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## The Evisceration of the Duty of Care

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# COMMENTARY

## THE EVISCERATION OF THE DUTY OF CARE

by  
Marc I. Steinberg\*

**T**HIS Commentary examines the phenomena of recent state legislation limiting or eradicating the duty of care. The Commentary also addresses statutory developments affecting indemnification of corporate fiduciaries. Rather than analyzing the particular aspects of the various state statutes, the Commentary focuses on the broad public policy issues.

### I. DIRECTOR-PROTECTION STATUTES—DELAWARE AND BEYOND

When the Delaware Supreme Court held in *Smith v. Van Gorkom*<sup>1</sup> that the defendant directors' conduct failed to come within the business judgment rule,<sup>2</sup> thereby resulting in a violation of the duty of care,<sup>3</sup> few observers

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The author serves as a legal consultant and has been retained as an expert witness on matters relating to breaches of fiduciary duty by corporate directors and other fiduciaries. The views herein are solely those of the author.

The author thanks Jeffrey P. Weiss (J.D., University of Maryland, 1988) for his helpful research.

1. 488 A.2d 858 (Del. 1985).

2. *Id.* at 874. For a discussion of the business judgment rule, see *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979).

3. 488 A.2d at 881. A number of commentators were critical of the decision. See, e.g., Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1455 (1985) ("one of the worst decisions in the history of corporate law"); Herzel & Katz, *Smith v. Van Gorkom: The Business of Judging Business Judgment*, 41 BUS. LAW. 1187, 1188 (1986) ("the court's decision seems misguided"); Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 1 (1985) ("the corporate bar generally views the decision as atrocious"); Herzel, Davis & Colling, "Smith" Brings Whip Down on Directors' Backs, *Legal Times*, May 13, 1985, at 14, col. 1 ("dumbfounding"). Some commentators were supportive of the decision, or at least felt that it did not spell doom for directors. See, e.g., Chittur, *The Corporate Director's Standard of Care: Past, Present, and Future*, 10 DEL. J. CORP. L. 505, 542 (1985) ("in tune with contemporary thinking"); Prickett, *An Explanation of Trans Union to "Henny-Penny" and Her Friends*, 10 DEL. J. CORP. L. 451, 462 (1985) ("the only justifiable result"); Schwartz & Wiles, *Trans Union: Neither "New" Law nor "Bad" Law*, 10 DEL. J. CORP. L. 429, 430 (1985) ("the case merely represents a reiteration of existing Delaware law"); see also Brennan, *New Cases on the Business Judgment Rule: Defend-*

could presage that a "revolution" would occur in the world of corporate fiduciary obligations under state law. Shocked at the Delaware court's "chutzpah" in imposing liability where no self-dealing or other breach of the duty of loyalty existed,<sup>4</sup> corporate fiduciaries and their counsel clamored for action.<sup>5</sup> Delaware, wishing to retain its preeminent position as the state of incorporation for nearly half of the New York Stock Exchange listed companies,<sup>6</sup> was accommodating. Within a few months, Delaware enacted legislation overturning *Van Gorkom*.<sup>7</sup> Today, provided that an appropriate amendment is inserted into the articles of incorporation, directors are not monetarily liable unless they commit a breach of the duty of loyalty, declare an unlawful distribution, receive an improper personal benefit, or act in bad faith.<sup>8</sup> Monetary liability in Delaware for "simple" gross negligence is a relic of the past.<sup>9</sup>

Delaware's evisceration of the duty of care prompted companies incorporated elsewhere to warn state houses that they would opt for Delaware chartering unless those states adopted similar statutes.<sup>10</sup> The state legislators enthusiastically responded, with at least thirty-six such statutes currently in effect.<sup>11</sup>

Most of these statutes resemble Delaware's; they are enabling statutes designed to eliminate monetary liability of directors for breach of the duty of care and to ease a director's task in obtaining indemnification.<sup>12</sup> Several

*ing Defensive Tactics Becomes More Difficult*, 14 SEC. REG. L.J. 245, 249 (1986) (analyzing *Van Gorkom* as "a short step" from prior holdings).

4. 488 A.2d at 873.

5. See Sparks, *Delaware's D&O Liability Law: Other States Should Follow Suit*, Legal Times, Aug. 18, 1986, at 10, col. 1.

6. See Ingersoll, *SEC Backs Tatke & Lyle Court Challenge to Delaware's New Anti-Takeover Law*, Wall St. J., Apr. 29, 1988, at 19, col. 2 ("56% of the Fortune 500 companies and almost half of the companies listed on the New York Stock Exchange are incorporated in [Delaware]").

7. DEL. CODE ANN. tit. 8, §§ 102(b)(7), 145 (1983 & Supp. 1986). For detailed analyses, see Balotti & Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5 (1987); Veasey, Finkelstein & Bigler, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399 (1987).

8. See DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986). The meaning of the term "lack of good faith" is discussed in Balotti & Gentile, *supra* note 7, at 18.

9. Because § 102(b)(7) is solely an enabling provision, directors will enjoy the benefits of the statute only if an applicable provision is contained in the corporation's articles of incorporation, normally by approval of the majority of shares outstanding.

10. See Hanks, *State Legislative Responses to the Director Liability Crisis*, 20 REV. SEC. & COMMODITIES REG. 23, 25 (1987).

11. See Hanks, *Maryland Adopts Director and Officer Liability Statute*, 2 INSIGHTS, No. 3, Mar. 1988, at 29; Hanks, *Update on State Legislative Responses to the Director Liability Crisis*, 21 REV. SEC. & COMMODITIES REG. 23, 24-29 (1988) (and citations contained therein); Radin, *The Director's Duty of Care Three Years After Smith v. Van Gorkom*, 39 HASTINGS L.J. 707, 747-52 (1988) (and citations contained therein).

12. See Radin, *supra* note 11, at 747-48 ("As of the end of 1987, legislation modeled upon the Delaware statute has been enacted in Arizona, Arkansas, California, Colorado, Georgia, Idaho, Iowa, Kansas, Louisiana, Massachusetts, Michigan, Minnesota, Montana, Nevada, New Jersey, New Mexico, New York, North Carolina, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Texas, Utah, Washington, and Wyoming.") (citations omitted). The Texas statute allows shareholders to amend the articles of incorporation to release directors from monetary liability to the corporation or its shareholders for acts or omissions in the

states, however, were not content merely to enact Delaware-type statutes. Seeking to show the corporate community that their forums were conducive to businesses' concerns,<sup>13</sup> these states enacted legislation that clearly "out-Delawared" the kingpin of corporate well-being. For example, pursuant to these statutes, officers as well as directors come under the protective umbrella,<sup>14</sup> certain breaches of the duty of loyalty are not actionable,<sup>15</sup> and liability for breach of the duty of care is eliminated for injunctive as well as for monetary relief.<sup>16</sup> A few of these statutes apply their provisions irrespective of whether a corporation has amended its articles of incorporation.<sup>17</sup>

Recent legislation enacted by Maryland<sup>18</sup> and Virginia<sup>19</sup> illustrate these states seizing the opportunity to out-do their northern neighbor. In addition to containing the usual exculpatory provisions,<sup>20</sup> Virginia's statute, subject to certain exceptions, includes a damages ceiling limited to the greater of \$100,000 or one-year's cash compensation received by the defendant. If approved by shareholders, a lower monetary ceiling may be applied, or even eliminated.<sup>21</sup> Maryland's statute is even more favorable to corporate fiduciaries; absent an improper benefit, directors and officers are monetarily liable only for "active and deliberate dishonesty."<sup>22</sup> In addition to absolving head-in-the-sand conduct, the Maryland statute, similar to certain other statutes,<sup>23</sup> may make derivative litigation profitable only for the lawyers. Historically, in derivative litigation, although reasonable expenses could be

director's capacity as a director, except in cases of: breach of the duty of loyalty, acts not in good faith or involving intentional misconduct or a knowing violation of law, receipt of an improper personal benefit, commission of statutory violations, and acts relating to illegal stock repurchases or dividend payments. See TEX. REV. CIV. STAT. ANN. art. 1302-7.06(B) (Vernon Supp. 1988).

13. See Goolsby & Whitson, *Virginia's New Corporate Code*, 19 REV. SEC. & COMMODITIES REG. 147 (1986).

14. E.g., LA. REV. STAT. ANN. § 12:24(C)(4) (West Supp. 1988); MD. CORPS. & ASS'NS CODE ANN. §§ 2-405.2, 2-418 (Supp. 1988); NEV. REV. STAT. § 78.037(1) (1987); N.J. STAT. ANN. § 14A:2-73 (West Supp. 1988); VA. CODE ANN. § 13.1-692.1(A)(1) (Supp. 1988).

15. E.g., NEV. REV. STAT. § 78.037 (1987). Few states have this type of provision.

16. E.g., OHIO REV. CODE ANN. § 1701.59(D) (Anderson Supp. 1987) (also raises the standard of proof to that of clear and convincing evidence).

17. See FL. STAT. ANN. § 607.1645 (West Supp. 1988); IND. CODE ANN. § 23-1-35-1(e) (Burns Supp. 1988); OHIO REV. CODE ANN. § 1701.59(D) (Anderson Supp. 1987); VA. CODE ANN. §§ 13.1-690 (A), (C) (1985); WIS. STAT. ANN. § 180.307(1) (West Supp. 1987).

18. MD. CORPS. & ASS'NS CODE ANN. §§ 2-405.2, 2-418 (Supp. 1988).

19. VA. CODE ANN. §§ 13.1-690 (A), (C), 13.1-692.1(A)-(C) (1985 & Supp. 1988). For analyses of Virginia law, see Goolsby & Whitson, *supra* note 13; Honabach, *All That Glitters: A Critique of the Revised Virginia Stock Corporation Act*, 12 J. CORP. L. 433 (1987); King, *Director Protection Under Virginia Law*, 20 REV. SEC. & COMMODITIES REG. 129 (1987).

20. See VA. CODE ANN. § 13.1-690 (A), (C) (1985).

21. *Id.* § 13.1-692.1(A), (B) (Supp. 1988); see Radin, *supra* note 11, at 752. The Virginia statute contains certain exceptions. Liability may not be limited for willful misconduct or knowing violations of criminal or securities laws. See VA. CODE ANN. § 13.1-692.1(B) (Supp. 1988). Also, amendments may not function retroactively to relieve liability for acts committed prior to the adoption of the amendment. *Id.* § 13.1-692.1(C).

22. MD. CORPS. & ASS'NS CODE ANN. § 2-405.2 (Supp. 1988).

23. E.g., FLA. STAT. ANN. § 607.014(2) (West Supp. 1988); IND. CODE ANN. § 23-1-37-8(a) (Burns Supp. 1988); LA. REV. STAT. ANN. § 12:83(A)(2) (West Supp. 1988); MICH. COMP. LAWS ANN. § 450.1562 (West Supp. 1988); N.Y. BUS. CORP. LAW § 722(c) (McKinney Supp. 1988); WIS. STAT. ANN. § 180.044(2)(a) (West Supp. 1987); WYO. STAT. § 17-1-105.1(a) (1987).

reimbursed, amounts paid by defendant fiduciaries in settlement could not be indemnified. Such a position is necessary to avoid the circularity of recovery that would otherwise result.<sup>24</sup> Under the Maryland statute, however, unless it is proven that the defendant fiduciary acted in bad faith, engaged in active and deliberate dishonesty, or received an improper personal benefit, then the fiduciary may be indemnified if certain conditions are met.<sup>25</sup>

## II. POLICY MERITS (OR DEMERITS) OF DIRECTOR-PROTECTION STATUTES

Do these statutes make bad policy? Given the asserted insurance crisis and the reaction to the *Van Gorkom* decision, one can argue that the Delaware statute was a balanced response to the problem. After *Van Gorkom*, outside directors, it was alleged, were reluctant to serve on corporate boards.<sup>26</sup> Given Delaware's financial dependence on franchise revenues and that state's concern with maintaining its preeminent status,<sup>27</sup> action was deemed necessary. Delaware reacted, particularly when viewed by hindsight, with moderation. The duty of care remains good law in Delaware in suits for injunctive relief. For actions not implicating the duty of loyalty that seek monetary damages, the culpability standard is lack of good faith, provided that a charter provision is adopted. Hence, actions for breach of fiduciary duty, even in the absence of self-dealing, still may be viable in Delaware.

On the other hand, it may be asserted that *Van Gorkom* was correctly decided. Directors considering a mega-million dollar merger transaction, who meet only for two hours and principally rely on a twenty-minute oral presentation by the chief executive officer, are not reasonably informed and act with gross negligence, if not with recklessness.<sup>28</sup> Shareholders ought to be entitled to demand greater scrutiny on the part of their elected fiduciaries. Certainly, accountants, attorneys, physicians, and other professionals are liable for mere negligence.<sup>29</sup> Because corporations are engaged in risk-taking

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24. See REVISED MODEL BUSINESS CORP. ACT § 8.51(e) (1984). Comment 5 to § 8.51, which concerns subsection (e), provides:

This subsection limits indemnification in suits brought by or in the right of the corporation to expenses incurred in connection with the proceeding. Its purpose is to avoid circularity that would be involved if a corporation seeks to indemnify a director for payments made in settlement by the director to the corporation.

*Id.*; see also Hansell, Austin & Wilcox, *Director Liability Under Iowa Law—Duties and Protections*, 13 J. CORP. L. 369, 402 (1988) (explaining Iowa provisions preventing circularity).

25. See MD. CORPS. & ASS'NS CODE ANN. § 2-418 (Supp. 1988).

26. See Baum, *The Job Nobody Wants*, BUS. WK., Sept. 8, 1986, at 56, 56-58; Block, Barton & Garfield, *Advising Directors on the D&O Insurance Crisis*, 14 SEC. REG. L.J. 130, 131-32 (1986); *Director Roundtable: The D&O Crisis and Board Liability*, DIRECTORS & BOARDS, Summer 1986, at 8, 9-10.

27. See Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 697-98 (1974); Ferrara & Steinberg, *A Reappraisal of Santa Fe: Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263, 267-72 (1980); Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORGANIZATIONS 225, 240 (1985) (revenues of corporate chartering constitute almost 17% of Delaware's revenues).

28. See Chittur, Prickett, and Schwartz & Wiles, *supra* note 3.

29. See, e.g., *Savings Bank v. Ward*, 100 U.S. 195, 198 (1879) (attorney negligence); Ban-

ventures, corporate fiduciaries arguably should be provided with greater protection.<sup>30</sup> The business judgment rule meets this objective, insulating fiduciaries from liability provided their decisions are reasonably informed, made in good faith without a disabling conflict of interest, and have a rational basis.<sup>31</sup> Although the business judgment rule does not prevent "Monday morning quarterbacking" based on the benefit of hindsight, this problem is by no means unique to corporate fiduciaries. It is a characteristic common to makers of difficult decisions, whether they be doctors, lawyers, or football coaches.

To justify greater protection provided to corporate fiduciaries beyond that of the business judgement rule, cogent reasons should prevail. The purported insurance crisis is the key rationale provided.<sup>32</sup> But lawyers and doctors as well as other professionals are also confronted with this crisis;<sup>33</sup> however, they must act with due care.<sup>34</sup> It may be asserted that the difference is that, absent the availability of adequate insurance and indemnification, outside directors would refuse to serve on corporate boards.<sup>35</sup> The adverse consequence would be the loss of competent overseers who effectively monitor corporate managers, thereby causing a fundamental breakdown in the corporate accountability structure.<sup>36</sup> Presuming that this assertion is meritorious, corrective legislative action is needed only for outside directors, in other words, for those persons who do not otherwise have an employment relationship with the company.<sup>37</sup> Yet, the Delaware statute provides insulation for inside directors as well, giving as its justifica-

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croft v. Indemnity Ins. Co. of N. Am., 203 F. Supp. 49, 53 (W.D. La.) (accountant negligence), *aff'd*, 309 F.2d 959 (5th Cir. 1962); *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441, 444 (1931) (Cardozo, C.J.) (accountants have duty to use the "care and caution proper to their calling"); 3 T. COOLEY, A TREATISE ON THE LAW OF TORTS OR THE WRONGS WHICH ARISE INDEPENDENTLY OF CONTRACT § 473 (4th ed. 1932) (discussing duty of the learned professions); 3 F. HARPER, F. JAMES & O. GRAY, THE LAW OF TORTS § 16.6 (2d ed. 1986).

30. See *Auerbach v. Bennett*, 47 N.Y.2d 619, 629, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926-27 (1979).

31. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(d) (Tent. Draft No. 3, 1984); M. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 14.02 (1988); Wander & LeCoque, *Boardroom Jitters: Corporate Control Transactions and Today's Business Judgment Rule*, 42 BUS. LAW. 29, 29-30 (1986).

32. See Herzog, Shepro & Katz, *Next-to-Last Word on Endangered Directors*, HARV. BUS. REV., Jan.-Feb. 1987, at 38, 38; Mallen & Evans, *Surviving the Directors' and Officers' Liability Crisis: Insurance and the Alternatives*, 12 DEL. J. CORP. L. 439, 459-64 (1987); authorities cited *supra* notes 7, 26. But see Waldman & Garcia, *Four Big Insurers Charged with Scheme to Limit Commercial Liability Coverage*, WALL ST. J., Mar. 23, 1988, at 2, col. 2 ("Seven state attorneys general . . . charged four of the nation's largest insurers with conspiring to manipulate the availability and cost of commercial liability coverage.").

33. See sources cited *supra* note 32.

34. See authorities cited *supra* note 29.

35. See authorities cited *supra* note 26.

36. See Brudney, *The Role of the Board of Directors: The ALI and Its Critics*, 37 U. MIAMI L. REV. 223, 234-36 (1983); The Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2107-08 (1978); Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1625-27 (1978).

37. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.17 comment (g), at 264 (Tent. Draft No. 8, 1988) [hereinafter Draft No. 8].

tion policy reasons that in large measure apply only to outside directors.<sup>38</sup>

Although the Delaware statute may be imperfect, it is a source of reason compared to the statutes of several other states. Although a broad survey of the various statutes is beyond this Commentary's focus, a few examples suffice to confirm this point. One such example is that a number of states extend the parameters of their statutes to encompass corporate officers.<sup>39</sup> These provisions exacerbate the deficiencies of the Delaware legislation. Indeed, no convincing evidence exists suggesting that the insurance crisis has chilled the willingness of senior executives to embrace the benefits of their corporate status.<sup>40</sup> An even more troubling provision contained in some statutes eliminates corporate fiduciary liability, absent self-dealing or certain other exceptions, unless the fiduciary acts with deliberate dishonesty.<sup>41</sup> A fairly recent case, *Francis v. United Jersey Bank*,<sup>42</sup> illustrates the delinquent misconduct that these statutes now permit to go monetarily unpunished. In that case, the defendant director, Pritchard, was inactive in the business and remained ignorant of the corporation's affairs. During that time, her sons mulcted the corporation by withdrawing sums that greatly exceeded profits. In holding Pritchard liable for breach of the duty of care, the New Jersey Supreme Court opined: "Her sons knew that she, the only other director, was not reviewing their conduct; they spawned their fraud in the backwater of her neglect."<sup>43</sup> Irrespective of such neglect, this misconduct is unlikely to be actionable in states adopting the deliberate dishonesty standard.<sup>44</sup> This

38. See Delaware Senate Bill No. 533, L. 1986, *amending*, DEL. CODE ANN. tit. 8, §§ 102, 145 (Supp. 1986):

Section 102(b)(7) and the amendments to Section 145 represent a legislative response to recent changes in the market for directors' liability insurance. Such insurance has become a relatively standard condition of employment for directors. Recent changes in that market, including the unavailability of the traditional policies (and, in many cases, the unavailability of any type of policy from the traditional insurance carriers) have threatened the quality and stability of the governance of Delaware corporations because directors have become unwilling, in many instances, to serve without the protection which such insurance provides and, in other instances, may be deterred by the unavailability of insurance from making entrepreneurial decisions. The amendments are intended to allow Delaware corporations to provide substitute protection, in various forms, to their directors and to limit director liability under certain circumstances.

39. See statutes cited *supra* note 14.

40. See Draft No. 8, *supra* note 37, at 264.

41. *E.g.*, FLA. STAT. ANN. § 607.1645(1) (West 1988); MD. CORPS. & ASS'NS CODE ANN. § 2-405.2 (Supp. 1988); WIS. STAT. ANN. § 180.307(1) (West Supp. 1987).

42. 87 N.J. 15, 432 A.2d 814 (1981).

43. *Id.* at 44, 432 A.2d at 829; see R. CLARK, CORPORATE LAW § 3.4.1, at 125 n.8 (1986): From a planning perspective, the opinion in *Francis* offers useful guidelines as to what every director should do:

(1) get a rudimentary understanding of the business; (2) keep informed about the corporation's activities; (3) engage in "a general monitoring of corporate affairs and activities"; (4) attend board meetings regularly; (5) review financial statements regularly; and (6) make inquiries into doubtful matters, raise objections to apparently illegal actions, and consult counsel and/or resign if corrections are not made.

44. One can argue that fiduciaries who intentionally ignore their obligations can be held liable under the deliberate dishonesty standard. The success of such an assertion seems, at best, uncertain.

development encourages an ostrich approach to the undertaking of a fiduciary's obligations. If it were not for the liability provisions of the federal securities laws,<sup>45</sup> these state statutes would have an even greater detrimental effect in causing the emasculation of a responsible corporate accountability framework.

The indemnification provisions adopted by a number of states serve as a final example. Under these "post-*Van Gorkom*" director-protection statutes, indemnification of fiduciaries is authorized not only for reasonable expenses incurred, but also for amounts paid in settlement of derivative actions so long as certain specified conditions are met.<sup>46</sup> These statutes expand the coverage of indemnification, which traditionally has not applied to sums paid to settle a derivative suit.<sup>47</sup> Under the director-protection statutes, the circularity of derivative actions is evident. The corporation receives the amount in settlement from the defendant fiduciaries who are thereupon entitled to indemnification from the corporation to whatever extent insurance does not cover the loss. In this regard, it is possible that the exclusions in director and officer insurance policies for self-dealing and deliberate misconduct may induce an insurer not to pay a claim in which a matter has been settled and to which the fiduciary is entitled to indemnification.<sup>48</sup> Moreover, because these suits are rarely litigated to an adjudication,<sup>49</sup> the attorneys on all sides are the only clear winners in a settlement; they receive their reasonable fees. Hence, under these statutes, it is evident that the real party in interest is no longer the corporation; rather, the attorneys are the real parties to benefit.<sup>50</sup>

One may argue that in view of inadequate insurance coverage these state indemnification statutes are necessary to induce outside directors to serve on corporate boards. Even if this were true, as it may well be,<sup>51</sup> such reasoning does not justify the inclusion of inside directors and officers within the protective cloak of these statutes.<sup>52</sup> Rather, when coupled with the procedural obstacles that a derivative plaintiff must hurdle, particularly the demand on director requirement,<sup>53</sup> these statutes convey a hostility by many legislatures

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45. See Securities Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1982). See generally Steinberg, *The Propriety and Scope of Cumulative Remedies Under the Federal Securities Laws*, 67 CORNELL L. REV. 557 (1982).

46. See statutes cited *supra* note 23.

47. See authorities cited *supra* note 24.

48. See Draft No. 8, *supra* note 37, § 7.30 comment (i), at 317-18.

49. See Jones, *An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-1978*, 60 B.U.L. REV. 306, 312-13 (1980).

50. See Draft No. 8, *supra* note 37, ch. 1 introductory note, at 7-15; *id.* § 7.13 comment (e), at 206 (describing plaintiff's counsel as "often the real party in interest").

51. See authorities cited *supra* notes 19, 32; see also Draft No. 8, *supra* note 37, § 7.17 reporter's note at 272 ("In recent years, the fear of liability appears to have resulted in several instances where outside directors have resigned from the board when liability insurance could not be renewed.").

52. See Draft No. 8, *supra* note 37, § 7.17 comment (g), at 264.

53. See *Aronson v. Lewis*, 473 A.2d 805, 818 (Del. 1984). See generally Buxbaum, *Conflicts-of-Interests Statutes and the Need for a Demand on Directors in Derivative Actions*, 68 CALIF. L. REV. 1122 (1980) (explaining reasons for demand requirement).



and courts to this type of litigation.<sup>54</sup> Perhaps the more straightforward manner of accommodating this perspective is to forbid the initiation of derivative actions for breach of fiduciary duty unless the alleged monetary loss amounts to a specified dollar total or percentage of the corporation's net assets, revenues, or profits. Although this route certainly would decrease the number of derivative suits filed, the federal securities law disclosure mandates would still provide a basis for bringing a number of such claims.<sup>55</sup>

In this respect, however, many of the state indemnification statutes apply irrespective of whether a derivative claim is premised on a violation of federal or state law.<sup>56</sup> A forceful argument can be made that these statutes, and provisions contained in corporate charters through the authority granted by such statutes, effectuate a waiver of a complainant's rights and remedies under the federal securities laws, and are therefore void with respect to such federal claims.<sup>57</sup> As section 14 of the Securities Act of 1933<sup>58</sup> and section 29(a) of the Securities Exchange Act of 1934<sup>59</sup> provide, statutory and regulatory provisions under these Acts cannot be waived, voluntarily or otherwise.<sup>60</sup> The indemnification of corporate fiduciaries for amounts paid in settling derivative suits based on alleged federal securities law violations may be construed as invalidating a claimant's rights and remedies. Although the litigant's right to bring suit and procure a remedy remains technically intact, indemnification in this context has the substantive effect of rendering these federal rights a nullity.<sup>61</sup>

Even if the foregoing argument is not ultimately adopted by the courts, the failure to disclose the ramifications of indemnification to shareholders in a notice of settlement should be deemed a material disclosure deficiency under the federal securities laws. A reasonable shareholder certainly would want to know that, if settled, the derivative suit would not benefit the corporation due to the granting of indemnification to the defendant fiduciaries.<sup>62</sup>

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54. See *Lewis v. Curtis*, 671 F.2d 779, 789 (3d Cir. 1982) (reversing district court's dismissal of action and remanding matter to a different judge).

55. This statement assumes that the plaintiff can meet the standing, causation, reliance, culpability, and other requirements necessary in order to have a successful cause of action. See A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD AND COMMODITIES FRAUD* § 4-7 (1986); L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 144-64 (2d ed. 1988); M. STEINBERG, *SECURITIES REGULATION* 411-581 (1986).

56. *E.g.*, MD. CORPS. & ASS'NS CODE ANN. § 2-418 (Supp. 1988).

57. See Securities Act § 14, 15 U.S.C. § 77n (1982); Securities Exchange Act § 29(a), 15 U.S.C. § 78cc(a) (1982). For a discussion of the anti-waiver aspects of federal securities laws, see Gruenbaum, *Avoiding the Protections of the Federal Securities Laws: The Anti-Waiver Provisions*, 20 SANTA CLARA L. REV. 49 (1980).

58. 15 U.S.C. § 77n (1982).

59. *Id.* § 78cc(a).

60. See generally *Shearson/American Express, Inc. v. McMahon*, 107 S. Ct. 2332, 2339, 96 L.Ed.2d 185, 196 (1987) ("if a stipulation waives compliance with a statutory duty, it is void . . . whether voluntary or not").

61. Note, moreover, that the Securities and Exchange Commission takes the position that indemnification of directors and officers in regard to liabilities arising under the federal securities laws is against public policy and, therefore, unenforceable. See Regulation S-K item 510, 17 C.F.R. § 229.510 (1988); see also *Globus v. Law Res. Serv. Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969), (concur with SEC position) *cert. denied*, 397 U.S. 913 (1970).

62. *Cf.* Draft No. 8, *supra* note 37, § 7.13(b), at 198 (in evaluating a proposed settlement,

Such nondisclosure should provide grounds to the bringing of an SEC enforcement action,<sup>63</sup> as well as private actions, provided that standing and other requirements are met.<sup>64</sup>

As a final point, it may be asserted that the vast majority of these statutes are enabling in nature<sup>65</sup> and, therefore, are fully in accord with principles of corporate accountability. The shareholders' contractual relationship with the corporation normally is altered in this context only after a majority of shares outstanding, being adequately informed of the advantages and detriments of such modification, vote to amend the articles of incorporation.<sup>66</sup> Although this argument has certain appeal, its validity rings hollow in light of the realities of the corporate governance process. Meaningful shareholder consent in this context is an illusion given management's control of the proxy machinery process,<sup>67</sup> the strong inclination of institutional investors to vote with management,<sup>68</sup> and the typical individual stockholder's ignorance of corporate charter provisions.<sup>69</sup> Indeed, because these charter amendments have the effect of frustrating a shareholder's legitimate expectations, they may be characterized as contracts of adhesion and, therefore, void.<sup>70</sup> The leverage exerted by management, in any event, should call for the continued validity of these charter provisions to be subject to periodic ratification by the shareholders. For example, shareholder approval should be required every third year after such an amendment's initial passage.<sup>71</sup>

### III. THE ROAD TO WHERE?

Although a number of statutes have been enacted with more lax provisions than those contained in the Delaware legislation,<sup>72</sup> their impact may be relatively insignificant unless Delaware amends its statute in response to these developments. Because the Delaware statute applies only to directors, permits the imposition of monetary liability for director self-dealing as well as for actions not taken in good faith, and prohibits circularity of recovery in settlements of derivative actions,<sup>73</sup> insiders of companies chartered in Delaware remain subject to significant fiduciary obligations. Post-*Van Gorkom*

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the court should, inter alia, consider "any diminution of the recovery that will result from attorneys' fees or indemnification payments to be made by the corporation"). For the standard of materiality under the federal securities laws, see *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

63. See M. STEINBERG & R. FERRARA, *SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT* §§ 2.16, 2.22 (1985 & Supp. 1988).

64. See *supra* note 55.

65. See *supra* notes 9, 12 and accompanying text.

66. See REVISED MODEL BUSINESS CORP. ACT § 10.03 (1984).

67. See Draft No. 8, *supra* note 37, § 7.17 comment (e), at 255.

68. See W. KLEIN & J. COFFEE, *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 119 (2d ed. 1986).

69. See Gelb, *Director Due Care Liability: An Assessment of the New Statutes*, 61 *TEMPLE L. REV.* 13, 30 (1988).

70. See Draft No. 8, *supra* note 37, § 7.17 comment (e), at 255-56.

71. See *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 7.17(c)(1), at 41-43 (Tent. Draft No. 7, 1987).

72. See *supra* notes 39-50 and accompanying text.

73. See *DEL. CODE ANN.* tit. 8, §§ 102(b)(7), 145 (1983 & Supp. 1986).

director-protection statutes enacted in the majority of states are modeled upon the Delaware legislation.<sup>74</sup> If Delaware declines to react to the more extreme statutes,<sup>75</sup> other states may follow Delaware's lead.

An eradication of fiduciary duties and perhaps derivative suits would likely occur, however, if Delaware elects to amend its statute in order to incorporate the more lax provisions enacted by some states. Such a course of conduct would have disastrous consequences for shareholders, largely leaving them without effective redress under state law except in the most egregious cases of dishonesty and self-dealing. Such legislative action also may not ultimately be in the best interests of the respective states. Although cries for federal fiduciary duty of care and loyalty statutes<sup>76</sup> generally have fallen on deaf ears,<sup>77</sup> the onset of major scandals in which shareholders are left penniless while corporate fiduciaries retain the riches could prompt Congress to act. Although Congress often has been loathe to legislate internal corporate affairs, it has shown a willingness to do so in reaction to national catastrophes.<sup>78</sup> One fairly recent example is the 1977 enactment of the Foreign Corrupt Practices Act<sup>79</sup> in response to domestic slush fund and foreign bribery practices carried on by several hundred American corporations.<sup>80</sup> By mandating, *inter alia*, that publicly held corporations maintain reasonable accurate books and records and internal accounting controls,<sup>81</sup> the Act directly impacts upon internal accountability mechanisms.<sup>82</sup>

Thus, solely state governance of corporate internal affairs is not sacrosanct. The federal government has acted in the past and, if deemed necessary, may do so again. State statutes that decline to recognize legitimate shareholder expectations in order to accommodate locally situated managements of companies are short-sighted. Delaware and other major players in the state-chartering field should not be tempted. In this country's regulation of publicly held entities, we have achieved a delicate balancing of federal and state interests while, at the same time, maintaining the investor confidence so vital to capital formation and growth. Any significant alteration possibly affecting this balance should be implemented only after careful evaluation that calls for the undertaking of such action. The statute that Delaware has enacted, and that a majority of states have basically adopted, stretches this

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74. See *supra* note 12.

75. See *supra* notes 39-50 and accompanying text.

76. See, e.g., Cary, *supra* note 27, at 701-03.

77. A description of the unsuccessful efforts exerted for federal legislation in this area is contained in Ferrara & Steinberg, *supra* note 27, at 269-72.

78. Of course, Congress's passage in the midst of the Great Depression of the Securities Act of 1933 and the Securities Exchange Act of 1934 serve as the key examples.

79. Pub. L. No. 95-213, tit. I, 91 Stat. 1494 (1977).

80. See REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES, SUBMITTED TO THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 94TH CONG., 2D SESS. (Comm. Print 1976).

81. See Securities Exchange Act § 13(b)(2), 15 U.S.C. § 78m(b)(2) (1982).

82. See M. STEINBERG, CORPORATE INTERNAL AFFAIRS—A CORPORATE AND SECURITIES LAW PERSPECTIVE 59 (1983) ("the FCPA remains an important illustration of how Commission efforts geared toward effective corporate disclosure can have a direct impact on corporate internal affairs").

balance as far as can be legitimately justified. The evisceration of the duty of care is a drastic step in the corporate governance framework. Any further erosion makes a mockery of state law principles of fiduciary duty. Such expansionist state legislation also may portend the development that states and corporate fiduciaries fear—the adoption of federal legislation.

