RECENT DEVELOPMENTS

DELAWARE SECTION 102(b)(7): A STATUTORY RESPONSE TO THE DIRECTOR AND OFFICER LIABILITY INSURANCE CRISIS

The director and officer liability insurance crisis is a major concern to many executives.[1] A recent survey by Peat Marwick and the National Association of Corporate Directors (NACD) reveals that small to mid-size companies, not-for-profit organizations, public companies, financial institutions, chemical companies, hazardous waste firms and some high tech companies have experienced significant increases in director resignations.[2] Many executives are loathe to serve as corporate directors in today's litigious environment because they fear becoming the target of lawsuits. The increased incidence of suits against corporate directors has also prompted suggestions that potential directors be screened more rigorously for independence and expertise. These reforms only promise to compound the current director shortage.[3]

Several protections have arisen to ease director concerns over personal liability.[4] The most significant legal development is the trend of states to modify or enact indemnification statutes to permit the use of corporate

1. *See* Neff, *Liability Panic in the Board Room*, WALL ST. J. Nov. 10, 1986 at P.3, col. 2. Corporate Boardroom Woes Grow, NAT. L.J., Aug. 4, 1986, at 29 (a 1985 study found 68 percent of 592 companies whose insurance was up for renewal face premium hikes averaging 362 percent).

The director and officer liability insurance crisis is only part of a larger insurance problem facing the professional community at large. Rising premiums and policy cancellations are predominant and are worrying a wide variety of economic enterprises including doctors, lawyers, accountants, hospitals, daycare centers and school districts. *See generally* Hunter and Borzilleri, *The Liability Insurance Crisis*, 22 TRIAL April 1986, at 42.

2. *See* Nash, *Walking the Boardroom Tightrope*, WORLD, April-June 1987 at 46 (J.M. Nash is President of the Washington, D.C. based NACD) (WORLD is a published quarterly by Peat Marwick).

3. The overall concern about D & O liability is heightened by new requirements of the National Association of Securities Dealers that its listed companies must have two outside directors, and by a Treadway Commission proposal that the Securities and Exchange Commission requires all registered public companies to have audit committees composed entirely of independent directors. The situation becomes even more complex when one envisions the potential for legislation that would virtually "license" the duties and responsibilities of directors. For example, there is now debate at the federal and state level over whether to certify directors as *qualified to serve*. In other words, they may have to prove specific expertise.

Id.

4. *Id.* While restricted insurance coverages entering the director and officer insurance liability

funds to pay money judgments and costs incurred by directors in defending suits.

The pervasiveness of Delaware chartered corporations nationwide makes Delaware's recently enacted provision significant.[5] This development discusses the mechanics and policy behind Delaware's new statute, Section 102(b)(7) of the Delaware Code.[6] After comparing Section 102(b)(7) with other state indemnification provisions, this development concludes with some data on the effect of Delaware's provision on corporate boards and shareholders.

Most state indemnification provisions resemble Delaware's Section 145(a).[7] Section 145(a) allows a corporation to indemnify a director, officer, employee or agent for amounts paid in settlement "if [he is] reasonably believed to be [acting] in or not opposed to the best interests of the corporation. . . ."[8] Statutes like Section 145(a), however, do not protect directors who negligently or intentionally breach their duty to the corporation or its shareholders.

Section 102(b)(7)-type statutes broaden the scope of director protection by permitting corporations to shield directors from liability for grossly negligent acts. This type of statute differs from the typical indemnification provision because it affects the shareholder's cause of action. In contrast, indemnification statutes do not limit a shareholder's right to recover from a corporate director. In jurisdictions that have en-

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market are easing the liability insurance availability problem, there remains insufficient coverage to meet the need.

5. Approximately half of the Fortune 500 companies and 40 percent of those listed on the New York Stock Exchange are incorporated in Delaware. *See* WALL ST. J., June 19, 1986, at 8.

6. DEL. CODE ANN. tit. 8, § 102(b)(7) (1983 & Supp. 1986). *See infra* note 9 for text.

7. DEL. CODE ANN. tit. 8, § 145(a) (1983). *See also* REV. MODEL BUSINESS CORPORATION ACT (RMBCA) § 8.51-.52 (1983). RMBCA § 8.51 provides that a corporation may indemnify a director against liability if the director acted in good faith and, in the case of conduct in his official capacity, he reasonably believed his conduct was in the corporation's best interests. RMBCA § 8.52 *requires* a corporation to indemnify a director who was wholly successful on the merits *or otherwise* against reasonable expenses incurred in defending any proceeding. N.Y. BUS. CORP. LAW § 721 (Consol. 1983 & Supp. 1986), *infra* notes 20-23 and accompanying text; MO. REV. STAT. § 351.355(7) (1986).

8. DEL. CODE ANN. tit. 8, § 145(a) (1983 & Supp. 1986). Most indemnification statutes also authorize a corporation to purchase and maintain insurance on behalf of its directors and officers. *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(g) (1983 & Supp. 1986); ILL. REV. STAT. ch. 32, § 8.75(g) (1985); MO. REV. STAT. § 351.355(8) (1986).

Most director and officer liability insurance policies require the insureds to bear five percent of each loss at their own risk. Furthermore, if the application for insurance contains misrepresentations the insurance company may be able to rescind the policy. *See, e.g.*, Bird v. Penn Central Co., 334 F. Supp. 255 (E.D. Pa. 1971), *motion denied on rehearing*, 341 F. Supp. 291 (E.D. Pa. 1972).

acted 102(b)(7)-type statutes a director's exposure to personal liability is limited to his intentional misconduct in managing the corporation.

Delaware's Section 102(b)(7) expressly enables a corporation to amend its articles of incorporation to include "[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as director. . . ."[9] This provision, however, is limited to those cases where shareholders accuse directors of violating their duty of care.[10] Section 102(b)(7) does not permit a corporation to shield directors from liability for: (1) breaches of their duty of loyalty;[11] (2) any acts or omissions done in bad faith or knowingly in violation of the law;[12] (3) unlawful payment of dividends or unlawful stock repurchases or redemptions; or (4) transactions from which the director received improper personal benefit.[13] In those corporations which adopt 102(b)(7)-type provisions, the shareholders bringing suit bear the burden of proving that the challenged conduct of the director falls outside the scope of coverage.

Section 102(b)(7) is only an enabling provision and therefore is simul-

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9. DEL. CODE ANN. tit. 8, § 102(b)(7) (1983 & Supp. 1986) in its entirety provides that the certificate of incorporation of any corporation may contain

> [a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under section 174 of this Title, or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this subsection to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock.

When Delaware enacted Section 102(b)(7), it also enacted DEL. CODE ANN. tit. 8 § 145(j) (1983 & Supp. 1986). Section 145(j) extends a corporation's obligation to indemnify and advance expenses for costs of defending suits arising from acts of directors beyond the date of resignation.

10. Duty of care refers to negligent decisionmaking.

11. Duty of loyalty addresses those situations where a director has a conflict of interest with the corporation or where he may be engaged in self-dealing.

12. When a director has committed an intentional wrong, the complaining shareholders may ask for punitive damages. Courts are split as to whether a corporation may insure a director for punitive changes. *Compare* Northwestern Nat'l Casualty Co. v. McNulty, 307 F.2d 432 (5th Cir. 1962) *with* Greenwood Cemetery, Inc. v. Travelers Indemnity Co., 238 Ga. 313, 232 S.E.2d 910 (1977).

13. *See* Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993, 1994 (1978) (Under certain circumstances indemnification would violate public policy. Statutes should "seek the middle ground between encouraging fiduciaries to violate their trust, and discouraging them from serving at all.").

taneously restrictive and flexible. The provision merely authorizes shareholder approval of a charter amendment which limits or precludes director liability for breaches of their duty of care. The extent to which shareholders may protect directors is flexible. Shareholders may choose to entirely eliminate director liability for breaches of fiduciary duty or may limit the corporation's indemnification obligation to a stated dollar maximum.[14] Moreover, shareholders remain free to condition the elimination of liability on the performance of specific actions by directors or to deny the protection of the statute in connection with some types of transactions while permitting it in others.[15]

Section 102(b)(7) operates only when monetary judgments are assessed against directors. It has no effect on the availability of equitable remedies like injunction or rescission which may become available upon a director's breach of his duty of care.[16] The ability of shareholders to seek equitable relief, however, does not threaten the personal assets of directors. Thus, the fact that Section 102(b)(7) does not shield directors from

14. In enacting § 102(b)(7), the Delaware legislature rejected providing a *statutory* "cap" for the personal liability of directors because this approach would fix the remedy for liability in an arbitrary amount unrelated to the facts of each case. Under § 102(b)(7), corporate shareholders may choose to fix any amount it wants as a "cap" on liability and it may determine each particular "cap" according to the particular transaction at issue. *See* BUS. LAW, July/Aug. 1986, at 203.

The idea of putting a statutory "cap" on a director's potential liability is not a new concept. At least one commentator several years ago argued that directors, in the case of simple or even gross negligence, should have an idea of what their maximum liability could be. *See* Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW at 2032.

15. The Delaware legislature rejected a proposal to amend § 145(b) of its indemnification statute which would have allowed indemnification of judgments or amounts paid in settlement in derivative suits. The stockholders would not have benefited under the proposal because the corporation would simply be paying itself for injuries its directors caused. *See* BUS. LAW, July/Aug. 1986, at 2.

Under § 145(c) of the Delaware indemnification statute, and other state indemnification statutes, a corporation *must* indemnify a director who has been successful on the merits *or otherwise*. These statutes have led to questionable results, at least in terms of policy, when applied to a director's defense against criminal actions. For instance, in Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138 (Del. Super. Ct. 1974), the court held that any result other than conviction in a criminal proceeding was a success on the merits. *Id.* at 141. In *Merritt-Chapman*, the defendant directors were charged with five criminal counts. Two of the directors agreed not to pursue their defenses under two of the counts in exchange for the prosecutor's agreement to drop the other charges. The court held that the corporation had to indemnify those directors for their legal costs incurred in defending the charges that were subsequently dropped. *Id.* at 144. In doing so the court rejected the corporation's argument that it should not have to indemnify the directors because there had been no finding of the directors' innocence. *Id.* at 141.

16. Because the Delaware statute does not affect equitable remedies, it will not affect cases concerning elections, proxy contests, resignations, and removal contests.

liability in equity does not make the provision a less effective means of encouraging individuals to serve as corporate directors.

Other states have passed legislation which seeks to alleviate director concerns about personal liability but which differs from Section 102(b)(7). For example, New Jersey's recent enactment permits New Jersey corporations to include in their certificate of incorporation a provision that limits, either partially or entirely, the liability of *officers, employees or agents,* as well as directors, to the corporation or its shareholders.[17] New Jersey corporations must either authorize the new statute in their certificates of incorporation or obtain shareholder approval.[18] The New Jersey provision, like Delaware's, denies relief for an act or omission: (1) in breach of the person's duty of loyalty to the corporation or its shareholders; (2) made in bad faith or in knowing violation of the law; or (3) resulting in receipt of an improper personal benefit.[19]

New York has given corporations chartered under its laws the power to indemnify directors and officers.[20] New York's Section 721[21] permits a corporation to expand its indemnification provision by a resolution of shareholders, directors or by agreement.[22] Like Delaware and New Jersey, New York also prohibits corporate indemnification when a director acted in bad faith, was deliberately dishonest or when he made a

17. *See* New Jersey Senate Bill No. 2510 (enacted Feb. 4, 1987) *reprinted in* 19 SEC. REG. & L. REP. (BNA) 301 (Feb. 13, 1987).

Delaware's Section 102(b)(7) only protects directors. Two Delaware commentators have suggested that officer protection was not needed because officers of Delaware corporations who enact the statute are likely to take every controversial decision before the board of directors. The officers could thus shield themselves from personal liability by shifting the responsibility to the directors. Black and Sparks, *infra* note 20, at 312. The portion of the New Jersey law pertaining to limiting the liability of officers is subject to "sunset" provisions and will expire after two years unless the legislature extends this protection. 19 SEC. REG. & L. REP. (BNA) 301 (Feb. 27, 1987).

18. 19 SEC. REG. & L. REP. (BNA) 301 (Feb. 27, 1987).

19. *Id.* In addition to permitting corporate indemnity of directors, officers, employees and agents, the New Jersey Act permits corporations to purchase insurance on behalf of its agents. The remainder of the Act permits banks and capital stock savings banks to limit the liability of directors and officers by providing for indemnification in their certificate of incorporation.

20. A committee of the Delaware Corporate Law Section considered legislation which would greatly expand the power of Delaware corporations to indemnify their directors and officers. The committees, however, decided that legislation permitting shareholders to limit director liability was a more direct approach to the D & O liability insurance problems. *See* Black and Sparks, *Analysis of the 1986 Amendments to the Delaware Corporation Law,* Prentice-Hall, Inc., July 29, 1986, p. 311.

21. *See* N.Y. BUS. CORP. LAW § 721 (Consol. 1983 & Supp. 1986).

22. *Id.*

personal gain that he was not legally entitled to.[23]

Although there are differences in language, construction and scope, Delaware's new provision has undoubtedly prompted a trend in state corporate indemnity legislation. As of March 1987, twenty-one states had introduced legislation permitting corporations to eliminate or limit director liability in certain circumstances.[24] Additionally, three states had introduced legislation which would permit charitable and not-for-profit corporations to limit the liability of their directors.[25] In contrast, Hawaii has introduced a bill which would *statutorily* prescribe standards for director actions.[26] Of course, if enacted, Hawaii's statutory scope of acceptable activity will dictate director exposure to personal liability.

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23. N.Y. BUS. CORP. LAW § 721 (Consol. 1983 & Supp. 1986) provides as follows:

> NONEXCLUSIVITY OF STATUTORY PROVISIONS FOR INDEMNIFICATION OF DIRECTORS AND OFFICERS—The indemnification and advancement of expenses granted pursuant to, or provided by, this article shall not be deemed exclusive of any other rights to which a director or officer seeking indemnification or advancement of expenses may be entitled, whether contained in the certificate of incorporation or the by-laws or, when authorized by such certificate of incorporation or by-laws, (i) a resolution of shareholders, (ii) a resolution of directors, or (iii) an agreement providing for such indemnification, provided that no indemnification may be made to or on behalf of any director or officer if a judgment or other final adjudication adverse to the director or officer establishes that his acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled. Nothing contained in this article shall affect any rights to indemnification to which corporate personnel other than directors and officers may be entitled by contract or otherwise under law.

See also MO. REV. STAT. § 351.355(7) (1986). Missouri's indemnification statute is similar to New York's Section 721. A Missouri corporation may indemnify their directors, officers, employees or agents. Missouri requires that indemnity provisions be authorized in the corporation's articles of incorporation, by-laws or in an agreement adopted by shareholder vote. Like Delaware and New York, Missouri prohibits director indemnification when that person has been knowingly fraudulent, deliberately dishonest or has committed willful misconduct. *Id.* Recently, Missouri has considered legislation which would make directors immune from suit arising "from conduct of the affairs of [the corporation]." *See* 19 SEC. REG. & L. REP. (BNA) 179 (Jan. 30, 1987).

24. The twenty-one states are Arkansas, Colorado, Connecticut, Georgia, Idaho, Kansas, Maine, Maryland, Massachusetts, Michigan, Mississippi, Nebraska, Nevada, New Mexico, Oklahoma, South Dakota, Tennessee, Texas, Washington, West Virginia, and Wyoming. *See* 19 SEC. REG. & L. REP. (BNA) 384-85 (March 13, 1987); 19 SEC. REG. & L. REP. (BNA) 345-47 (March 6, 1987); 19 SEC. REG. & L. REP. (BNA) 267-68 (Feb. 20, 1987); 19 SEC. REG. & L. REP. (BNA) 203 (Feb. 6, 1987).

According to Mr. Lewis S. Black, Jr., of the Delaware law firm Morris, Nichols, Arsht & Tunnell, states may be using different terminology in their new proposed statutes, but they are using the Delaware statute as a starting point. Telephone interview with Mr. Lewis S. Black, Jr., member of Delaware Bar, Partner, Morris, Nichols, Arsht & Tunnell (March 26, 1987).

25. The three states are Arizona, Montana and Vermont. *See* 19 SEC. REG. & L. REP. (BNA) 346-47 (March 6, 1987); 19 SEC. REG. & L. REP. (BNA) 267-68 (Feb. 20, 1987).

26. *See* 19 SEC. REG. & L. REP. (BNA) 385 (March 13, 1987).

While a statutory standard could protect directors from personal liability to the corporation or its shareholders, legislatures favor giving the shareholders or the corporation an option to limit director liability. Accordingly, where permitted, corporations must take steps to limit director liability, usually by shareholder vote or, for new corporations, in drafting the articles of incorporation.

Since Delaware's indemnity statute was the first of its kind, enactment of this statute by Delaware corporations may foretell whether corporations and shareholders nationwide are likely to sanction director liability and indemnification provisions. Whether Delaware's Section 102(b)(7) will result in widespread adoption of similar statutes is not yet certain.[27] Nonetheless, there is encouraging evidence that the statute will have its desired effect. Some corporations have already received shareholder approval and added a Section 102(b)(7)-type provision to their articles of incorporation.[28] One commentator sees most of these corporations limiting director liability to the fullest extent permitted by law rather than adopting caps or conditional indemnity.[29]

Many more corporations are currently seeking shareholder approval to shield their corporate boards. According to one report, more than two-thirds of Delaware corporations are proposing Section 102(b)(7)-type provisions to their shareholders.[30] Moreover, some suggest that enactment of these statutes will remain the most popular proxy item for the next few years.[31]

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27. N.Y. Times, Jan. 13, 1987, at 26, col. 1. According to Marie Shultie, Delaware's Corporation Administrator, about two hundred corporations a month were filing changes in their certificates of incorporation to take advantage of the Delaware statute. This number was expected to be much higher during the Spring months in 1987 after shareholders returned their proxies. *Id.*

28. Such corporations include Health Management Associates Inc. (*see* 1987 Business Wire, March 24, 1987, available on Nexis News Service); Tejon Ranch Co. (*see* 1987 Business Wire, March 24, 1987, available on Nexis News Service); Synercom Technology Inc. (*see* 1987 Business Wire, March 12, 1987, available on Nexis News Service); Penril Corp. (*see* PR Newswire, March 2, 1987, available on Nexis News Service); Holiday Corporation (*see* 1987 Business Wire, Feb. 27, 1987, available on Nexis News Service); Hudson Foods (*see* PR Newswire, Feb. 6, 1987, available on Nexis News Service); and Resource Exploration Inc. (*see* 1987 Business Wire, Jan. 28, 1987, available on Nexis News Service).

Tejon Ranch Co. recently reincorporated in Delaware and the new certificate of incorporation will *eliminate* director liability "to the maximum extent permitted by Delaware law." The company reports that limiting its directors' liability will enhance its ability to attract high quality directors. Tejon also believes that this limitation may also eventually reduce insurance costs. *See* 1987 Business Wire, March 24, 1987, available on Nexis News Service.

29. Telephone interview with Mr. Lewis S. Black, Jr., *supra* note 24.

30. N.Y. TIMES, Jan. 13, 1987, at 26, col. 1.

31. Telephone interview with Mr. Lewis S. Black, Jr., *supra* note 24.

Although a trend toward adopting Section 102(b)(7)-type provisions is not yet evident, its widespread proposal signifies Delaware corporate board confidence that it will ease director concerns over personal liability. Moreover, widespread enactment of Section 102(b)(7)-type provisions by state legislatures and a corresponding adoption of indemnity provisions by corporations nationwide could remove the need of many directors to retain costly indemnity insurance.

James B. Behrens

THE URGENT NEED FOR SURROGATE MOTHERHOOD LEGISLATION

I. INTRODUCTION

An estimated ten to fifteen percent of all married couples are infertile.[1] The rate of infertility has increased dramatically over the past 20 years.[2] The rise in infertility is due to a variety of causes including use of certain drugs and contraceptive devices,[3] sexually transmitted diseases,[4] chemi-

1. L. ANDREWS, NEW CONCEPTIONS: A CONSUMER'S GUIDE TO THE NEWEST INFERTILITY TREATMENTS, INCLUDING IN VITRO FERTILIZATION, ARTIFICIAL INSEMINATION, AND SURROGATE MOTHERHOOD, 2 (1984). Approximately 15% of couples are unable to conceive after one year of unprotected intercourse. R. HATCHER & G. STEWARD, CONTRACEPTIVE TECHNOLOGY 1986-1987 (13th rev. ed. 1986).

2. The overall infertility rate in the United States is almost three times as much as it was 20 years ago. *The Saddest Epidemic*, TIME, Sept. 10, 1984, at 50. The National Center for Health Statistics compared a 1965 survey with a 1976 survey and found an 83% increase in infertility among married couples in which the wife was 20-24 years old, a group which is considered most fertile. L. ANDREWS, *supra* note 1, at 2.

3. A variety of drugs including high blood pressure and ulcer medications can lower a man's sperm production. Sons and daughters of women who took DES (di-ethyl-stilbestrol) have a higher incidence of certain types of fertility problems. L. ANDREWS, *supra* note 1, at 23-25. Use of the IUD sometimes leads to infertility by causing severe inflammation of the uterine lining or by increasing a woman's risk of pelvic inflammatory disease which causes scarring and blockage of a woman's fallopian tubes. *Id.* at 25-26. Abortion can also cause infections which can lead to infertility. *Id.* at 26.

4. According to Centers for Disease Control, one million people contract sexually transmitted diseases each year. Infertility results in 150,000 to 200,000 of those cases. Sexually transmitted diseases lead to infertility by scarring the woman's fallopian tubes or the man's sperm ducts. *Id.* at 29.