parties in the present case were sophisticated business people, represented by counsel, who had a long history of contentious litigation leading up to the negotiation of the 1993 AmBase Settlement Agreement. Based on this history, and because AmBase was aware of [plaintiff's] indemnity rights contained in other documents, AmBase had the means to

discover that [plaintiff] might assert a claim for indemnification in connection with the . . . Bankruptcy Actions.

Id. at 759. It appears in hindsight that AmBase should have attempted to fashion the settlement agreement such that plaintiff surrendered his claims to indemnification or advancement regarding any action other than the specific ones for which AmBase was willing to cover his expenses.

***Pearson v. Exide Corp., Gauthier v. Exide Corp.*, 157 F. Supp. 2d 429 (E.D. Pa. [April 19] 2001).**

Background: Two former officers of Exide Corporation sued for advancement of litigation expenses in four lawsuits and one criminal prosecution. The Court grants summary judgment for the officers.

Exide raised a number of arguments against summary judgment, each of which the Court finds lacking in merit. First, the Court holds that Exide’s indemnification bylaws clearly do not permit the company to deny advancement (as opposed to indemnification) on the grounds that the applicant has not met a standard of conduct set forth in the Delaware General Corporation Law. Second, the bylaws’ provision prohibiting advancement as to actions initiated by an officer or director, except when the board has authorized the proceeding, is held not to bar advancement for an action that the plaintiffs’ brought in Pennsylvania to enforce their separation agreements with Exide. Citing *Citadel Holding Corp. v. Roven*, Del. Supr., 603 A.2d 818 (1992), the Court reasons that the Pennsylvania action was “initiated” by Exide, because “the central issue involved in the Pennsylvania Action, the enforceability of the Separation Agreements in light of the alleged fraudulent conduct of the plaintiffs, was first initiated by Exide” when it joined the officers, plaintiffs herein, as counterclaim defendants in an action Exide was defending in Michigan. *Pearson*, 157 F. Supp. 2d at 439.

The Court also holds that plaintiffs are entitled to the expenses incurred in successfully enforcing their advancement rights (so-called “fees for fees”), pursuant to the Exide bylaws.

Comment: It is instructive to compare this opinion with the Chancery Court opinion *Gentile v. SinglePoint Financial, Inc.*, Del. Ch., C.A. No. 17755, 2001 Del. Ch. LEXIS 4, Lamb, V.C. (Jan. 5, 2001), *aff’d*, Del. Supr., No. 339, 2001, 2001 Del. Ch. LEXIS 577, per curiam (Dec. 26, 2001), discussed above. In *Gentile*, the Court held that the reasoning of *Citadel* did not extend to expenses for an action brought by the indemnitee, where the indemnitee’s claims were not subject to a forfeiture risk comparable to that of unasserted counterclaims. (Note that this holding is not relied upon in the Supreme Court’s affirmance, discussed below.) The *Pearson* Court, by contrast, finds that the suit brought by the officers in Pennsylvania is subject to advancement, pursuant to *Citadel*, because Exide first filed claims, in another court, against the officers on the same underlying issues.

Also note that the officers apparently pled their claims for advancement as part of one of the actions for which they were seeking advancement. While the Court acknowledges Exide’s objection to that procedure, it does not otherwise address the issue and, given the outcome, evidently finds the objection to be meritless.

***In re Cendant Corp. Litigation*, 264 F.3d 286 (3d Cir. [Aug. 28] 2001).**

Background: Cendant Corporation had settled a shareholder class action alleging securities fraud. An objection to the settlement was filed by a shareholder who did not fall within the class, and who claimed that the settlement terms were not fair to Cendant because they did not specify how much of the settlement consideration was to be paid by the company and how much by the defendant directors. The District Court approved the settlement notwithstanding the objection, and the objector appealed.

The Third Circuit affirms. First, it holds that, contrary to the objector's assertions, the standard for approval of a class action settlement is whether it is fair to the class. Thus, to the extent the objector has a valid claim for an injury to the company, that claim should properly be brought in a derivative action against the board that approved the settlement. Moreover, the Court rejects the objector's argument that a derivative claim cannot provide adequate relief. Specifically, the demand requirement, being "generally applicable" to any derivative action, "does not make the derivative action inadequate[.]" and the fact that Delaware law permits the directors to seek indemnification "reflects the policy of the state corporation law but does not provide a basis for objection[.]" *Id.* at 296.

Among the other arguments advanced by the objector is that, "because Cendant is paying the entire cash amount of the settlement, it constitutes an impermissible indemnification of the [individual defendants] for securities law violations." *Id.* at 301. The Court rejects this out of hand, holding that Cendant's settlement payment to the class is not indemnification or reimbursement of the directors or officers, and observing that the objector has not cited any caselaw to the contrary.

Comment: Note the Court's strict interpretation of its role in reviewing a class action settlement and its corresponding deference to established state law procedures for seeking relief on behalf of a corporation.

***Owens Corning v. National Union Fire Insurance Co.*, 257 F.3d 484 (6th Cir. [July 5] 2001).**

Background: Owens Corning sued its D&O insurer for a declaratory judgment that the insurer was obligated to reimburse it for amounts it paid, as indemnification of its directors, in settling an action against them. Following judgment for Owens Corning in the trial court, the insurer appealed, arguing that (1) Owens Corning should have been required to allocate its settlement costs between the directors and the company (which was not covered by the policy), and (2) the indemnification did not satisfy the policy's requirement that it be in accordance with Delaware law, since the board did not first make a determination that the directors acted in good faith.

The Sixth Circuit affirms on both issues. Regarding allocation of the settlement costs, the Court (applying Ohio law) finds that the insurer failed to rebut Owens Corning's evidence that its actions (as opposed to those of its directors) did not have an effect on the settlement amount.

Turning to whether indemnification was consonant with Delaware law, the Court first finds that 10 *Del. C.* § 145 imposes a non-waivable requirement that any director who is to be indemnified must have acted in good faith. The Court therefore rejects out of hand Owens Corning's argument that its bylaws abrogate the good faith requirement.

Owens Corning's alternative argument -- that indemnification was mandatory pursuant to Section 145(c) because the directors succeeded "on the merits or otherwise" -- is then examined at greater length and likewise rejected. The Court opines that "it is . . . extremely dubious that a [settlement] payout of almost ten million dollars would be deemed 'success' by the courts of Delaware[,] and expresses doubt about the type of incentives that could follow from a Ninth Circuit holding that "appears willing to extend the meaning of 'success' [under a similar Maryland statute] to payment of a substantial monetary settlement, so long as the defendant has not conceded liability." *Id.* at 495 (citing *Safeway Stores, Inc. v. National Union Fire Insurance Co.*, 64 F.3d 1282, 1290 n.24 (9th Cir. 1995)). Moreover, a comparison of the various provisions of Section 145 (which mention "settlement" only with respect to permissive, not mandatory, indemnification) leads the Court to conclude that Section 145(c) "is not intended to be ordinarily applicable to settlements." *Owens Corning*, 257 F.3d at 495.

The Court accordingly finds that Owens Corning could not avoid the good faith requirement of Section 145. However, the Court goes on to hold (1) that "[i]t is not impermissible for a Delaware corporation to accord a director seeking indemnification a rebuttable presumption of good faith"; (2) that, since Owens Corning's bylaws provided for indemnification to the maximum extent available under Delaware law, "such a presumption may be applied"; and (3) that Section 145(d), providing that the board shall determine that the good faith requirement has been met before indemnifying a director, is not mandatory. *Id.* at 495-96. As a result, the Court holds, the presumption that the Owens Corning directors acted in good faith is sufficient to satisfy Delaware law, provided that it is not rebutted by the insurer:

Our reading of [the provisions of Section 145] is that good faith may be presumed under the expansive by-laws of Owens Corning, even if the relevant determination is not specifically made. [The insurer] could still challenge, under Delaware law, whether Owens Corning's directors were in fact acting in good faith back in 1989 and thereafter, when the factual predicate of the [underlying] action arose. . . . However, [the insurer] does not seem to have offered specific allegations on this issue in its appeal.

Id. at 496. The Court therefore finds the indemnification to have been in accordance with Delaware law.

Comment: The Court's holding that the determination of a prospective indemnitee's good faith can be presumed appears to contradict the plain language of Section 145(d): indemnification "shall be made by the corporation only as authorized in the specific case upon a determination that indemnification . . . is proper in the circumstances because the person has met the applicable standard of conduct set forth in subsections (a) and (b) of this section" (emphasis added).

Also note that the Court acknowledges (but Owens Corning did not assert) the theory that a sufficiently small settlement amount could be construed as success "on the merits or otherwise": "If a defendant could show that the amount paid in settlement was lower than the prospective attorney's fees and other costs it would have incurred save for the settlement, there is a good argument for a label of 'success' despite payment." *Id.* at 495 n.6 (citing *Von Feldt v. Stifel Fin. Corp.*, Del. Ch., C.A. No. 15688, 1999 Del. Ch. LEXIS 131, Chandler, C. (June 11, 1999)). Cf. *Cochran v. Stifel Financial Corp.*, Del. Ch., C.A. No. 17350, 2000 Del.

Ch. LEXIS 58, Strine, V.C. (March 8, 2000) (holding that, where a director or officer is entitled to mandatory indemnification pursuant to Section 145(c), no showing of good faith is required).

***Gentile v. SinglePoint Financial, Inc.*, Del. Supr., No. 339, 2001, 2001 Del. LEXIS 577, per curiam (Dec. 26, 2001).**

Background: Plaintiff Gentile appealed the Chancery Court's grant of partial summary judgment for the defendant on his claim seeking advancement of litigation expenses in four proceedings. *See Gentile v. SinglePoint Financial, Inc.*, Del. Ch., C.A. No. 17755, 2001 Del. Ch. LEXIS 4, Lamb, V.C. (Jan. 5, 2001) (discussed above). The Supreme Court bases its affirmance on one of the Chancery Court's holdings. Finding that the language of SinglePoint's indemnification bylaw unambiguously requires advancement only where the indemnitee is a "named defendant or respondent," the Supreme Court affirms Chancery's holding that the bylaw does not require advancement when the indemnitee commences litigation against the corporation. The Court does not pass on the other holdings in the Chancery opinion: "Because we conclude that the language of SinglePoint's bylaws controls the current dispute, we do not reach the contention that advancement is unavailable to a director who is acting solely to protect his personal interests, rather than those of the corporation." *Gentile*, 2001 Del. LEXIS 577, at *4-*5.

Comment: The Supreme Court's focus solely on the company's bylaws, without reaching the other arguments advanced by the parties, leaves for a later day the Court's potential reaction to the other holdings of the Court below.