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Elimination of the Duty of Care In Delaware? Statutory Exculpation of Officers: Recent Amendment to Section 102(B)(7) of the Delaware General Corporation Law

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Introduction

Effective as of August 1, 2022, the Delaware legislature adopted an amendment to Section 102(b)(7) of the Delaware General Corporation Law ("DGCL") that permits a Delaware corporation to implement a provision in its certificate of incorporation to eliminate or limit the personal liability of certain officers of the corporation for monetary damages to the corporation or its stockholders for the breach of the fiduciary duty of care (an "exculpation provision").[1] Prior to such amendment and since 1986, Section 102(b)(7) of the DGCL was only available to exculpate directors of a corporation from personal liability for the breach of the fiduciary duty of care, but remained unavailable to corporate officers.[2] The Delaware General Assembly originally enacted Section 102(b)(7) to address a perceived crisis in the market for directors' and officers' liability insurance.[3][4] This article will address (1) key considerations concerning newly amended Section 102(b)(7), including, among other things, the limitations placed on exculpation, the types of claims subject to exculpation, the remedies that remain available with respect to exculpatory claims, the types of corporate officers to which exculpation may apply, and temporal requirements concerning the effectiveness of an exculpation provision in a corporation's certificate of incorporation, and (2) a model exculpation provision, including a discussion of its common features and the various terms and conditions to consider when drafting such a provision.

Key Considerations Concerning Newly Amended Section 102(B)(7)

A Delaware corporation itself does not owe fiduciary duties to its stockholders and cannot be sued by its stockholders for breach.[5] Fiduciary duties are owed by the directors and officers to the corporation and its stockholders, and, therefore, they are personally liable for any such breach.[6] Section 102(b)(7) of the DGCL allows a Delaware corporation to include an exculpatory provision in its certificate of incorporation that eliminates or limits the personal liability of an officer to the corporation or its stockholders for monetary damages for a breach of fiduciary duty, subject to the following conditions and limitations:

1. Only Applicable to the Fiduciary Duty of Care. Officers of Delaware corporations owe a fiduciary duty of care, and such duty is the same as that owed by directors of a Delaware corporation.[7] If officers' actions qualify for the presumptions of the business judgment rule, the standard for a finding of a breach of the duty of care is gross negligence.[8] Therefore, Delaware courts have held that, in essence, Section 102(b)(7) (given the other limitations on exculpation set forth in subsections (i), (ii) and, (iv) of Section 102(b)(7) discussed below), permits a corporation to protect its officers for duty of care violations only, that is, liability for gross negligence.[9]

2. Not Applicable to the Fiduciary Duty of Loyalty (including Bad Faith Conduct and Obtaining an Improper Personal Benefit). Section 102(b)(7)(i) provides that exculpation provisions may not apply to "[an] officer for any breach of . . . the duty of loyalty." Generally speaking, the duty of loyalty requires officers to act in good faith for the benefit of the corporation and its stockholders, not for their own personal gain.[10] Further, the duty of loyalty requires officers to refrain from engaging in conduct that could harm the corporation and its stockholders, so that the duty may be applicable to conduct that involves a conflict of interest or involves bad faith on the part of an officer.[11] For that reason (and in support and augmentation of the exclusion of duty of loyalty claims from exculpation pursuant to subsection (i) of Section 102(b)(7)), subsections (ii) and (iv) of Section 102(b)(7) also prohibit exculpation provisions from applying to "[an] officer for acts or omissions not in good faith" and to "[an] officer for any

transaction from which . . . the officer derived an improper personal benefit," respectively.[12] Thus, officers may still be found personally liable for monetary damages for breach of the fiduciary duty of loyalty.

3. Not Applicable to Intentional Misconduct or Knowing Violation of Law. Section 102(b)(7)(ii) provides that exculpation provisions may not eliminate or limit the liability of "[an] officer for acts or omissions . . . which involve intentional misconduct or knowing violation of law." These categories of exemptions attempt to distinguish between wrongful conduct that involves officer "intent" and conduct that is the result of an officer's lack of due care.

4. Only Eliminates or Limits Monetary Damages (not Equitable Relief or Related Claims). The plain language of Section 102(b)(7) makes it clear that the statute applies to the elimination of an officer's *monetary* liability only,[13] and does not exculpate the underlying breach of the fiduciary duty. Therefore, under Delaware law, officers continue to be subject to the fiduciary duty of care and an officer's conduct is still subject to equitable remedies, including rescissory and injunctive relief.[14] As a practical matter, however, the unavailability of monetary damages against officers may effectively eliminate any real remedy when a stockholder has no knowledge of the corporate action of the officers until after such action is taken (subject to any derivative claims that remain available, as discussed in item 7 below). Further, because the breach of the duty of care is not eliminated notwithstanding an exculpation provision, a third-party advisor, such as an attorney, accountant or financial expert, can also be held liable for aiding and abetting an officer's breach of the fiduciary duty of care (even if such officer is exculpated pursuant to Section 102(b)(7)).[15]

5. Only Applies to Certain Corporate Officers. Section 102(b)(7) provides that the term officer "shall mean only a person at the time of an act or omission as to which liability is asserted is deemed to have consented to service of process . . . pursuant to §3114(b) of Title 10 [of the Delaware Code Annotated]." In practice, this means that the officer must have been (at the time of the act or omission) a president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer, or chief accounting officer of the corporation, or is or was identified in the corporation's public filings with the SEC as a "highly compensated executive officer" of the corporation, or is a person who has consented in writing to be identified as an officer for purposes of accepting service of process. All other officers, employees, or agents of a Delaware corporation are not entitled to the protection of an exculpation provision adopted pursuant to Section 102(b)(7).

6. Not Self-Executing - Considerations When Adopting (including Rationale for Adoption and Proxy Advisory Firm Positions). Section 102(b)(7) of the DGCL is an enabling provision only, and it is not self-executing. In order for a Delaware corporation to provide for the limitation of liability authorized by Section 102(b)(7), corporate action must be taken to affirmatively adopt an exculpation provision in its certificate of incorporation or an amendment thereto.[16] When a corporation is being formed or if it is going public via an initial public offering, a de-SPAC business combination, a spin-off, or similar transaction, the organizer can consider including an exculpation provision in the initial (or, in the case of an IPO, a de-SPAC business combination, a spin-off, or similar transaction, the new/surviving public corporation's) certificate of incorporation that includes both directors and officers. If a Delaware corporation is already in existence and is not going public, then it should consider amending its certificate of incorporation to expressly include officers (if there is already a director exculpation provision in effect), which may require both board and stockholder approval depending upon its organizational and governance documents. If the corporation is public, this may also involve a board-sponsored proposal in the proxy statement to be filed with the SEC, which would subsequently be approved by the stockholders. After obtaining approval of any certificate of incorporation or certificate of amendment containing an exculpation provision, such charter or charter amendment must be filed with the Delaware secretary of state's office in order for the exculpation provision to become effective.

Given that board and stockholder approval will likely be required for both private and public companies, including companies anticipating going public, to adopt or extend the protections of an exculpation provision to officers of a Delaware corporation, the board seeking this adoption or extension would want to present to the stockholders the rationale behind such action, and why it is in the best interests of the corporation to make such changes. The board would also need to address any potential objections thereto.

Boards may want to emphasize that the amendment to Section 102(b)(7) of the DGCL partially remedies the inconsistent treatment of directors and officers, both of whom have fiduciary duty obligations. Additionally, the desire to recruit and retain the talent of a corporation and the protection from personal financial liability due to claims against officers would further support the board's proposal to adopt such a provision in the certificate of a corporation or amend it to reflect the same. While it is unclear whether D&O insurance carriers will give companies any credit on their premiums for including such a provision, it is expected that the adoption of the officer exculpation provision would help temper insurance premiums, which can be expensive and, therefore, might not be available to all companies. However, some stockholders may deem it unnecessary to extend exculpation protections to officers. Others may claim that officer exculpation could lead to careless behavior at the officer level, which would hinder the development of a company's ESG risk management and oversight.

Existing public companies would also want to consider how proxy advisory firms, such as Institutional Shareholders Services ("ISS") and Glass, Lewis & Co., LLC ("Glass Lewis"), view the change. At the time

of this writing, neither has published a position on this topic. However, based on the 2022 U.S. Proxy Voting Guidelines published by ISS, where the general voting guideline is to vote proposals on officer indemnification and liability protection on a case-by-case basis, ISS recommends voting against proposals that would "[e]liminate entirely directors' and officers' liability for monetary damages for violating the duty of care."[17] In light of that, if ISS updates its 2023 proxy voting guidelines to reflect the officer exculpation, we may see ISS either oppose officer exculpation and recommend "against" a related proposal to include such a provision or adopt an unfavorable policy with respect to the same. However, given that Section 102(b)(7)(v) prohibits exculpation provisions from eliminating personal liability of an officer for the breach of the duty of care if a litigation claim is derivative (see the discussion in Item 7 below), then ISS may not voice its opposition. The 2022 U.S. Proxy Voting Policy Guidelines published by Glass Lewis takes a relatively mild position on this matter. Although it "strongly believes that directors and officers should be held to the highest standard when carrying out their duties to shareholders, some protection from liability is reasonable to protect them against certain suits so that these officers feel comfortable taking measured risks that may benefit shareholders" and therefore "find[s] it appropriate for a company to provide indemnification and/or enroll in liability insurance to cover its directors and officers so long as the terms of such agreements are reasonable."[18] Still, we would not be able to tell how Glass Lewis would weigh in on this topic. In any case, if the proxy advisory firms support the proposals to extend the protections of an exculpation provision to officers of a Delaware corporation, we would expect most public companies will pursue the charter amendments in their next stockholder meeting (not necessarily in the upcoming proxy season) and typically in their next annual general meeting of stockholders. In addition to proxy advisory firms, the board would also want to assess the view of large institutional investors.

7. Only Applies to Direct Claims (Including Class Actions) and not to Derivative Claims Against Officers. Subsection (v) of Section 102(b)(7) provides that exculpation is not available to "[a]n officer in any action by or in the right of the corporation," i.e., a derivative claim. This is a litigation claim brought by a stockholder on behalf of the corporation against its directors or officers typically alleging breach of fiduciary duty, fraud, or mismanagement. Generally, harm to the corporation or to all stockholders pro rata in proportion with their ownership gives rise to a derivative claim, while harm to the stockholders independent of any harm to the corporation gives rise to a direct claim.[19] Unlike directors who may be exculpated for derivative claims under Section 102(b)(7), subsection (v) makes this protection unavailable to corporate officers. However, any damages from a successful derivative claim accrue to the corporation rather than to the stockholders, so it is less attractive to stockholder plaintiffs than direct claims.[20]

8. Exculpation of Claims May Not Be Retroactive. Exculpation provisions under Section 102(b)(7) are only available to corporate officers as of August 1, 2022. Further, Section 102(b)(7) provides that "no [exculpatory provision] shall eliminate or limit liability of . . . [an] officer for any act or omission occurring prior to the date when such provision becomes effective", i.e., when the certificate of incorporation or charter amendment is approved by the stockholders and then filed and accepted by the Delaware secretary of state. Therefore, any amendment will have a prospective effect only and shall not affect acts or omissions occurring prior to the effectiveness of the exculpatory provision. However, and as also discussed in the next section below, exculpatory provisions may also be drafted in such a way so that any amendment or repeal of an effective exculpation provision in a corporation's certificate of incorporation by subsequent stockholder or legislative action shall not affect exculpation of personal liability of an officer for any acts or omissions occurring prior to the date of such amendment or repeal. In this way, corporations cannot retroactively weaken or eliminate protection for officers for otherwise exculpatory claims that already occurred.

9. Not Applicable to Other Laws. A Section 102(b)(7) exculpation provision cannot limit or eliminate liability if an officer is liable for an infraction of a federal law. This limitation would include damages under, without limitation, the federal securities laws, the antitrust laws, or the Racketeer Influenced and Corrupt Practices Act.

Common Features of an Exculpation Provision

Set forth below is an example of a standard exculpation provision that may be included in the certificate of incorporation of a Delaware corporation:

"**Limitation of Liability. [**To the fullest extent permitted by the Delaware General Corporation Law, as it presently exists or may hereafter be amended (the "DGCL")], a director or officer of the Corporation shall not be personally liable to the Corporation or to its stockholders for monetary damages for any breach of fiduciary duty as a director or officer [except to the extent such exemption from liability or limitation thereof is not permitted under the DGCL][except for liability (i) for any breach of the director's or officer's duty of loyalty to the Corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) of a director pursuant to Section 174 of the DGCL, (iv) for any transaction from which the director or officer derived an improper personal benefit, [and] (v) of an officer in any action by or in the right of the corporation][, and (vi) related to the following corporate actions: [_____]] [to a maximum of $[____] per officer]. [If the DGCL is amended hereafter to authorize the further elimination or limitation of the liability of directors or officers, then the liability of a director or an officer of the Corporation shall be eliminated or limited to the fullest extent authorized by the DGCL, as so amended, automatically and without any further action, as of the date of such amendment.] [No amendment to, modification of, or repeal of this Section shall apply to or have any effect on the liability or alleged liability of any director or officer of the Corporation for or with respect to any acts

or omissions of such director or officer occurring prior to such amendment.]"

To the fullest extent permitted by law clause. In some cases, the board of directors and the stockholders of the corporation may elect to adopt an exculpation provision that essentially tracks the current language of Section 102(b)(7), so that they are relatively confident in the parameters and limitations of the exculpation applicable to the directors and officers. In other cases, as used in the model language above, an exculpation provision may be proposed providing for elimination of liability in much broader language, such as "to the fullest extent permitted by the DGCL." By doing so, it would permit the corporation to not only exculpate officers and directors from personal liability for the matters currently set forth in Section 102(b)(7), but also any permissible limitations on liability embodied in future amendments of the DGCL. Conversely, to the extent that limitations on liability are culled back in Section 102(b)(7) or elsewhere in the DGCL by future legislative action, this would automatically become effective and would limit directors' and officers' use of the exculpation provision as a defense (subject to the "No amendments or modifications clause" discussed below). Corporations may not be comfortable with this uncertainty, given that such changes to the exculpation provision would automatically become effective upon any amendment to the DGCL.

Elimination vs. limitation of personal liability. Depending upon the preference of the board of directors, the stockholders, or both, a corporation may seek to eliminate the personal liability of the corporate officers entirely or instead opt to partially limit such personal liability.**[21]** Examples of ways to limit personal liability pursuant to an exculpation provision without eliminating all liability include instituting a dollar "cap" per corporate officer, applying an aggregate dollar cap to the entire slate of corporate officers who were in office when the claim arose, making exculpation applicable to only certain corporate matters but not others, or a combination of these options. In the example above, there is bracketed language that places a dollar "cap" per officer on the amount of the limitation of personal liability for monetary damages. Further, limitation or elimination of liability could be conditioned upon corporate officer action in connection with specific matters, as provided in the model language above. As a matter of practice, it seems that the vast majority of Delaware corporations have adopted provisions that entirely eliminate personal liability rather than partially limit it.**[22]**

No amendment or modification clause. The last sentence of the model exculpation provision provides that future amendments to the provision cannot be retroactively applied to impose monetary liability on a director or an officer for acts or omissions occurring prior to such amendment. As discussed above, this provision attempts to protect directors and officers against the uncertainties of a future stockholder or legislative action.

If a director-only exculpation provision is already in effect. Corporations with existing director-only exculpation provisions might consider adopting a stand-alone officer exculpation provision that is customized for the specific limitations and conditions applicable to a corporate officer under Section 102(b)(7) of the DGCL given its disparate treatment of directors and officers on certain matters (e.g., derivative claims, the unlawful payment of dividends, and unlawful stock purchases and redemptions).

Endnotes

[1] *See* DEL CODE ANN. tit. 8 § 102(b)(7) (2022).

[2] *Gantler v. Stephens*, 965 A.2d 695, 709 n.37 (Del. 2009).

[3] Synopsis of §102(b)(7), 65 Del. Laws., c. 289, §§1-2 (1986).

[4] A combination of indemnification, directors' and officers' insurance, and exculpation provisions in the certificate of incorporation has been used to shield directors and officers from personal liability arising out of their fiduciary duties to the corporation and its stockholders.

[5] *Buttonwood Tree Value Partners LP v. R.L. Polk & Co., Inc.*, C.A. No. 9250-VCL (Del Ch. Aug. 7, 2014).

[6] *Arnold v. Society for Sav. Bankcorp, Inc.*, 678 A.2d 533, 539-40 (Del. 1996).

[7] *Gantler v. Stephens,* 965 A.2d 695, 708-709 and 709 n.37 (Del. 2009).

[8] R. BALOTTI & J. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS §4.15 (2022) (hereinafter R. BALOTTI & J. FINKELSTEIN).

[9] *Rothenberg v. Santa Fe Pac. Corp.,* 18 Del. J. Corp. L. 743, 753 (Del. Ch. May 18, 1992) (A duty-of-care claim by itself cannot fall within one of the exceptions to exculpation under Section 102(b)(7): "[S]ince the purpose of §102(b)(7) is to enable corporations to eliminate [officer] liability for monetary damages for duty of care violations, it follows that the statutory exceptions to §102(b)(7) concern [officer] conduct that involves other than breaches of the duty of care.").

[10] R. BALOTTI & J. FINKELSTEIN §4.16.

[11] *See Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

[12] *See In re PNB Holding Co. Consolidated,* C.A. No. 28-N (Del. Ch. Aug. 18, 2006), slip op. at 52 n. 117 (stating that exclusions for the duty of loyalty, bad faith actions, and deriving personal benefits are "arguably redundant and certainly overlapping"). A paradigm example of an officer receiving an improper personal benefit would be the diversion of a corporate opportunity.

[13] *See* DEL CODE ANN. tit. 8 § 102(b)(7) (2022)

[14] *Malpiede v. Townson*, 780 A.2d 1075, 1095-96 (Del. 2001)(discussing director actions).

[15] *In re Rural Metro Corp.*, 88 A.3d 54, 86 (Del. Ch. 2014) (discussing director actions).

[16] *See* DEL CODE ANN. TIT. 8 § 102(b) (2022)

[17] ISS **United States Proxy Voting Guidelines Benchmark Policy Recommendations**, by Institutional Shareholders Services, 2021.

[18] **Glass Lewis 2022 Policy Guidelines — United States**, by Glass, Lewis & Co., LLC, 2021.

[19] Practical Law, *Shareholder Derivative Litigation* by Joseph M. McLaughlin, Simpson Thacher & Bartlett LLP, with Practical Law Litigation.

[20] *Id.*

[21] DEL CODE ANN. tit. 8 § 102(b)(7) (2022).

[22] Based upon the author's review of a sample of publicly available exculpation provisions set forth in the certificates of incorporation of Delaware corporations posted on the SEC's EDGAR database during the last five years.

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