

# The Exculpatory Clause Defense to Shareholder Derivative Claims

By Richard B. Kapnick and Courtney A. Rosen

A director's responsibilities in serving on a corporation's board of directors are accompanied by significant personal financial risks. When shareholders disagree with the director's actions or believe that the director harmed the corporation by inaction, they can assert a breach of fiduciary duty claim. Exculpatory clauses—or, in the parlance of Delaware law, section 102(b)(7) clauses—provide a defense. When properly invoked, exculpatory clauses can provide a basis for the dismissal at the outset of a case of certain types of breach of fiduciary duty damages claims brought derivatively by shareholders. Recent Delaware Chancery Court decisions have accepted exculpatory clauses as a valid defense for director-defendants at the motion to dismiss stage. This article explores how exculpatory clauses work to shield directors from personal liability for non-intentional breaches of fiduciary duties owed to the corporation.

## Background on Exculpatory Clauses

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*<sup>1</sup> decision in 1985, 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 enacted legislation permitting exculpation to shield directors from certain lawsuits.

For instance, Delaware 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 personal liability of a director to shareholders for monetary damages for breach of fiduciary duty, provided that such clause does not eliminate liability (1) for "any breach of the director's duty of loyalty," (2) "for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law," and (3) "for any transaction from which the director derived an improper personal benefit."<sup>2</sup>

Many other states also enacted statutes providing similar protections for directors.<sup>3</sup>

Some states, like Delaware, protect only directors, while others also extend the protections to officers.<sup>4</sup> These exculpatory clauses are protections that are adopted only if the shareholders, as the owners of the corporation, choose to so provide.<sup>5</sup> If shareholders believe that the corporation can attract quality directors and officers without such protection, they need not adopt an exculpation clause.<sup>6</sup>

For directors, exculpatory clauses are most valuable when courts allow the directors and the corporation to use the clause to terminate litigation by motion early in the case. This carries far-reaching implications. If a director-defendant can raise an exculpatory clause in a motion to dismiss, the lawsuit can be terminated mere weeks into the proceeding—and before the beginning of costly discovery.

## Evolution of the Exculpatory Clause 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.<sup>7</sup> 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.<sup>8</sup>

Recent Delaware decisions have steered exculpatory clause jurisprudence in a course that is even more favorable to director-defendants. In *McPadden v. Sidhu*, for example, the plaintiff-shareholder had challenged i2 Technologies' decision to sell its subsidiary TSC, alleging 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.<sup>9</sup> 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 Corporation Shareholders Litigation*<sup>10</sup> reinforced this distinction. In *Lear*, the shareholder-plaintiffs alleged that the directors of Lear 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 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 shareholder-plaintiffs 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 . . . 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.<sup>11</sup> In this way, the court reiterated that conscious wrongdoing is a critical element of directorial bad faith, just as the *McPadden* court had done.<sup>12</sup>

### Exculpatory Clauses in Other Jurisdictions

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. Pleading around section 102(b)(7) should be considered a substantive element of any claim against a Delaware director whose corporation has such a provision in its charter, and for that reason, 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.

### Federal Courts

Several federal courts have weighed in on two key interpretive issues: first, whether a defendant can base a motion to dismiss on the protections afforded by an exculpatory clause; and, second, whether directorial acts that are merely reckless—but not conscious or intentional—can be excused by a section 102(b)(7) exculpatory clause.

First, some federal courts applying Delaware law have denied motions to dismiss founded on section 102(b)(7) clauses, theorizing that this defense is not properly asserted in a motion to dismiss, but is analogous to an affirmative defense that may be raised only at a later stage in the proceedings. The 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.<sup>13</sup> 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 Third 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.”<sup>14</sup>

The reluctance of these jurisdictions 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. These federal cases are based on snippets of quotations from older Delaware cases implying that section 102(b)(7) is in the nature of an affirmative defense and ignore more recent Delaware case law that demands the plaintiff 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.<sup>15</sup>

Second, in granting defendants’ motions to dismiss, two federal courts, applying Delaware law, recently addressed the type of directorial behavior that should be labeled “in bad faith.” Both of these cases involved allegations of directorial bad faith that were found to be inadequate. 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 where the plaintiff admitted that the defendants had set up a reporting system for addressing such communications.<sup>16</sup> 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 advisors concerning the underlying matters.<sup>17</sup> These cases shed little light on whether either of these courts would rely in an appropriate case on an exculpatory clause as the exclusive ground for its decision.

After the decisions of the Delaware Supreme Court in *Lyondell* and *Disney*, there should be no lack of clarity on the perennially thorny question of what constitutes directorial bad faith. The Delaware courts clearly have resolved to treat unintentional recklessness as fully excusable and to require that such allegations be specifically made in the complaint in order to state a claim for relief against any director 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*

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.<sup>18</sup> 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. 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.<sup>19</sup> In that case, the director-defendants 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.<sup>20</sup> 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; the court did not even mention the section 102(b)(7) provision in its opinion affirming the dismissal.<sup>21</sup>

Likewise, in *Elloway v. Pate*, the Texas Court of Appeals affirmed under Delaware law the lower court's decision to direct a verdict in favor of the director-defendants on a due care claim, finding that the plaintiff "has not presented evidence that the Directors' conduct constitutes gross negligence."<sup>22</sup> 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.<sup>23</sup> In fact, 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.<sup>24</sup> Both the courts and the lower court litigants displayed some reluctance to rely explicitly on a section 102(b)(7) defense.

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 analysis dismissing the complaint.<sup>25</sup> 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).<sup>26</sup> 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 very recent case indicates that the New York courts might be willing to base a decision, applying Delaware law, directly on section 102(b)(7). In that case, a court confronted with an exculpatory clause dismissed the complaint in favor of defendants but did not rely exclusively on its protections, finding that the directors' actions in that case "would survive scrutiny" even heightened scrutiny, although such heightened scrutiny was "simply not warranted" in that case.<sup>27</sup> The court correctly articulated the legal standards under section 102(b)(7), but it never had the opportunity to determine whether it would rely solely on the exculpatory provision as a basis for dismissal of the complaint.<sup>28</sup>

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 at least one case, the California Court of Appeals has interpreted a California 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."<sup>29</sup> Strangely, the court relied on the California Corporations Code clause that, like section 102(b)(7), expressly authorizes such waivers.<sup>30</sup> 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. This reasoning—which smacks strongly of a general suspicion of exculpatory clauses—indicates that the California state courts, given the opportunity, may limit the applicability of exculpatory clauses.

Some state courts' failure to base their rulings squarely on exculpatory clauses means that it is unclear how those courts will interpret section 102(b)(7) or similar provisions in the future. On the one hand, 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. 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). Because recent Delaware cases have clarified that exception, practitioners and courts should come away with one lesson: Neither should be reluctant to rely on exculpatory clauses as the basis for an early dismissal.

### Using Exculpatory Clauses to Their Fullest Effect

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 allow such defenses to be asserted at the motion to dismiss stage. The existence of the exculpatory clause requires that the shareholder-plaintiff satisfy an extremely high pleading standard to allow cases to go forward. Specifically, a shareholder-plaintiff must show that a director must have committed “intentional dereliction of duty” or “a conscious disregard for one’s responsibilities.”<sup>31</sup> In light of this current trend in Delaware case law, counsel representing corporate directors should consider raising appropriate exculpatory clause defenses at the earliest possible opportunity. ■

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### Endnotes

1. 488 A.2d 858, 893 (Del. 1985) (finding that directors may be personally liable if their decision to approve merger was too hasty or unsupported).

2. DEL. CODE ANN. tit. 8, § 102(b)(7) (2009).

3. See, e.g., MD. CODE ANN., CTS. & JUD. PROC. § 5-418(a)(1)-(2) (2009); N.Y. BUS. CORP. LAW § 402(b)(1) (McKinney 2009); 805 ILL. COMP. STAT. 5/2.10(b)(3) (2009). Maryland’s law is particularly relevant because Maryland is “by far the most popular state in which to organize a REIT [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, Jan./Feb. 2002, [www.realestateportfolio.com/portfoliomag/02janfeb/policy.shtml](http://www.realestateportfolio.com/portfoliomag/02janfeb/policy.shtml). Other states, such as Nevada, allow shareholders to adopt exculpatory charter provisions that appear to be even more favorable to director-defendants,

providing exculpation for a director or an 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).

4. See, e.g., LA. REV. STAT. ANN. § 12:24(C)(4) (2008); MD. CODE ANN., CTS. & JUD. PROC. § 5-418(a) (2009); 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).

5. See *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001).

6. Delaware courts have recognized that the exculpatory clause exists 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, LLC v. NCT Group, Inc.*, 863 A.2d 772, 777 (Del. Ch. 2004).

7. *Malpiede v. Townson*, 780 A.2d 1075, 1094 (Del. 2001). 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 Del. Ch. LEXIS 86, at \*130 (Del. Ch. May 9, 2006) (the court may “take judicial ‘notice of matters that are not subject to reasonable dispute’”) (internal quotation omitted).

8. See *Emerald Partners*, 787 A.2d at 92; see also *Alidina v. Internet.com Corp.*, No. 17235-NC, 2002 Del. Ch. LEXIS 156, at \*28 (Del. Ch. Nov. 6, 2002) (holding that “when a duty of care breach is not the *exclusive* claim [i.e., the duty of loyalty is implicated], . . . the § 102(b)(7) provision cannot operate to negate plaintiffs’ duty of care claim on a motion to dismiss”).

9. *McPadden v. Sidhu*, 964 A.2d 1262, 1275 (Del. Ch. 2008).

10. No. 2728-VCS, 2008 Del. Ch. LEXIS 121 (Del. Ch. 2, 2008).

11. *In re Lear Corp. S’holder Litig.*, 2008 Del. Ch. LEXIS at \*20, 23, 25, 36, 41–43, n.62.

12. Exculpatory clauses like Delaware’s section 102(b)(7) effectively may also be employed in motions to dismiss derivative lawsuits for failure to make demand under Rule 23.1. In *Wood v. Baum*, 953 A.2d 136 (Del. 2008), the Delaware Supreme Court held that when courts adjudicate the sufficiency of 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 are 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. Deriv. Litig.*,

588 F. Supp. 2d 502 (S.D.N.Y. 2008) (granting motion to dismiss on futility grounds); *In re* Extreme Networks, Inc. S'holder Deriv. Litig., 573 F. Supp. 2d 1228 (N.D. Cal. 2008) (same); *In re* Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106 (Del. Ch. 2009) (same).

13. *In re* TASER Int'l S'holder Deriv. Litig., No. CV-05-123-PHX-SRB, 2006 U.S. Dist. LEXIS 11554, at \*59 (D. Ariz. Mar. 17, 2006) (internal quotation omitted).

14. Ad Hoc Comm. of Equity Holders of Tectonic Network, Inc. v. Wolford, 554 F. Supp. 2d 538, 561 (D. Del. 2008). See also *Collins & Aikman Corp. v. Stockman*, No. 07-265-SLR-LPS, 2009 WL 1530120, at \*20 (D. Del. May 20, 2009).

15. See *Emerald Partners. v. Berlin*, 787 A.2d at 92 (“[I]n 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 *In re* Medtronic, 622 F. Supp. 802, 809 (D. Minn. 2009) (dismissing derivative claim under Minnesota law for failure to make a demand and noting that exculpatory clause requires “the more difficult burden of pleading a non-exculpated claim to avoid dismissal”).

16. *Bronstein v. Austin*, No. 07 C 3984, 2008 U.S. Dist. LEXIS 42881, \*14–16 (N.D. Ill. May 30, 2008).

17. *Nisselson v. Lernout*, 568 F. Supp. 2d 137, 149 (D. Mass. July 25, 2008).

18. See e.g., *In re* F5 Networks, Inc., Deriv. Litig., No. C06-794RSL, 2007 U.S. Dist. LEXIS 57464, at \*7 (W.D. Wash. Aug. 6, 2007); *Shoen v. SAC Holding Corp.*, 137 P.3d 1171, 1187 (Nev. 2006).

19. *Shaper v. Bryan*, 371 Ill. App. 3d 1079, 1082 (Ill. App. Ct. 2007).

20. Brief of Defendants-Appellees at 41, *Shaper*, 371 Ill. App. 3d 1079 (No. 1-05-3849).

21. *Shaper*, 371 Ill. App. 3d at 1082. Illinois courts are internally inconsistent on this. See *Sherman v. Ryan*, No. 1-07-2944, 2009 Ill. App. LEXIS 300, at \*39–40, \*15 (Ill. App. Ct. May 20, 2009) (relying in part on the company’s section 102(b)(7) clause for the court’s dismissal for failure to state a claim).

22. *Elloway v. Pate*, 238 S.W.3d 882, 896 (Tex. Ct. App. 2007).

23. See also *Ind. State Dist. Council of Laborers v. Brukardt*, No. M2007-02271-COA-R3-CV, 2009 Tenn. App. LEXIS 269, at \*34 (Tenn. Ct. App. Feb. 19, 2009) (holding that the complaint sufficiently alleged bad faith to avoid exculpatory clause defense in motion to dismiss).

24. See *id.*

25. See *Kensington Int'l Ltd. v. Hiner*, No. 602748/03, 2006 N.Y. Misc. LEXIS 2321, at \*14 (N.Y. Sup. Ct. Aug. 22, 2006).

26. See *Potter v. Arrington*, 810 N.Y.S.2d 312, 317 (N.Y. Sup. Ct. 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.”

27. See *In re* Bear Stearns Litig., No. 600780/08, 2008 N.Y. Misc. LEXIS 7075, at \*2, 17 (N.Y. Sup. Ct. Dec. 4, 2008).

28. See *id.*

29. *Neubauer v. Goldfarb*, 108 Cal. App. 4th 47, 57 (Cal. Ct. App. 2003).

30. *Id.* (interpreting CAL. CORP. CODE § 204(a)(10)).

31. *In re* Walt Disney Co. Deriv. Litig., 906 A.2d at 62, 67; *Lyondell Chem. Co.*, 970 A.2d at 240.