Should Boards Eliminate Corporate Officer Liability for Fiduciary Duty Breaches?

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Boards will need to consider whether to provide officers with a new shield to liability. **BY DOUG RAYMOND**

More than 35 years ago, in the case of *Smith v. Van Gorkom*, the Delaware Supreme Court surprised many when it held members of a board of directors financially liable for the breach of their fiduciary duty of care. This unexpected catalyst for director personal liability triggered dramatic increases in D&O insurance premiums and fears that qualified directors would resign en masse from their boards.

In response, Delaware and most other states quickly amended their corporate laws to allow corporations to eliminate the risk of personal liability for a director's breach of the duty of care, subject to narrow exceptions. With this, the markets calmed, and directors stayed in the boardroom. These protections recently were extended by the Delaware legislature to officers of Delaware corporations, who are subject to the same fiduciary duties of care, loyalty and good faith as the directors. However, this extension was made without the dramatic precedent that occasioned the initial adoption of the protections for directors. Delaware is therefore the most prominent jurisdiction that has taken this step, though such protections are also permissible in several other jurisdictions, including Pennsylvania.

Director protections

The protections for both directors and officers are not automatic but must be included by the corporation in its certificate of incorporation, either as initially filed with the Secretary of State of Delaware when the corporation is formed or by a subsequent amendment approved by the stockholders. In general, the statute permits the corporation to eliminate personal liability of directors and officers for financial damages resulting from a breach of their fiduciary duties, except in circumstances involving:

- A breach of a director's duty of loyalty.
- Acts or omissions made not in good faith, intentional misconduct or knowing violations of law.
- Illegal stock redemptions, stock repurchases or dividends.
- Transactions where a director derives an improper personal benefit.

As a result, if this provision is included in the certificate of incorporation, breach of fiduciary duty claims against the directors

and officers will almost always be dismissed so long as the alleged actions do not fall into one of the four specified exceptions. For this reason, most corporations in Delaware and elsewhere (and virtually all public companies) have adopted this provision to at least protect the board. (It is important to remember that a court always can nonetheless issue an injunction to prevent actions that would breach the duty of care, and directors remain liable for actions taken by them in bad faith, for their intentional misconduct and for self-dealing transactions.)

Crucial change in expanded provision

The expanded provision protects corporate officers in the same way as directors, with one notable difference: Corporations cannot limit the liability of their officers for breaches of fiduciary duty arising out of claims brought by the corporation or on its behalf. The board retains the ability to sue an officer for breach of their fiduciary duties and, in some circumstances, the shareholders may bring such an action on a derivative basis on behalf of the corporation. However, this exception does not extend to a suit by shareholders directly against the officers when shareholders sue in their capacity as shareholders. Furthermore, unlike the protection for the directors, this extension does not apply to all officers, but only to the president, chief operating officer, chief financial officer, chief legal officer, controller, treasurer or chief accounting officer, and other officers identified by the corporation in its SEC filings as among the most highly compensated executive officers of the corporation. However, the protection of the amended statute can also be extended to other officers if the corporation and the other officer(s) enter into an agreement to that effect.

These new provisions have been positively received by corporate officers and many commentators, who point to the unfairness of litigation increasingly brought against officers, from which the directors are dismissed because of the exculpatory provision in the corporation's charter. This applies even to those officers who also serve on the board, and who may be able to get claims dismissed against them in their capacity as a director, but not those against them in their capacity as an officer. Leaving these claims to proceed against the officers seems illogical, particularly when, in many (or most) cases, the officers are primarily carrying out the board's directives. Indeed, one can argue that allowing breach of duty of care claims to proceed against the officers, but not against the directors, only serves to allow these cases to proceed against parties who are usually not at significant fault and increases the diversion and the expense, including the settlement costs, of such litigation, all of which typically is paid by the corporation.

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A reason for boards to pause

Despite these considerations, boards may want to pause before rushing to extend this liability shield to the senior officers of the corporation. And, unlike the situation in the 1980s, there have not been significant threats of resignations because of the risk of a duty of care claim. Moreover, even if a director is shielded from monetary damages for breach of their duty of care, the stockholders can — in theory, at least — remove a director who they conclude has not lived up to their fiduciary obligations. Because the officers are appointed by the board and not by the stockholders, they do not even have the ability to remove an officer who has failed to act with due care. And, if no one is at risk for the breach of the duty of care, can stockholders really rely on any protections they may have found in that obligation? Because it will require an amendment to the certificate of incorporation to add the officer exculpation provision to an existing corporation, it will be interesting to see how boards respond to this new development in Delaware law. ■

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