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WRITER'S DIRECT DIAL NUMBER
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MEMORANDUM

To: Members of Corporation Law Section

From: Bruce M. Stargatt

Date: May 7, 1986

Re: Proposed amendment to GCL § 102 permitting charter amendments to eliminate director liability for violation of fiduciary duty of care: A dissenting opinion

Proposed for debate by the Section is an amendment to the Delaware General Corporation Law (in the form of a new subsection "(7)" to GCL § 102) which will allow Delaware corporations to adopt (or amend) charters in a way so as to immunize directors from liability for the violation of their historic fiduciary duty of due care. I am in strong disagreement with that proposal. Since a meeting of the Section is being convened on Wednesday, May 15, at 4:00 p.m. in City/County Council chambers to consider the proposal, it seemed constructive to circulate in advance of the meeting a brief statement of the reasoning behind my point of view. Hence this memorandum.

* * *

My proposition is this: The duty of care is part of the fabric of the corporation law of Delaware and, apparently, every other jurisdiction in this country. Smith v. Van Gorkom, Del. Supr., 488 A.2d 858 (1985); Aronson v. Lewis, Del. Supr., 473 A.2d 805, 811 (1984); Lutz v. Boas, Del. Ch., 171 A.2d 381, 395-396 (1961). See, in general, cases collected by Fletcher Cyc. Corp. (Perm. Ed.) §§ 1029-1064, and Tentative Draft No. 3, Proposed Restatement of Principles of Corporate Governance: Analysis and Recommendations, Duty of Care and Business Judgment Rule, pp. 28-40, and note that in no jurisdiction does it appear that legislation exists allowing corporations to adopt charter provisions immunizing directors from liability for violation of duty of care. To my best knowledge the wisdom of the rule has never been seriously questioned. For Delaware, which leads in the development of our country's corporate law, to exercise that leadership by abolishing the duty of care rule is, to me, unacceptable.

Of course the historic existence of the duty of care, and its universal acceptance, are well known to all of us. Further, until our Supreme Court's recent decision in Smith v. Van Gorkom, Del. Supr., 488 A.2d 858 (1985), I heard not even a faint murmur of dissatisfaction with the duty of care formulation as a matter of legal concept. The reasons now expressed by those who feel themselves obliged to allow its elimination are pragmatic.

First, it is said that a group of Delaware corporations have made it known that they will introduce legislation in Dover which will be

worse than that which the Council proposes, that such legislation has a chance of passage, and that even if defeated it will engender an unseemly debate. My reaction is that if worse legislation is proposed, it should be opposed by the Council and the Bar. And there should be no hesitancy to debate it. Indeed I think that corporations trying to get legislation enacted to shield their directors from liability for their own gross negligence would receive a jaundiced reception. In all events the risk of a "worse" bill passing is speculative, and not a reason for us to sponsor a "bad" one.

On this I have a sense of bemused deja vu. Attached hereto behind the yellow separator are three small pieces of a large file dealing with the last effort to legislate on the duty of care subject. As you will see, in 1978 a respected member of the Bar proposed an amendment to our statute so as to modify the Delaware rule and conform it to the Model Business Corporation Law standard. (From our common-law "gross negligence" rule, see, recently, Aronson v. Lewis, Del. Supr., 473 A.2d 805, 812-813 (1984), to the MBCA's "ordinary care" codification.) The argument was that, if we did not act, federal legislation was imminent. The (then) Corporation Law Committee openly debated the subject at length over a long period, and concluded not to codify our duty of care standard to conform with the MBCA. This decision was made notwithstanding the then expressed threat of federal preemption. It is noteworthy that despite heavy study and hot debate (which I think you will sense from the attachments), seven or eight years ago when the subject was last visited there was not even

the breath of a suggestion that Delaware's duty of care standard be abolished.*

It is now submitted that the current crisis in obtaining D&O insurance is a reason to allow the elimination of the duty of care. With that I also disagree. There is absolutely no assurance that the elimination of the duty of due care will in the near future bring back into the market insurers willing to write policies at historically reasonable rates. Indeed, adjudications of liability based on violations of the duty of care are quite rare, a consideration which it must be assumed is as known to the insurance industry as it is to us. Finally the insurance business, like others, is cyclical. It makes no sense to me to adopt the Draconian measure of eliminating the duty of due care, developed over decades of carefully reasoned judicial decisions, in supposed response to a possibly transitory problem.

It is also said that many high quality, independent directors are now finding it impossible to serve on boards because of the perceived risk of personal liability. I agree that this is a problem. But the problem, both from my personal knowledge and what I have read, is not with the existence of a duty of care. Directors' concerns are, I believe, with the lack of D&O coverage, rather than the legal rules which govern their various duties. To say it another way, I am doubtful that many (if any) directors who are inclined to resign because of the absence of insurance coverage will stay on if we amend our statute to eliminate the duty

* Indeed, it was praised. Codified Standard - Safe Harbor or Uncharted Reef, Veasey and Manning, The Business Lawyer, April 1980.

of care.

While recognizing that an objective of the proposed statute is to keep able, independent directors on the board, it will permit (if not promote) the exact opposite effect. To make the point one need look no further than the draft Restatement of Principles of Corporate Governance which, as an illustration of violation of due care duty, (which the Restatement supports), cites this example:

> 1. A, a prominent banker who has served on the board of X Corporation for five years, is in ill health and expects to remain in ill health for the foreseeable future. A agrees with X's board of directors to continue serving as a director, but with the understanding that he will rarely attend board meetings and that his only function will be to advise the board on banking practices. A's service in accord with such a limitation will constitute a breach of his duty of care. Even with the consent of his fellow directors, A cannot abrogate legally mandated functions. The functions of a director prescribed by the law of X's state of incorporation are controlling. Prolonged ill health does not provide a legally cognizable excuse for a director's inactivity. When a director recognizes, or should reasonably recognize, that because of prolonged ill health he can no longer perform his functions with reasonable care, he must resign or face exposure to liability. Of course, in usual circumstances, a director's failure to attend board meetings because, for example, of temporary ill health would be reasonable.*

Tentative Draft No. 4, pp. 17-18 (footnote omitted). The elimination of the duty of care might, arguendo, encourage in rare cases high quality directors to serve without liability coverage. But it would also permit less than capable and diligent persons to serve on corporate boards with

the realization on their part, and the part of corporate managers who are exposed to them, that only venality could make them liable to the stockholders they serve. So the Restatement's "Banker A" would be free of risk. That is a result which I reject.

Lastly, it is said that other states may adopt statutes which are even more favorable to corporate management than the proposed amendment to Section 102. That keep-our-market-share argument is shortsighted. It calls to mind the scathing words of Professor Cary:

> In summary, as long as we operate within a capitalist society and as long as confidence in management is prerequisite to its continuance, there should be a federal interest in the proper conduct of the corporation itself as much as in the market for its securities. A civilizing jurisprudence should import lifting standards; certainly there is no justification for permitting them to deteriorate. The absurdity of this race for the bottom, with Delaware in the lead -- tolerated and indeed fostered by corporate counsel -- should arrest the conscience of the American bar when its current reputation is in low estate.

Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663, 705 (March 1984). I did not then, and do not now, agree with Professor Cary's cynical thesis that Delaware's self-interest in retaining and enhancing its census of corporate taxpayers has caused it to lead a "race to the bottom." To the contrary while we have consistently modernized our statute to keep it in step with the modern corporate world, Delaware has reserved to the courts the function of developing a body of law defining directors' duties. Some of those decisions have pleased the corporate

community. Some have not. Our courts have taken no popularity polls. Nor should they. That is why Delaware's corporation law has the respect of commentators and courts nationwide. It is one reason that companies elect to be domiciled here. To reverse the decades of jurisprudence which have identified the duty of care, and defined and applied it to varied and changing facts, by the enactment of a statute enabling corporations to relieve their directors from the consequences of their gross negligence on the basis of perceived "market" advantage is shortsighted and, in the long haul, is apt to have the opposite effect.

* * *

In sum, I favor the preservation of the common-law duty of care as a guiding standard for directorial performance. The reasons I have heard for allowing the elimination of liability for breach of the duty are unsatisfactory. I submit that the proposed amendment should be opposed by all of us.

BMS:jv

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October 11, 1978

Charles S. Crompton, Jr., Esquire
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Dear Charlie:

I am reliably informed that Senator Metzenbaum is having prepared for introduction by him early in the next session of Congress a Corporation Minimum Standards Bill which, among other things, will establish a standard of care for directors of covered corporations and make such directors liable for breach thereof. The Metzenbaum bill will vest jurisdiction in the federal courts over such cause of action; but, in the case of a corporation incorporated in a state whose law provides for a standard of care equivalent to that declared in the Metzenbaum bill, jurisdiction to adjudicate actions for breach thereof will be ceded to the state courts. The Metzenbaum bill's standard of care will be that now found in the 1974 amendment of Section 35 of the Model Business Corporation Act (§35 MBCA), viz:

> "A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances."

The Metzenbaum bill will, of course, prescribe other requirements for covered corporations, but those provisions are not germane to the purpose of this letter.

It has been suggested to me by George Wm. Coombe, Jr. (Chairman of the Section of Corporation, Banking and Business Law of the American Bar Association, but probably talking to me in his capacity as general counsel for Bankamerica Corporation or as a member of the steering committee of The Business Roundtable) and by John K. Tabor (of Purcell and Nelson, counsel for The Business Roundtable) that if Delaware would promptly enact the §35 MBCA standard of care, it would take much of the wind out of Senator Metzenbaum's sail and might be sufficient to stall his bill's progress, particularly since both New York and California, as well as other states, now have the §35 MBCA standard in their corporation laws. Cessante ratione legis, cessat et ipsa lex. (The reason of the law ceasing, the law itself also ceases).

Which brings me to the purpose of this letter.

You will remember that early in 1975 I recommended that the Delaware Corporation Law Committee propose an amendment of Section 141 of the Delaware Corporation Law to include the 1974 §35 MBCA amendment. You then referred the matter to a special subcommittee consisting of Bruce Stargatt as chairman, Henry Herndon, Drew Moore, Dave Williams, Norm Veasey and me. The subcommittee's action and the present status of the matter were reported as follows in Bruce Stargatt's April 6, 1976 letter to the subcommittee members:

> "Reservations had been expressed in respect of the ideas expressed in the recent revisions to MBCA § 35 by members of the Subcommittee, and there was no ground swell of enthusiasm in its favor. Hence at the meeting of the Subcommittee convened yesterday afternoon, it was decided that further consideration of the MBCA amendments be tabled.
>
> The deferment of further discussion of MBCA § 35 was not meant to shut the door on the question. Sam Arsht (who was detained and arrived at the Subcommittee meeting as it was breaking up) had indicated to me last week that Joseph Hinsey, Esquire, a principal architect of the revisions to MBCA § 35, might wish to speak with the Subcommittee and offered to try to arrange for this. As

> expected, the sense of the meeting yesterday afternoon was that the members of the Subcommittee would be delighted to have the benefit of Mr. Hinsey's thoughts, or the comments of some other member of the ABA's drafting committee. With that in mind I am sending Mr. Hinsey a copy of this letter, along with my letter of November 26, and the memorandum it enclosed."

Through no fault of Bruce, the suggested meeting with Joe Hinsey was never held and the subcommittee did not consider the matter further.

It has always been my view that the standard of care added in 1974 to §35 MBCA is but a codification of existing Delaware law as declared by the Delaware Supreme Court in 1963 in Graham v. Allis-Chalmers Manufacturing Company, 188 A.2d 125, where the Court said: "...directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances." Bruce Stargatt disagrees. He believes that language in Graham v. Allis-Chalmers which appears later than that which I have quoted, as well as language of the Chancery Court in Penn Mart Realty Company v. Becker, 208 A.2d 349, makes it possible to argue that a director of a Delaware corporation is liable only for gross negligence and not for mere failure to exercise ordinary care.

Be that as it may. If Bruce is correct that gross and not ordinary negligence is the Delaware standard, I think Section 141 of the Delaware Corporation Law should be amended as promptly as possible to make ordinary care the Delaware standard. But if Bruce is not correct and §35 MBCA is, as I believe, merely declaratory of existing Delaware law, we should promptly amend Section 141 to codify the rule in the language of §35 MBCA because of the effect such codification is likely to have on Senator Metzenbaum's proposed Corporation Minimum Standards Bill.

To speed the matter up, I suggest that Subsection (e) of Section 141 of the Delaware Corporation Law, which now contains a great deal of what was added to §35 MBCA in 1974, should be amended to read, in the language of §35 MBCA, as follows:

"A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(2) counsel, public accounts, appraisers* or other persons as to matters which the director reasonably believes to be within such person's professional or expert competence; or

(3) a duly designated committee of the board upon which he does not serve as to matters within its designated authority, which committee the director reasonably believes to merit confidence.

but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been a director of the corporation.

A director of a corporation who is present at a meeting of its board of directors at which action on any corporate matter is taken shall be presumed to have assented to the action taken unless his dissent shall be entered in the minutes of the meeting or unless he shall file his written dissent to such action with the secretary of the meeting before the adjournment thereof or shall forward such dissent by registered mail

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* "Appraisers" is not in §35 MBCA, except as encompassed by "other persons". Since "appraisers" is now expressly mentioned in 141(e) it should be continued to negate a contention that its deletion changed the law as respects appraisers.

to the secretary of the corporation immediately after the adjournment of the meeting. Such right to dissent shall not apply to a director who voted in favor of such action."

Sincerely,

S. Samuel Arsht

SSA/pld
cc: A. B. Kirkpatrick
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May 25, 1979

TO: General Corporation Law Committee

RE: Amendment of §141(e) of the Delaware Corporation Law to Prescribe Standards for Performance of a Director's Duties

---

The purpose of this letter is, once again, to urge this Committee to approve an amendment of §141(e) of the Delaware Corporation Law to prescribe the standards for performance by directors of their fiduciary duties presently found in §35 of the Model Business Corporation Act ("35 MBCA"), so that §141(e) will read as follows:*

> "(e) A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. In performing his

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* The proposed amendment of §141(e) is in the exact language of the second paragraph of 35 MBCA with three minor and non-substantive variations in the second and third sentences (the standards are stated in the first sentence) which are explained in footnotes. Some of the background for the proposal is stated in my letter of October 11, 1978 to Charlie Crompton which was distributed to all members of the Corporation Law Committee at a meeting on October 31, 1978. A copy of that letter is enclosed for convenient reference.

duties, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by: (i) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented, (ii) counsel, public accountants, appraisers* or other persons as to matters which the director reasonably believes to be within such person's professional or expert competence, or (iii) a duly designated committee of the board upon which he does not serve**, as to matters within its designated authority, which committee the director reasonably believes to merit confidence: but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who performs his duties in accordance with this subsection shall have no liability by reason of being or having been a director of the corporation or for his conduct as a director.***

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* "Appraisers" is not in 35 MBCA, except as encompassed by "other persons." Since "appraisers" is expressly included in the present 141(e) it is included in the amendment to negate any contention that its deletion changed the law as respects reliance on appraisers.

** The corresponding language in 35 MBCA is "a committee of the board upon which he does not serve duly designated in accordance with a provision of the articles of incorporation or the by-laws." The change to the simpler "a duly designed committee" assures that all lawfully designated committees of the board are within the statute's ambit.

*** The words "or for his conduct as a director" are not in 35 MBCA. Those words are added because liability never results from the mere fact of being or having been a director, but from the fact of a director's failure properly to perform his duties as a director.

My proposal that §141(e) of the Delaware Corporation Law be amended to include the statement of standards for performance by a director of his duties found in 35 MBCA was debated by this Committee at its October 31, 1978 meeting. A vote taken at the debate's end disclosed that a majority of the Committee favored codification of standards of fiduciary conduct for directors and my proposal was referred to a subcommittee for further consideration. The subcommittee had eight members - Bruce Stargatt, Chairman, Mike Goldman, Henry Herndon, Drew Moore, Dick Sutton, Norm Veasey, Dave Williams and me. Although the subcommittee considered the matter over a six months period, no concensus developed.

Substantially all of the subcommittee's efforts were concentrated on attempts to draft an alternative to 35 MBCA which the subcommittee considered would be an improvement of 35 MBCA. A majority to the subcommittee felt: (1) that the "business judgment rule" should be included in a statement of standards for measuring the proper performance by a director of his duties and (2) that a director should only be required to "believe in good faith" (not "reasonably believe") that corporate action authorized by him was in the best interests of the corporation. A draft of a modified version of 35 MBCA reflecting those views of the subcommittee was submitted to persons who are in the front line of the opposition to federal chartering and federal minimum corporate standards legislation. They advised that in their opinion adoption by Delaware of a statute like the draft submitted to them would be counterproductive insofar as its effect on federal legislation is concerned. They continue to believe that if Delaware would enact a statute in the language of 35 MBCA it would help "the common cause" and they continue to hope we will do so.

When the subcommittee last met, on April 11, they had the opinion of our "political consultants" that enactment by Delaware of the subcommittee's latest draft of an alternative or modified version of 35 MBCA would be counterproductive. The four members of the subcommittee who were present (Messrs. Stargatt, Goldman, Veasey and Arsht) seemed to be of three different views and concluded to refer the matter back to the parent committee without recommendation from the subcommittee.

Bruce Stargatt and Mike Goldman, if I correctly interpreted their remarks, were opposed to the enactment by Delaware of any statute on the subject because, in their view, the subject of directors liability should continue to be dealt with by the courts on a case-by-case basis under common law principles and, more specifically, under the common law business judgment rule as developed in Delaware in many decisions. I favor adoption of the fiduciary standards in the language of 35 MBCA and will hereinafter state my reasons in some detail. Norm Veasey favored a further effort by

the subcommittee to draft standards substantially identical to the 35 MBCA standards, but with what he termed "one or two minor variations." The only variation he mentioned at the meeting was the omission of "reasonably" from the phrase "in a manner he reasonably believes to be in the best interests of the corporation."

Charlie Crompton and Rod Ward, although not members of the subcommittee, were present at the subcommittee's April 11 meeting and participated in the discussion. They, too, were divided in their views. Charlie was of the view that Delaware should not adopt the 35 MBCA standards and Rod felt that it should.

The following are the reasons why I believe Delaware should adopt the 35 MBCA standards:

1) Perhaps 35 MBCA is not the perfect or even the best possible statement of the standards to which a director should conform his conduct in performing his fiduciary duties. Probably some members of this Committee could draft a more perfect statement of standards. The fact is, however, that the subcommittee attempted to "improve" on 35 MBCA over a period of six months and succeeded only in coming up with alternatives that are regarded as counterproductive, insofar as federal legislation is concerned.

2) 35 MBCA is a statement of proper and minimum standards to which a fiduciary should conform. It has been accepted by the most responsible representatives of the business, legal and academic communities as a proper statement of the manner in which a director should perform his duties.

3) The 35 MBCA standards, in my view, are not substantively different from present Delaware law. Indeed, they are now the law of Delaware. The first two elements of the standard are "in good faith" and "in a manner he [director] reasonably believes to be in the best interests of the corporation." These are an almost exact quote of the standards stated in §145(a) and (b) of the Delaware Corporation Law with which a director's conduct must have conformed if he is to be indemnified. When, in 1967, the standards for indemnification of a director were drafted, the draftsmen believed that the standards for measuring a director's entitlement to indemnification were or should be the same as those that measured proper performance of a director's duties. In other words, only a director who had properly performed his duties as a director is eligible to be indemnified. The third element of the 35 MBCA standard, "with such care as an ordinarily prudent person in a like position would use in similar circumstances", is a codification of existing Delaware law as declared by the Delaware Supreme Court in 1963 in Graham v. Allis-Chalmers Manufacturing Co., 188 A.2d 125, where

the court said "...directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances."

Non-negligence is also recognized in §145(b) as a required element of proper conduct since §145(b) disqualifies from indemnification a director who has "been adjudged to be liable for negligence or misconduct in the performance of his duty to the corporation."

4) It is not possible to read the decisions of our Supreme Court and Chancery Court in Schnell v. Chris-Craft, Del. Supr., 285 A.2d 437 (1971) rev'g., Del. Ch., 285 A.2d 430 (1971); Chasin v. Gluck, Del. Ch., 282 A.2d 188 (1971); Thomas v. Kempner, No. 4138, Del. Chancery (March 22, 1973); Gimbel v. Signal Companies, Inc., Del. Ch., 316 A.2d 599 (1974), aff'd., Del. Supr., 316 A.2d 619 (1974); and Singer v. Magnavox Co., Del. Supr., 380 A.2d 969 (1977), rev'g., Del. Ch., 367 A.2d 1349 (1976), among others, as coming even close to holding that Delaware courts will not enjoin a transaction or hold liable the directors who authorized it unless the plaintiff stockholder has established "fraud", "palpable overreaching", "reckless indifference" or "deliberate disregard of the interests of the stockholders". While those phrases appear in a number of Delaware decisions, they are, in my opinion, garbage on which no Delaware decision has, in fact, turned and it would be a disservice to the State to enact a statute which perhaps arguably gave its blessing to conduct of directors falling just short of that characterized by those quoted phrases.

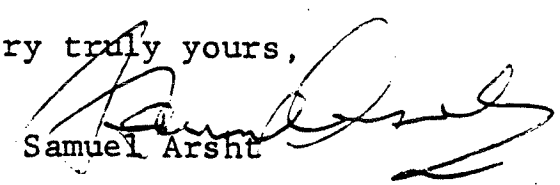
5) The aspect of Delaware law that draws the hottest fire from those who would replace state corporation law with federal corporation law is Delaware's so-called business judgment rule. That rule must be the least understood of corporate law concepts. Whatever the true dimensions of the business judgment rule may be, it is not intended to be a statement of how a director should perform his duties as a director; which is what 35 MBCA is. The business judgment rule is simply not a standard which governs the manner in which a director should conduct himself in performing his duties as a director. Therefore, even if we could agree on what the business judgment rule is, it would be inappropriate to include it in a statement of how a director should conduct himself in performing his fiduciary duties. Not including it in the statute is not overruling it or repealing it, as the article in Vo. 29, The Business Lawyer, would seem to make clear.

6) Assuming arguendo that there is a difference between the 35 MBCA standards and the present Delaware standards for performance of directorial duties, we should accept the judgment of the responsible spokesmen for the business, legal and academic communities that 35 MBCA is an acceptable statement of acceptable standards for measuring the conduct of fiduciaries. We should resolve our doubts, reasonble 'tho they be, in favor of cooperating to the extent we can with those who are on the same side as we in opposing further federalization of corporate law. Our friends in the business and legal communities think it important and in their and our best interests that Delaware adopt 35 MBCA.

7) Lastly, I will address myself to Norm Veasey's position: viz, a willingness to recommend approval of 35 MBCA as written, but with the deletion of"reasonably" in the phrase "in a manner he reasonably believes to be in the best interests of the corporation". He points out that the California and New York statutory versions of 35 MBCA do not include "reasonably" as a modifier of "believes" and that the next to final version of 35 MBCA published in Vol. 29, The Business Lawyer, p. 949 did not include "reasonably". "Reasonably" was added as a modifier of "believes" in the final version of 35 MBCA "in order to make the phraseology exactly parallel with the indemnification language" in the indemnification section. Vol. 30, The Business Lawyer, p. 501. Norm has stated that he is willing to compromise by substiting "in good faith" for "reasonably" as a modifier of "believes". Our "political consultants" have advised that this seemingly inconsequential change in the 35 MBCA standards would be counterproducive as respects federal legislation. In the circumstances, I hope Norm will compromise once again and accept "reasonably", and not press for "in good faith", as a modifier of "believes". In this regard, I point out that "reasonably" does not mean "correctly". It means "not arbitrarily," "not capriciously," "not whimsically", "rationally", and "arrived at by a process of reasoning". Delaware's deletion of "reasonably" or the substitution therefor of "in good faith" would be viewed with suspicion by the proponents of federal legislation and pointed to as but another example of Delaware's design to lead the race for the bottom. No person on the subcommittee has worked as hard as Norm Veasey to produce an acceptable and improved version of the 35 MBCA standards. Only one word "reasonably", now separates him from me in our positions on the 35 MBCA standards. I hope he will be "reasonable", in the best sense of the word, and join me in recommending that §141(e) be amended to read as set forth on pages 1 and 2 of this too long letter.

Thank you all for your indulgence.

Very truly yours,



S. Samuel Arsht

M E M O R A N D U M

To: General Corporation Law Committee for discussion at 5/30/79 meeting

From: Subcommittee on Liability of Directors

Background

In September 1974, the ABA approved a proposed codification of the duties of corporate directors in the form of MBCA § 35. On May 5, 1975, a Subcommittee of our General Corporation Law Committee was created for the purpose of studying whether Delaware ought to codify its decisional development of directorial duties and, if so, whether MBCA § 35 was the proper form of words to do the job. Toward this purpose a number of meetings of the Subcommittee were convened in 1975 and early 1976. In the end it appeared that there was an absence of enthusiastic pro-codification sentiment, and a sense of heavy malaise about MBCA § 35. Hence, the project was tabled. (See Attachment #1.)

The enterprise was revived in October 1978 upon the suggestion of one of the Subcommittee members that by adopting the model provision Delaware might deflect possible legislative efforts, particularly by Senator Metzenbaum, to enact a federal minimum standards law. At an early stage a majority of the Subcommittee again rejected MBCA § 35 as written.

(See Attachment #2.) Shortly thereafter MBCA § 35's strongest supporter joined the other members of the Subcommittee in concluding that MBCA § 35 should not be adopted in Delaware in its existing form. (See Attachment #3.) Without being sure that codification was itself desirable, the Subcommittee drafted various "talking papers" as more complete and accurate alternatives to MBCA § 35. A progress report was submitted by the Subcommittee to the Committee as a whole at its December 20, 1978 meeting. (See Attachment #4.)

As the redrafting effort progressed, inquiries were made on an informal basis by a member of the Subcommittee to knowledgeable persons on the question of whether the Subcommittee's ideas as to changes in MBCA § 35 would, if approved and enacted, have the effect of retarding the Metzenbaum minimum standards effort. In February 1979, the Subcommittee was advised that the revisions (or, as the Subcommittee thought, improvements) to MBCA § 35 would not be helpful to the effort to deflect federal legislation. Only the adoption of MBCA § 35 without change by Delaware, the Subcommittee was told, might help politically in resisting Metzenbaum's efforts. On this basis MBCA § 35, twice rejected, was again proposed. Again it was rejected. (See Attachment #5.)

With this background, it was decided that the matter ought to be put before the General Corporation Law Committee for final resolution. Procedurally it made sense for the

undersigned, as Subcommittee Chairman, to write the Subcommittee's report. This writing fulfills that function. It seemed best to me to write a very brief advocate's paper, summarily submitting the main anti-MBCA § 35 argument. To balance the advocacy I invited Sam Arsht, who now supports MBCA § 35, to submit a paper taking the other side. This clash of opposing points of view should assist the members of the Committee in reaching a reasoned decision as to whether to recommend the adoption of MBCA § 35 as written, or recommend against it.

Discussion

While MBCA § 35 is a printed page in length, the most controversial part appears in this single sentence:

> "A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances." (Underlining added.)

That the standard of the proposed statute is different from the standard of business judgment required of a director by the Delaware cases, appears unarguable. The words of the cases differ. But the common theme is that a loyal director, who has adequately apprised himself of the facts relevant to the business decision at issue, Kaplan v. Centex Corp., Del. Ch., 284 A.2d 119, 124 (1971); Cheff v. Mathes, Del. Supr., 199 A.2d 548, 556 (1964); Gimbel v. Signal Companies, Inc., Del. Ch., 316 A.2d 599, 609 (1974), will not be liable for the adverse consequences of his good faith judgments unless those judgments amount to "a gross abuse of discretion", Warshaw v. Calhoun, Del. Supr., 221 A.2d 487, 493 (1966); Kelly v. Bell, Del. Ch., 254 A.2d 62 (1969); Baron v. Allied Artists Pictures Corporation, Del. Ch., 337 A.2d 653, 659 (1975), or are characterized by "recklessness".

Gimbel v. Signal Companies, Inc., Del. Ch., 316 A.2d 599, 610-611 (1974). "Honest judgment", Eshleman v. Keenan, Del. Ch., 194 A. 40, 43 (1937), and the absence of "arbitrary" decision-making, Moskowitz v. Bantrell, Del. Supr., 190 A.2d 749, 750 (1963), are what is required.* As the Court put it in Perrine v. Pennroad Corporation, Del. Supr., 47 A.2d 479 (1946):

> ". . . '[T]he business of every corporation . . . shall be managed by a Board of Directors', and under this provision the Directors of Pennroad Corporation had authority . . ., if they acted in good faith.
>
> ". . . If it appears that they acted honestly, they are not responsible for mere mistakes, and under such circumstances Courts will not interfere with their action or attempt to assume their authority to act." 47 A.2d at 487.
>
> * * *
>
> "Good faith may always be brought in question where it appears that the settlement of a dispute between stockholders of a corporation is so grossly inadequate that one is required to reach the decision that the directors were reckless and indifferent as to the rights of the stockholders and did not exercise reasonable business judgment." 47 A.2d at 489.

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* The rule is sometimes stated in presumptive terms: "Under the Delaware business judgment rule a board of directors enjoys a presumption of sound business judgment which remains inviolate unless their decision cannot be attributed to any rational business motives." Judge Schwartz in Harriman v. E. I. DuPont de Nemours and Company, 411 F.Supp. 133, 153, fn. 112 (D.Del. 1975), citing Sinclair Oil Corporation v. Levien, Del. Supr., 280 A.2d 717 (1971).

This is the test the Delaware Courts have traditionally applied in reviewing the discretionary business decisions of directors. It is the Delaware business judgment rule. It is not the same as MBCA § 35's "reasonably believes", "ordinary prudent person", standard.

It appears that the drafters of MBCA § 35 have hoped the courts will read into the provision the rule they have omitted. So in their Comment they express the hope that a ". . . director should not be liable for an honest mistake of business judgment." The Business Lawyer, Vol. 30, p. 504 (Jan. 1975). But the Comment will not repair what the statute repels. And, with what some would view as irony, the Subcommittee's effort to clarify the statute by inserting business judgment language,* gave rise to the criticism that the insertion would sufficiently change the meaning of MBCA § 35 as to render it unacceptable to the anti-minimum standards advocates.

There were other problems with the model provision. But this was the sticking point.

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* E.g., ". . . in making decisions on matters which affect the business and affairs of the corporation he [the director] shall exercise his business judgment in accordance with what he believes to be the best interests of the corporation. . ."

Conclusion

The Subcommittee could make no judgments as to the probable impact of Delaware's adopting, or failing to adopt, MBCA § 35 on the political effort to federalize directorial responsibility with so-called minimum standards legislation. Its concentration was on the merits of whether codification was desirable in Delaware and, if so, whether MBCA § 35 was a fair encapsulation of our Delaware common law. Doubtful as to the codification question, the Subcommittee was in no doubt that MBCA § 35 if adopted would change the law created by decades of reasoned decisions. All of the Subcommittee late last year, and most of the Subcommittee now, believed and believes the change would not be for the better.

Bruce M. Stargatt, Chairman
Subcommittee to Study Liability
of Directors

Dated: May 23, 1979