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Expert Analysis

Using Exculpatory Clauses in Defending Against Breach-of-Fiduciary-Duty Claims

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A director's responsibilities in serving on a corporation's board are accompanied by significant personal financial risks. When shareholders² disagree with the director's actions or believe that the director harmed the corporation by inaction, they can assert a variety of breach-of-fiduciary-duty claims. Many corporations provide their directors with a defense to claims of negligent breach of fiduciary duty in the form of an exculpatory clause or, in the parlance of Delaware law, a Section 102(b)(7) defense.

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When properly invoked, exculpatory clauses can provide a basis for the dismissal of certain types of breach-of-fiduciary-duty damages claims brought derivatively by shareholders at the outset of a case.³ While courts have varied in their approaches to and acceptance of exculpatory-clause defenses over the past 20 years, recent Delaware Chancery Court cases have accepted exculpatory clauses as a valid defense for directors at the motion-to-dismiss stage of a lawsuit.

Moreover, while the Chancery Court has traditionally been the chosen venue for shareholders pursuing breach-of-fiduciary-duty claims against directors, plaintiff shareholders have become more strategic in determining where to file their claims.

Shareholders may choose a corporation's principal place of business as the venue in which to file their lawsuit, for example, as opposed to the state of incorporation. This strategy apparently is based upon an aspiration that the other jurisdiction, which has a much less developed body of corporate case law than Delaware, may be more lenient to shareholder plaintiffs.

Given this trend, it is important for directors and corporate counsel to understand how courts outside Delaware have been interpreting director exculpatory clauses, including Section 102(b)(7).

This article explores how exculpatory clauses work to shield directors from personal liability for unintentional breaches of fiduciary duties owed to the corporation. It then outlines recent and director-favorable developments in Delaware's exculpatory-clause jurisprudence and contrasts that jurisprudence with other courts' interpretations of such clauses. Finally, this article provides guidance to directors and corporate counsel on how to best use exculpatory clauses in defending against shareholder breach-of-fiduciary-duty litigation.

Background on Exculpatory Clauses

A corporation's business and affairs are to be principally overseen by its board of directors. For this reason, courts have adopted a "business judgment" rule, which assumes that directors act in good faith and in the best interests of the corporation unless certain specific fact patterns are pleaded.⁴ The first of these fact patterns involves breach of the fiduciary duty of care; when a director is alleged to have acted hastily or without sufficient information to make an informed decision, that decision may not be protected by the business judgment rule.⁵ The second fact pattern concerns breach of the fiduciary duty of loyalty, which occurs when a director is alleged to have acted with some personal interest in the outcome of his or her decisions.⁶ In this case, the director's decision will not be protected by the business judgment rule and will be evaluated by the courts, most often under the "entire fairness" standard.⁷

Directors have always been able to maintain some measure of control over the threat of any breach-of-loyalty claim by maintaining their independence vis-à-vis corporate decision-making. With respect to the duty of care, however, following the *Smith v. Van Gorkom* decision in 1985,⁸ directors were confronted with the very real possibility that courts would second-guess the care with which they made corporate decisions. The resulting personal financial risk became a serious concern to directors. As a result, the legislatures of many states, including Delaware, enacted legislation permitting exculpation to shield directors from certain lawsuits.

State Exculpatory Statutes

Delaware, a state in which close to 1 million businesses — and more than half the Fortune 500 companies — are incorporated,⁹ adopted a statute in 1986 that permitted the limitation of directors' personal liability for monetary damages for breaches of the duty of care. Specifically, Section 102(b)(7) authorizes shareholders to include a clause in a corporation's charter eliminating a director's personal liability to shareholders for monetary damages for breach of fiduciary duty, provided that such a clause does not eliminate liability for:

- "Any breach of the director's duty of loyalty";
- "Acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law"; and
- "Any transaction from which the director derived an improper personal benefit."¹⁰

As a general matter, the Delaware exculpatory clause is typically invoked to protect directors against breach-of-fiduciary-duty claims brought by shareholders. Delaware courts have held, however, that the protections of Section 102(b)(7) also work to bar claims of breach of fiduciary duty that are brought derivatively by creditors of an insolvent corporation.¹¹ In so concluding, the courts have said that while "claims of the corporation asserted derivatively by creditors fall within the charter defense," creditors' direct claims "such as claims for breach of contract or for common-law or statutory torts like misrepresentation and fraudulent conveyance" are not barred by Section 102(b)(7).¹²

Many other states also enacted statutes providing similar protections for directors.¹³ In so doing, some states, like Delaware, protect only directors, while others also extend the protections to officers.¹⁴ It is important to recognize that, as a general matter, these exculpatory clauses are protections that are adopted only if the owners of the corporations (shareholders) choose to so provide.¹⁵ If shareholders believe that the corporation can attract quality directors and officers without such protection, they need not adopt an exculpation clause.¹⁶

Exculpatory Bylaws

Where shareholders have adopted exculpatory clauses, they are most valuable to directors, provided that courts allow the directors and the corporation to use

them to terminate litigation by motion early in the case. Although the issue was not always well settled, most recent case law holds that, under certain conditions, the existence of an exculpatory clause can bring about early dismissal of a breach-of-fiduciary-duty case.¹⁷

This carries far-reaching implications. If a director can raise an exculpatory clause in a motion to dismiss, the lawsuit can potentially be terminated only weeks into the proceeding — and before the beginning of costly discovery.

Evolution of the Section 102(b)(7) Defense In Delaware

In 2001 the Delaware Supreme Court enumerated the circumstances under which a motion to dismiss based on an exculpatory clause will prevail: If a complaint alleges only breach of the duty of care, it can be dismissed if the directors are protected by an exculpatory clause.¹⁸ However, if the complaint alleges a breach of the duty of loyalty or good faith — and the complaint cites specific facts, rather than conclusory allegations — the existence of an exculpatory clause will not warrant early dismissal.¹⁹ In that event, courts must undertake an “entire fairness” analysis in which the directors must prove to the trier of fact that the challenged transaction was “entirely fair” to the shareholder plaintiff.²⁰ Only after such an analysis should a court consider the effect of an exculpatory clause.

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Recent Delaware decisions have steered exculpatory-clause jurisprudence on a course that is favorable to directors. In *McPadden v. Sidhu*, for example, the Chancery Court dismissed a case brought against directors who were protected by an exculpatory charter clause authorized by Section 102(b)(7). The plaintiff shareholder had challenged i2 Technologies’ decision to sell its subsidiary, TSC, to members of TSC’s management for an allegedly below-market price. The complaint alleged that the i2 directors had first placed TSC management in charge of the sale process and then had

failed to ensure that the sale process was “thorough and complete.”

Importantly, the court found that the complaint alleged actions that were “recklessly indifferent or unreasonable” but fell short of alleging that the directors “acted in bad faith through a conscious disregard for their duties.” Consequently, the court found that the directors’ actions were protected by their corporation’s exculpatory clause.²¹ In drawing this distinction between recklessness and bad faith, the court emphasized that a certain level of intentionality — a *conscious* disregard for one’s directorial duties, not a merely *reckless* disregard — is necessary for a claim to fall into the bad-faith exception to Section 102(b)(7).

In re Lear Corp. Shareholders Litigation similarly reinforced the distinction between fully exculpable negligent or reckless behavior and the type of conscious wrongdoing that constitutes non-exculpable bad faith. In *Lear* the shareholders alleged that the directors had acted in bad faith by agreeing to pay a \$25 million “no-vote termination fee” to a potential acquirer in exchange for a \$1.25-per-share increase in the proposed merger price. Despite the plaintiffs’ characterization of their claim as one alleging breach of the directors’ duty to act in good faith, the court found that the shareholders had failed to show that the directors were not protected by *Lear*’s exculpatory charter clause and, accordingly, dismissed the complaint. In so finding, it warned that courts should “be extremely chary about labeling what they perceive as deficiencies in the deliberations of an independent board majority over a discrete transaction as not merely negligence or even gross negligence, but as involving bad faith.”

The court emphasized that absent allegations of “an illicit directorial motive,” it can be “difficult” for a plaintiff to raise a viable bad-faith claim.²² In this way, the court reiterated that conscious wrongdoing is a critical element of directorial bad faith, just as the *McPadden* court had done.

In short, *McPadden* and *Lear* have affirmed the protections afforded to directors by exculpatory clauses under Delaware law. These cases show that the Delaware courts remain firmly supportive of directors’ ability to use Section 102(b)(7) to dismiss fiduciary duty litigation brought against them unless there are specific allegations of the directors’ bad faith defined as conscious disregard of their fiduciary duties.²³

The Definition of Bad Faith

In *In re Walt Disney Co. Derivative Litigation* the Delaware Supreme Court clarified what was necessary to plead a breach of the duty of good faith. There, shareholders challenged the company's decision to hire and shortly thereafter fire its president, Michael Ovitz. Ovitz was hired in October 1995 but was terminated without cause only 14 months later. After Disney shareholders learned that he had received a \$130 million severance package, they sued the directors on a theory that the directors had breached their duty of good faith by approving such a lucrative arrangement.

In affirming the lower court's finding that the Disney board had acted in good faith, the Supreme Court established that directors will be found to have acted in bad faith only if they act with intent to harm the company or its shareholders or if they intentionally disregard their responsibilities.²⁴

Lyondell Makes Waves

The Delaware Chancery Court's opinion in *Ryan v. Lyondell Chemical Co.* represented a brief digression from the line of Delaware cases that have steadily narrowed the scope of the bad-faith exception to the Section 102(b)(7) defense.²⁵ In that case the court denied summary judgment to directors who approved the sale of Lyondell to Basell AF at a 45 percent premium over market. A shareholder plaintiff alleged that the Lyondell directors had breached their *Revlon*²⁶ duties by limiting their consideration of Basell's merger proposal to six or seven hours worth of board meetings, failing to retain an investment banker to evaluate the company after Basell filed a Schedule 13-D announcing its acquisition of 8.3 percent of Lyondell's outstanding shares in 2007, and failing to conduct effective market checks both before and after agreeing to merge with Basell.

The Lyondell directors responded with a motion for summary judgment invoking the protections that they believed were afforded by their corporate charter's exculpatory clause. Even though the plaintiff's claims appeared to closely resemble claims for breach of the duty of care, the court found that the defendants' conduct might constitute bad faith and thus could fall outside the protections of the Lyondell charter's exculpatory clause.²⁷

The *Lyondell* decision was deeply concerning to corporate directors for its attempt to reshape the nature of the bad-faith exception to exculpatory clauses. As discussed previously, the Delaware courts have defined "bad faith" to require some level of *scienter*, or intent to deceive, on the part of defendants. By refusing to exculpate the directors' conduct in *Lyondell*, however, the Chancery Court appeared to be elevating directorial behavior that at worst was grossly negligent or reckless — and that certainly was not alleged to be intentionally or consciously done — into something approaching non-exculpable bad faith.

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On interlocutory appeal, the *Lyondell* case squarely presented the Delaware Supreme Court with an opportunity to define bad faith in the context of director decision-making in a merger transaction. In reversing the Chancery Court, the Supreme Court first reasserted that the *Disney* bad-faith standard, which includes "not only an intent to harm but also intentional dereliction of duty," was the controlling standard.²⁸ The court held that directors will be found to have breached their duty of loyalty only "if they knowingly and completely failed to undertake their responsibilities."

The court found that the Chancery Court had erred by "equat[ing] an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith." It explained that the Lyondell directors' acts fell short of the "extreme set of facts" required to show bad faith: The directors were "disinterested and independent," they were "generally aware of the company's value and its prospects," and they "considered the offer, under the time constraints imposed by the buyer, with the assistance of legal and financial advisers." The court held that the Lyondell directors' actions implicated, at most, the duty of care; the plaintiffs' claims, in turn, failed because of the protections afforded by the exculpatory clause.²⁹

In short, for years, a critical question under Delaware law has been whether directors can use Section 102(b)(7) to dismiss a breach-of-fiduciary-duty claim at the outset of a case. As discussed above, recent Delaware case law clearly supports directors

in using such protections at the motion-to-dismiss stage. While it is impossible to predict where this trend may lead in coming years, to survive a motion to dismiss when a director invokes a Section 102(b)(7) defense under current Delaware law, a shareholder must allege that a director committed an “intentional dereliction of duty” or “a conscious disregard for one’s responsibilities.”³⁰

Other Jurisdictions’ Views of Exculpatory Clauses

Adjudicating the application of exculpatory clauses is not a task reserved exclusively for the Delaware state courts. Dozens of other jurisdictions have heard exculpatory-clause cases, and while many simply follow the Delaware judiciary’s lead, others have forged their own independent understandings. Directors and corporate counsel should be aware of the ways in which non-Delaware courts have treated exculpatory clauses, so that if they face litigation in one of those venues, they will be informed of potential jurisprudential opportunities and pitfalls.

The Lyondell decision was deeply concerning to corporate directors for its attempt to reshape the nature of the “bad faith” exception to exculpatory clauses.

Whether courts in other forums applying Delaware law are required to follow the Delaware practice of permitting the Section 102(b)(7) defense to be raised in a motion to dismiss turns upon whether that practice arises from a rule of Delaware civil procedure or whether it involves the “internal affairs” of the Delaware corporation.³¹ It should be obvious from the preceding discussion that the better view is that pleading around Section 102(b)(7) is a substantive element of any claim against a Delaware director whose corporation has such a provision in its charter. Accordingly, courts in other jurisdictions applying Delaware law should consider themselves bound to enforce Section 102(b)(7) at the motion-to-dismiss stage, just as the Delaware courts do. To do otherwise only encourages plaintiff forum-shopping. To the extent that other jurisdictions refuse to allow the Section 102(b)(7) defense to be used in a motion to

dismiss, the Delaware Legislature should consider amending the statute to make this explicit.

Federal Court Decisions

Several federal courts have weighed in on two key interpretive issues:

- Whether a defendant can base a motion to dismiss on the protections afforded by an exculpatory clause; and
- Whether directorial acts that are merely reckless — but that are not intentional or conscious — can be exculpated by a Section 102(b)(7) exculpatory clause.³²

First, some federal courts applying Delaware law have denied motions to dismiss founded on Section 102(b)(7) clauses on a theory that this defense is not properly asserted in a motion to dismiss. These courts deemed the existence of such a clause analogous to an affirmative defense that could be raised only at a later stage in the proceedings. The U.S. District Court for the District of Arizona, for example, has held that a “statutory liability shield provided by a certificate of incorporation ... is in the nature of an affirmative defense” and thus is inappropriate for consideration in the context of a motion to dismiss for failure to state a claim.³³

The District of Delaware has broken with Delaware state courts on this issue, holding recently that “[b]ecause a Section 102(b)(7) provision is in the nature of an affirmative defense and following the statement of the 3rd Circuit that such defenses will generally not form the basis of a Rule 12(b)(6) dismissal, defendants’ motion to dismiss the duty of care claims is denied.”³⁴

These jurisdictions’ reluctance to grant a motion to dismiss based on an exculpatory clause defense contrasts with the result in the Delaware state courts, where a director is permitted to use an exculpatory clause to dismiss a duty-of-care claim at the outset of a case.³⁵ These federal cases are based on snippets of quotation from older Delaware cases implying that Section 102(b)(7) is “in the nature of an affirmative defense”³⁶ and ignore more recent Delaware case law that requires a plaintiff to plead around the requirements of the exculpatory clause as a substantive element of a claim against any director of a corporation with a Section 102(b)(7) charter clause.³⁷

Second, in granting defendants' motions to dismiss, two federal courts, applying Delaware law, recently addressed the type of directorial behavior that should be labeled bad faith. The Northern District of Illinois, for example, recited the bad-faith standard correctly as requiring "a conscious disregard [of] responsibilities" and held that the defendants' alleged failure to act in response to a single communication from a regulatory agency did not constitute bad faith.³⁸

Likewise, the District of Massachusetts, applying Delaware law, also correctly stated the bad-faith standard as requiring "a conscious disregard of a known risk" and held that the defendants' alleged failure to discover a fraud was not bad faith where the fraudulent actors had concealed their actions and where the board had retained and relied upon professional advisers concerning the underlying matters.³⁹ In neither case were the facts alleged sufficiently close to the line for the court to rely exclusively on an exculpatory clause as grounds for its decision.

Any lack of clarity on the perennially thorny question of what constitutes directorial bad faith is perhaps understandable; indeed, even in Delaware state court, cases such as *Disney* and *Lyondell* demonstrate that this subject still gives rise to controversy from time to time. Nonetheless, the Delaware courts have now clearly resolved to treat unintentional recklessness as fully exculpable and to require that such allegations be specifically made in the complaint in order to state a claim for relief against any directors whose company has an exculpatory clause. There is every reason for the federal courts to apply this substantive law in ruling on motions to dismiss shareholder claims.

State Courts Generally

Some plaintiffs' counsel apparently believe that by filing lawsuits in a corporation's principal place of business rather than in Delaware, they will benefit from ambiguities in those states' less-developed corporate law. A survey of the law in states other than Delaware reveals that there are few published opinions addressing Section 102(b)(7) or similar exculpatory clauses. Broadly speaking, this dearth of published case law makes it unclear how courts in states other than Delaware will interpret an exculpatory clause. In the absence of a well-developed body of authority, the courts of many states will rely on applicable Delaware authorities in appropriate

circumstances.⁴⁰ Whether this will occur in the context of exculpatory clauses remains to be seen.

The limited case law that exists suggests that state courts have an inconsistent record in relying upon or enforcing exculpatory provisions, including Section 102(b)(7). For example, in *Shaper v. Bryan* the Illinois Appellate Court affirmed, under Delaware law, the dismissal of a due care claim but failed to base its ruling on the exculpatory provision in the corporation's charter.⁴¹ In that case, the directors argued in their briefs that the Section 102(b)(7) provision in their corporate charter shielded them from liability for the actions challenged by plaintiffs.⁴² Although ultimately ruling in favor of the defendants and dismissing the case, the Illinois court based its decision on the plaintiffs' failure to allege sufficient facts to rebut the business judgment rule; it did not even mention the Section 102(b)(7) provision in its opinion affirming the dismissal.⁴³

The court held that directors will be found to have breached their duty of loyalty only "if they knowingly and completely failed to undertake their responsibilities."

Likewise, in *Elloway v. Pate*, also under Delaware law, the Texas Court of Appeals affirmed the lower court's decision to direct a verdict in favor of the directors on a due care claim, finding that the plaintiff "has not presented evidence that the directors' conduct constitutes gross negligence."⁴⁴ In reaching its ruling, the court did not rely upon the Section 102(b)(7) clause in the company's charter, which would have set the applicable standard even higher. In fact, the defendants themselves failed even to raise the exculpatory provision at the directed-verdict hearing in the trial court, even though such an argument would have strongly supported a dismissal.⁴⁵ Both the courts and the lower court litigants displayed some reluctance to rely explicitly on a Section 102(b)(7) defense.

New York Courts

In New York at least one court, applying Delaware law, emphasized that the "great deference given to the existence and legal effect of the exculpatory provision" seen in Delaware cases like *Malpiede v. Townson* is "highly influential to the within analysis" dismissing the complaint.⁴⁶ Another New York court, applying

Delaware law, went in a different direction, stating that Section 102(b)(7) does not protect a director against any complaint alleging that the director engaged in “misconduct” — an overbroad statement obviously at odds with Delaware state courts’ interpretation of Section 102(b)(7).⁴⁷ Nevertheless, the court dismissed the complaint, finding the allegations of misconduct to be “wholly conclusory” and insufficient to rebut the presumption of the business judgment rule.

Further, one recent case indicates that the New York courts might be willing to base a decision, applying Delaware law, directly upon Section 102(b)(7).⁴⁸ In that case a court confronted with an exculpatory clause dismissed the complaint in favor of defendants but did not rely exclusively upon its protections, finding that the directors’ actions would survive even heightened scrutiny although such an inquiry was “simply not warranted.”⁴⁹ The court correctly articulated the legal standards under Section 102(b)(7) but never had the opportunity to determine whether it would rely solely on the exculpatory provision as a basis for dismissal of the complaint.⁵⁰

California Courts

As for the California courts, it is worth noting that they have shown themselves inclined to limit the protections afforded by exculpatory clauses in general. In one case the California Court of Appeal interpreted a state law clause analogous to Section 102(b)(7) in a highly limited fashion, holding that “waiver of corporate directors’ and majority shareholders’ fiduciary duties to minority shareholders in private close corporations is against public policy, and a contract provision ... purporting to effect such a waiver is void.”⁵¹

Strangely, the court relied on the California Corporations Code clause that, like Section 102(b)(7), expressly authorizes such waivers.⁵² The court found that the clause’s various exceptions forbidding the exculpation of acts taken in bad faith or intentional misconduct — which echo, in substance, the exceptions to Section 102(b)(7) — indicate, in turn, that the state’s overarching policy is to strongly disfavor attempts to eliminate liability for any breach of fiduciary duty.⁵³ This reasoning, which savors strongly of a general suspicion of exculpatory clauses, indicates that the California state courts, given the opportunity, may limit the usefulness of exculpatory clauses.

The failure of some state courts to base their rulings squarely upon exculpatory clauses means that

it is unclear how those courts will interpret Section 102(b)(7) or similar provisions in the future. This failure may only indicate that state courts lack familiarity with the concept of an exculpatory clause, or it may indicate a reluctance to permit such defenses to be asserted at the dismissal stage. Either way, the courts of these states may be far less deferential to the shareholders’ decision to adopt exculpatory provisions than are Delaware courts. On the other hand, it is possible that some directors’ counsel may have been reluctant to base arguments (and courts to base rulings) on the bad-faith exception to Section 102(b)(7). Since recent Delaware cases have clarified that exception, practitioners and courts should not be reluctant to rely on exculpatory clauses as the basis for an early dismissal.

For years, a critical question under Delaware law has been whether directors can use Section 102(b)(7) to dismiss a breach-of-fiduciary-duty claim at the outset of a case.

Conclusion

Exculpatory clauses, such as the type authorized by Section 102(b)(7), can offer protection to directors who find themselves defending against certain breach-of-fiduciary-duty claims. The scope and usefulness of exculpatory clauses are greatly affected by the willingness of the forum courts to apply them. To date, a number of jurisdictions have failed to recognize the importance of exculpatory clauses in ruling on motions to dismiss. Likewise, counsel representing directors in jurisdictions outside Delaware have not always explicitly raised the exculpatory-clause defense at the motion-to-dismiss stage.

Recent Delaware case law strongly demonstrates that it is appropriate to pursue such defenses at the motion-to-dismiss stage. The existence of the exculpatory clause requires that the plaintiff satisfy an extremely high pleading standard to allow cases to go forward. Specifically, a plaintiff must show that a director must have committed “intentional dereliction of duty” or “a conscious disregard for one’s responsibilities.”⁵⁴ In light of this current trend in Delaware case law, counsel representing corporate directors should clearly consider raising appropriate exculpatory-clause defenses at the motion-to-dismiss stage.

Notes

- ¹ This article reflects the views of the authors only and not necessarily those of Sidley Austin LLP. This article has been prepared for information purposes only and does not constitute legal advice. This information is not intended to create, and the receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this without seeking advice from professional advisers.
- ² Some states, including Delaware, use the term “stockholder” in their statutes. Other states use the term “shareholder.” For consistency, the term “shareholder” is used here throughout.
- ³ It is important to emphasize that exculpatory clauses like Delaware’s Section 102(b)(7) do not cover corporate officers and do not protect directors against injunctive relief or injury to their reputational interests. Such exculpatory clauses also do not shield directors from liability for breach of non-corporate fiduciary duties such as those that may be enforceable under the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1132. ERISA expressly provides that any attempt to exculpate ERISA fiduciaries “shall be void.” 29 U.S.C. § 1110(a).
- ⁴ See, e.g., *Emerald Ptrs. v. Berlin*, 787 A.2d 85, 90-91 (Del. 2001).
- ⁵ See, e.g., *In re CompuCom Sys. S’holders Litig.*, No. 499-N, 2005 WL 2481325, *6 (Del. Ch. Sept. 29, 2005) (breach of the fiduciary duty of care occurs when a director makes a decision in a “rushed or uninformed” manner).
- ⁶ See, e.g., *Marciano v. Nakash*, 535 A.2d 400, 403 (Del. 1987) (“the fiduciary relationship between directors and the corporation imposes fundamental limitations on the extent to which a director may benefit from dealings with the corporation he serves”).
- ⁷ See, e.g., *Bomarko Inc. v. Int’l Telecharge*, 794 A.2d 1161, 1179 (Del. Ch. 1999) (where there is “evidence of a breach of the duty of loyalty sufficient to rebut application of the business judgment rule, [the court] will review the transaction under the entire-fairness standard of review”).
- ⁸ 488 A.2d 858, 893 (Del. 1985) (finding that directors could be held personally liable for millions of dollars because shareholder plaintiffs considered their decision to approve a merger too rash).
- ⁹ See LEWIS S. BLACK JR., WHY CORPORATIONS CHOOSE DELAWARE, at 1 (2007), available at http://corp.delaware.gov/whydelaware/whycorporations_web.pdf.
- ¹⁰ 8 Del. C. § 102(b)(7) (2009). The remedy against directors for unlawful payment of dividend, stock purchase or redemptions under Section 174 of the Delaware General Corporation Law also cannot be eliminated by a Section 102(b)(7) exculpatory clause. See *id.*
- ¹¹ *Prod. Res. Group v. NCT Group*, 863 A.2d 772, 793 (Del. Ch. 2004); see also *Continuing Creditors’ Comm. of Star Telecomm. v. Edgecomb*, No. 03-278-KAJ, 385 F. Supp. 2d 449, 463 (D. Del. Dec. 21, 2004). Under Delaware law, directors of corporations that are insolvent owe fiduciary duties to the corporation’s creditors that are enforceable in a derivative (and not a direct) action. *N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 98-102 (Del. 2007).
- ¹² *Prod. Res. Group*, 863 A.2d at 794.
- ¹³ Some examples include the following: Maryland law permits corporations to adopt clauses that limit the liability of directors and officers to the corporation or its shareholders for money damages, although liability may not be waived where “it is proved that the person actually received an improper benefit or profit in money, property, or services for the amount of the benefit or profit in money, property, or services actually received” or where a court finds that “the person’s action, or failure to act, was the result of

active and deliberate dishonesty and was material to the cause of action adjudicated in [a] proceeding.” Md. Courts and Judicial Proceedings Code Ann. § 5-418(a)(1-2) (2008). Maryland’s law is particularly relevant because Maryland is “by far the most popular state in which to organize a REIT,” a real estate investment trust. *Crossing the Line: Neighboring States Delaware and Maryland Are Miles Apart When It Comes to Laws Affecting REITs*, REAL ESTATE PORTFOLIO, January/February 2002, available at <http://www.realestateportfolio.com/portfoliomag/02janfeb/policy.shtml>.

Under New York law, a corporate charter may eliminate or limit directors’ personal liability for damages, provided that no such provision may eliminate or limit, among other things, “the liability of any director if a judgment or other final adjudication adverse to him establishes that his acts or omissions were in bad faith or involved intentional misconduct or a knowing violation of law or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled.” N.Y. Bus. Corp. Law § 402(b)(1) (2008).

Under Illinois law, a corporate charter may contain “a provision eliminating or limiting the personal liability of a director to the corporation or its shareholders for monetary damages for breach of fiduciary duty as a director, provided that the provision does not eliminate or limit the liability of a director” for, among other things, “any breach of the director’s duty of loyalty to the corporation or its shareholders,” “acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law,” or “any transaction from which the director derived an improper personal benefit.” 805 Ill. Comp. Stat. 5/2.10(b)(3) (2009).

Other states allow shareholders to adopt exculpatory charter provisions that appear to be even more favorable to directors than those authorized by Delaware’s Section 102(b)(7). In Nevada, for example, corporate charters may provide that “a director or officer is not individually liable to the corporation or its shareholders or creditors for any damages as a result of any act or failure to act in his capacity as a director or officer unless it is proven that . . . [h]is breach of those duties involved intentional misconduct, fraud or a knowing violation of law.” Nev. Rev. Stat. § 78.138(7) (2009).

- ¹⁴ See, e.g., La. Rev. Stat. Ann. § 12:24(C)(4) (2008); Md. Code Ann., Cts. & Jud. Proc. § 5-418(a) (2008); Nev. Rev. Stat. § 78.037(2) (2009); N.J. Stat. Ann. § 14A:2-7(3) (2009); Va. Code Ann. § 13.1-692.1(A)(1) (2009).
- ¹⁵ See *Emerald Ptrs.*, 787 A.2d at 90 (noting that “[t]he purpose of Section 102(b)(7) was to permit shareholders — who are entitled to rely upon directors to discharge their fiduciary duties at all times — to adopt a provision in the certificate of incorporation to exculpate directors from any personal liability for the payment of monetary damages for breaches of their duty of care, but not for duty-of-loyalty violations, good-faith violations and certain other conduct”).
- ¹⁶ Such clauses are intended to prevent directors from behaving too conservatively for fear of being sued; indeed, the Delaware courts have recognized that the exculpatory clause exists in order to “encourage directors to undertake risky, but potentially value-maximizing, business strategies, so long as they do so in good faith.” See *Prod. Res. Group*, 863 A.2d at 777.
- ¹⁷ See, e.g., *In re Lear Corp. S’holder Litig.*, No. 2728-VCS, --- A.2d ---, 2008 WL 5704774, at *1 (Del. Ch. Sept. 2, 2008) (relying on exculpatory clause in dismissing claim alleging that directors violated their duty of care when they approved a merger agreement that was likely to be rejected by shareholders and agreed to pay a hefty termination fee to the bidder if the shareholders voted down the

- deal); *McPadden v. Sidhu*, 964 A.2d 1262, 1277 (Del. Ch. 2008) (exculpatory clause resulted in the dismissal of a shareholder's claim that a board of directors sold a subsidiary for far less than its fair market value).
- ¹⁸ *Malpiede v. Townson*, 780 A.2d 1075, 1094 (Del. 2001) ("if there is only an unambiguous, residual due care claim and nothing else — as a matter of law — then Section 102(b)(7) [bars] the claim"). Raising the exculpatory clause in a motion to dismiss may convert the motion into one for summary judgment, but "it does not follow that the 'floodgates of discovery' have to be opened." *Id.* at 1091. Discovery, if any, is limited to issues such as the authenticity of the exculpatory provision and whether it was properly adopted by the shareholders. *Id.* at 1092. Alternatively, the court may take judicial notice of the exculpatory clause. See *Khanna v. McMinn*, No. 20545-NC, 2006 WL 1388744, at *30 (Del. Ch. May 9, 2006) (the court may "take judicial notice of matters that are not subject to reasonable dispute") (internal quotations omitted); *In re Wheelabrator Techs. S'holders Litig.*, No. 11495, 1992 WL 212595, at **11-12 (Del. Ch. Sept. 1, 1992) (same).
- ¹⁹ See *Emerald Ptrs.*, 787 A.2d at 92 (stating that "in actions against the directors of Delaware corporations with a Section 102(b)(7) charter provision, a shareholder's complaint must allege well-pled facts that, if true, implicate breaches of loyalty or good faith"); see also *Alidina v. Internet.com Corp.*, No. 17235-NC, 2002 WL 31584292, at *8 (Del. Ch. Nov. 6, 2002) (holding that "when a duty-of-care breach is not the exclusive claim, a court may not dismiss based upon an exculpatory clause. Because the duty of loyalty is implicated in this case, the Section 102(b)(7) provision cannot operate to negate plaintiffs' duty-of-care claim on a motion to dismiss."). When plaintiffs plead such facts, they need not plead them with the level of particularity required under Chancery Court Rule 23.1. See, e.g., *McPadden*, 964 A.2d at 1269 (stating that the pleading burden of Rule 23.1 is "more onerous" than the pleading burden under Rule 12(b)(6)); *Desimone v. Barrows*, 924 A.2d 908, 928 (Del. Ch. 2007) (explaining that "[t]he difference between the 12(b)(6) and 23.1 standards is in the level of detail demanded of the plaintiff's allegations. On a 12(b)(6) motion, particularity in fact pleading is not required. Nonetheless, to survive a Rule 12(b)(6) motion, a complaint alleging breach of fiduciary duty must plead facts supporting an inference of breach, not simply a conclusion to that effect.") (emphasis added).
- ²⁰ See *Emerald Ptrs.*, 787 A.2d at 97 (stating that to show entire fairness, a board must "present evidence of the cumulative manner by which it discharged all of its fiduciary duties. An entire fairness analysis then requires the Court of Chancery to consider carefully how the board of directors discharged all of its fiduciary duties with regard to each aspect of the non-bifurcated components of entire fairness: fair dealing and fair price.") (internal quotations omitted).
- ²¹ 964 A.2d at 1275.
- ²² --- A.2d ---, 2008 WL 5704774, at **6, 7, 11 & n. 62.
- ²³ Exculpatory clauses like Delaware's Section 102(b)(7) effectively may also be used in motions to dismiss derivative lawsuits on for failing to make a demand. In Delaware, for example, Court of Chancery Rule 23.1 requires that derivative plaintiffs allege with particularity either that they have made a demand on the corporation's board of directors to pursue the corporate claim and the directors have wrongfully refused to do so or that pre-suit demand is "futile" under one of two standards. *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984) (*Aronson* test applies to claims challenging a company transaction and requires particularized allegations creating a reasonable doubt that "the directors are disinterested and independent [or that] ... the challenged transaction was otherwise the product of a valid business judgment"); *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993) (*Rales* test applies to claims alleging failure of board oversight and requires particularized allegations creating a reasonable doubt that "the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand"). In *Wood v. Baum*, 953 A.2d 136 (Del. 2008), the Delaware Supreme Court held that when courts adjudicate such allegations of demand futility, they should take exculpatory clauses into account and that a derivative complaint should be dismissed where, as in that case, there were no particularized allegations that the directors "had 'actual or constructive knowledge' that their conduct was legally improper." *Id.* at 141. *Wood* effectively combines Rule 23.1 and Section 102(b)(7) at the earliest procedural stage to filter out derivative claims that do not allege conscious knowledge of wrongdoing. See also *In re ITT Corp. Derivative Litig.*, 588 F. Supp. 2d 502 (S.D.N.Y. 2008) (granting motion to dismiss on futility grounds); *In re Extreme Networks S'holder Derivative Litig.*, 573 F. Supp. 2d 1228 (N.D. Cal. 2008) (same); *In re Citigroup S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009) (same).
- ²⁴ 906 A.2d 27, 35, 46, 62 (Del. 2006) (affirming the Chancery Court's definition of bad faith as "intentional dereliction of duty, ... a conscious disregard for one's responsibilities, ... [or] [d]eliberate indifference and inaction in the face of a duty to act"). Cf. *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996) (Where it is alleged that directors failed properly to monitor company activities "only a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable reporting system [exists] — will establish the lack of good faith that is a necessary condition to liability."); *In re Citigroup*, 964 A.2d at 129-31 (dismissing complaint alleging director failure to anticipate business risks relating to real estate and credit markets).
- ²⁵ 2008 WL 2923427 (Del. Ch. July 29, 2008), *rev'd*, --- A.2d ---, 2009 WL 1024764 (Del. Mar. 25, 2009).
- ²⁶ *Revlon Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182 (Del. 1986) (once sale of the company becomes inevitable, the directors are "auctioneers charged with getting the best price for the [shareholders' stock]").
- ²⁷ *Ryan*, 2008 WL 2923427, at **1 & n.3, 14, 18-19 (finding that "[t]he record, as it presently stands, does not, as a matter of undisputed material fact, demonstrate the Lyondell directors' good-faith discharge of their *Revlon* duties").
- ²⁸ --- A.2d ---, 2009 WL 1024764, at *3.
- ²⁹ *Id.* at 2, 13-14, 21.
- ³⁰ *In re Walt Disney Co. Derivative Litig.*, 906 A.2d at 62, 67; *Lyondell*, --- A.2d ---, 2009 WL 1024764, at *4. *Disney* and *Lyondell*, of course, are not pleading cases but establish the legal standard of bad faith.
- ³¹ Issues concerning the substantive internal affairs of a corporation generally are decided under the laws of the state of incorporation. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS, § 302(2) & cmt. a (noting that matters involving the "internal affairs" of a corporation are typically governed by the "local law of the state of incorporation"); see also *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987) ("No principle of corporation law is more firmly established than a state's authority to regulate domestic corporations."). Issues concerning procedure, on the other hand, are generally decided under the laws or rules of the forum court. See RESTATEMENT (SECOND) OF CONFLICTS OF LAWS, § 122 ("A court usually applies its own local law rules prescribing how litigation shall be conducted even when it applies the local law rules of another state to resolve other issues in the case.").

- ³² Most, though certainly not all, cases outside Delaware that have involved Section 102(b)(7) clauses have been brought in the federal courts, so the body of federal Section 102(b)(7) case law is more fully developed than corresponding state case law outside Delaware.
- ³³ *In re Taser Int'l S'holder Derivative Litig.*, No. CV-05-123-PHX-SRB, 2006 WL 687033, at *19 (D. Ariz. Mar. 17, 2006) (internal citations and quotations omitted).
- ³⁴ *Ad Hoc Comm. of Equity Holders of Tectonic Network v. Wolford*, 554 F. Supp. 2d 538, 561 (D. Del. 2008).
- ³⁵ See "Evolution of the Section 102(b)(7) Defense in Delaware," *supra* P. 4.
- ³⁶ See, e.g., *Emerald Ptrs.*, 726 A.2d at 1223.
- ³⁷ *Id.* at 92 ("in actions against the directors of Delaware corporations with a Section 102(b)(7) charter provision, a shareholder's complaint must allege well-pled facts that, if true, implicate breaches of loyalty or good faith"); *McMillan v. Intercargo Corp.*, 768 A.2d 492, 501 (Del. Ch. 2000) (in the context of a Section 102(b)(7) provision, in ruling on a motion to dismiss, "the court's focus is necessarily upon whether the complaint alleges facts that, if true, would buttress a conclusion that the defendant directors breached their duty of loyalty or otherwise engaged in conduct not immunized by the exculpatory charter provision").
- ³⁸ *Bronstein v. Austin*, No. 07 C 3984, 2008 WL 4735230, *5 (N.D. Ill. May 30, 2008).
- ³⁹ *Nisselson v. Lernout*, 568 F. Supp. 2d 137, 149 (D. Mass. July 25, 2008).
- ⁴⁰ *In re F5 Networks Derivative Litig.*, No. C06-794RSL, 2007 WL 2476278, at *6 (W.D. Wash. Aug. 6, 2007) (in the absence of Washington substantive law on demand futility Washington courts likely to follow the Delaware standard); *Shoen v. SAC Holding Corp.*, 137 P.3d 1171, 1187 (Nev. 2006) (adopting as Nevada law the *Aronson* and *Rales* standards for determining demand futility).
- ⁴¹ 371 Ill. App. 3d 1079, 1082 (Ill. App. Ct. 2007).
- ⁴² *Id.*, Brief of Defendants-Appellees at 41.
- ⁴³ *Id.* at 1082.
- ⁴⁴ 238 S.W.3d 882, 896 (Tex. App. 2007).
- ⁴⁵ See *id.*
- ⁴⁶ See *Kensington Int'l Ltd. v. Hiner*, No. 602748/03 (N.Y. Sup. Ct. Aug. 22, 2006).
- ⁴⁷ See *Potter v. Arrington*, 810 N.Y.S.2d 312, 317 (N.Y. 2006). This statement appears as part of a larger, somewhat unclear analysis in which the court states that "[a] director may not exempt himself or herself from acts of misconduct" but then goes on to dismiss certain causes of action that "only alleged misconduct and similar improper actions." See *id.*
- ⁴⁸ See *In the Matter of Bear Stearns Litig.*, No. 600780/08, 870 N.Y.S.2d 709 (N.Y. Sup. Ct. Dec. 4, 2008).
- ⁴⁹ See *id.* at *2, 48.
- ⁵⁰ See *id.*
- ⁵¹ *Neubauer v. Goldfarb*, 108 Cal. App. 4th 47, 57 (Cal. Ct. App., 2d Dist. 2003).
- ⁵² *Id.* (interpreting the text of Cal. Corp. Code § 204(a)(10)).
- ⁵³ *Id.*

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