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Post Smith v. Van Gorkom Director Liability Legislation with a Proactive Perspective

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POST *SMITH v. VAN GORKOM* DIRECTOR LIABILITY LEGISLATION WITH A PROACTIVE PERSPECTIVE

I. INTRODUCTION

Outside corporate directors are quickly becoming a leaner, better informed, suspicious and almost extinct species. Prior to the Delaware Supreme Court's landmark decision in *Smith v. Van Gorkom*,[1] a corporate director's judgment was vehemently protected in the legal system by the business judgment rule. In the *Van Gorkom* decision, the Court "imposed liability upon directors for accepting an outside offer for the purchase of the corporation without investigating whether a higher price might be obtained and without making an investigation into the value of the business."[2]

The disappearance of outside directors in American corporations had already begun at the time of the *Van Gorkom* decision. But, the *Van Gorkom* decision stripped corporate directors and officers of the protective cloak formerly provided by the business judgment rule, rendering them liable for the tort of gross negligence for the violation of their duties under the rule.[3]

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

[2] R.W. HAMILTON, THE LAW OF CORPORATIONS 306 (1986).

[3] Leisner, *Boardroom Jitters: A Landmark Court Decision Upsets Corporate Directors*, *BARRON'S*, Apr. 22, 1985, at 34.

Prior to the decision, the business judgment rule was simply defined as the immunization of management from liability when the transaction in question is within the powers of the corporation and the authority of management, and the directors have complied with their duty to exercise due care and their applicable fiduciary obligations, i.e., good faith.[4] The protection of the rule, coupled with director and officer liability insurance, provided a relatively safe environment in which directors and officers could function without fear of liability.[5]

The availability of director and officer insurance began to notably decrease as early as 1984.[6] It was at this point that the insurance market began tightening policy constraints and cancelling policies for financial institutions.[7] This effect triggered awareness by attorneys of director and officer liability as additional deep pockets.[8]

The *Van Gorkom* decision was viewed by many as the catalyst which triggered the dramatic increases in the number of shareholder suits filed, director and officer (hereinafter D & O) insurance policy cancellations, skyrocketing premiums,[9] and the flight of the outside directors.[10]

Devastating decisions like *Van Gorkom* could be prevented or at least be of a lesser magnitude if corporate counsel chose to use the proactive approach to corporate representation by employing the techniques of preventive law. The theory is similar to the time honored cliche "an ounce of prevention is worth a pound of cure."[11]

This Article will address the Board of Directors' mission, including the various theories surrounding the duty of care, the effects of *Van Gorkom*, the legislative remedies enacted to counteract the effect of *Van Gorkom* and finally, the proactive approach of corporate client counseling.

II. THE FACTS OF *SMITH V. VAN GORKOM*

The issue before the Delaware Supreme Court in *Smith v. Van Gorkom* was the adequacy of care exercised by the directors in the sale of the

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[4] H.G. HENN AND J.R. ALEXANDER, LAWS OF CORPORATION 661 (3d ed. 1983).

[5] *See generally* Scheibla, *The Liability Syndrome: Why So Many Corporate Directors Suffer From It*, *BARRON'S*, Nov. 4, 1985, at 28.

[6] Taravella, *D & O Rates Rising as Much as 50%*, BUS. INS., Sept. 3, 1984, at 1.

[7] *Id.* There is no one reason for the tightening in the D & O market, but many say the crisis at Chicago's Continental Bank, which has festered several lawsuits, has focused underwriters' attention on D & O coverage.

[8] *Id.* at 55.

[9] Scheibla, *supra* note 5, at 28.

[10] Korn, *Directors Are Getting Hard to Find*, FORTUNE, Apr. 29, 1985, at 351.

[11] The viewpoint expressed in this paragraph is the author's working definition of proactive.

corporation. The alleged negligence involved the amount of money that would accrue to the shareholders as a result of the sale.[12]

The target company was the Trans Union Corporation (hereinafter TUC). TUC was a Chicago-based diversified holding company whose principal line of business was leasing rail cars, water and waste treatment equipment.[13] TUC was faced with an accumulation of investment tax credits and an insufficient cash flow to offset them. TUC's market value was estimated in the hundreds of millions of dollars.[14]

The leader of TUC was fifty-seven-year old Jerome W. Van Gorkom. Van Gorkom served for nearly twenty years as chairman of the board and chief executive officer (CEO) of TUC.[15] The acquiring concern was the Marmon Group owned by the Pritzker brothers of Chicago. Jay Pritzker was the principal for the Marmon Group in this transaction. Pritzker was a well-known takeover specialist and social acquaintance of Van Gorkom.[16]

Prior to engaging in negotiations with Pritzker, Van Gorkom asked the TUC comptroller to "work up some numbers" for a leveraged buyout with a five year payoff.[17] A leveraged buyout is a method of acquiring a corporation by using borrowed funds which are normally repaid with funds generated by the target's operations or by the sale of the target's assets.[18]

In early September, Van Gorkom, without the knowledge of the other directors or senior management, met with his social acquaintance, Pritzker. At this meeting, Van Gorkom presented Pritzker with a proposed offering price of $55 per share (current market price ranged between $37 and $38)[19] for 12.5 million TUC shares as well as a financing structure that would accomplish the sale. Usually at meetings of this type, Pritzker's interest in the possibility of acquiring the corporation would have been tested.[20]

Van Gorkom had based his figure on his own intuition and the eleventh-hour figures prepared by a TUC comptroller. Van Gorkom, as a director, had participated in the acquisition of many other companies.[21]

Within one week from this initial meeting with Pritzker, Van Gorkom called an emergency Saturday board meeting. The TUC board, a group of

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12 Spiegel, *The Liability of Corporate Officers*, 71 A.B.A.J. 51 (1985).

13 *Directors Beware*, FORTUNE, Mar. 4, 1985, at 8-9.

14 Spiegel, *supra* note 12, at 51.

15 Leisner, *supra* note 3, at 34.

16 Spiegel, *supra* note 12, at 51.

17 Leisner, *supra* note 3, at 34.

18 Levin, *Owens-Illinois Inc. Says It Will Consider Sweetened Proposal by Kolhberg Kravis*, Wall St. J., Jan. 14, 1987, at 2, col. 3.

19 Spiegel, *supra* note 12, at 51.

20 *Id.*

21 Leisner, *supra* note 3, at 34.

friends and business acquaintances, heard a twenty-minute presentation by Van Gorkom about the merger. The presentation was followed by an hour and a half of deliberations, after which they approved the merger. Their approval was based solely on Van Gorkom's oral presentation.[22]

That very same evening, Van Gorkom signed the actual merger documents during a social function marking the opening of the Chicago Lyric Opera season.[23] Van Gorkom would personally benefit from the sale of TUC because he held approximately 75,000 shares of the company.[24]

When Van Gorkom told senior management of the impending buyout, he encountered massive resistance. Senior management later objected to both the offering price and lack of an opportunity for TUC to seek competing offers. The key officers threatened Van Gorkom with their resignations if the buyout was permitted.[25] Succumbing to the pressure, Van Gorkom negotiated a ninety-day period in which TUC could solicit other offers,[26] a possibility which had not previously existed for TUC.[27] During this period, Salomon Brothers was engaged to field other offers. With the omnipresence of the Pritzker clan, Salomon Brothers was unable to come up with anything other than two nibbles, which were not considered to be viable offers.[28] Finally, the acquisition was consummated in February of 1981 when almost 70% of the TUC stock voted in favor of the merger.[29]

Following the merger approval, a class action suit was filed seeking rescission of the merger. The issue facing the court was whether the shareholders were adequately informed of their options, including the nibbles received by Salomon Brothers. The lower Delaware court ruled in favor of Van Gorkom and the TUC directors.[30]

On appeal, the question before the court was whether Van Gorkom and the TUC directors had exercised sufficient care in order to make an informed decision. The Delaware Supreme Court, in a 3-2 decision, found in favor of the shareholders.[31] The court held that the directors breached their fiduciary duty of care to the shareholders by failing to disclose all facts germane to the transactions. Additionally, the directors failed to adequately inform themselves as to the value of the corporation and how Van Gorkom arrived at the selling price. The court found the directors to

[22] *Id.* at 36.
[23] *Id.*
[24] *Id.* His benefit was roughly calculated to be four million dollars.
[25] Spiegel, *supra* note 12, at 51.
[26] *Id.*
[27] Leisner, *supra* note 3, at 36.
[28] *Id.*
[29] *Id.*
[30] Spiegel, *supra* note 12, at 51.
[31] *Id.*

be grossly negligent in approving the merger with only an hour and a half of deliberation.[32]

The court ruled that Van Gorkom and the TUC directors' "meeting was so badly flawed that no subsequent actions could rehabilitate things sufficiently to make the protection of the Business Judgment Rule available."[33]

III. Board of Directors' Mission

The Board of Directors operating as a whole are to ensure that:

> [L]ong-term strategic objectives and plans are established and that proper management structure (organization, systems, and people) is in place to achieve these objectives, while at the same time making sure that the structure functions to maintain the corporation's integrity, reputation, and responsibility to its various constituencies.[34] To best meet these duties, the board of directors should act as an evaluative body independent of management.[35]

Traditionally, directors had been protected by the safe harbor afforded by the business judgment rule.[36] The business judgment rule provides that directors will not be held personally liable in damages for honest mistakes in judgment.[37] The rule is usually raised as a defense.[38] "The reasons usually advanced for the rule are that a court is ill-equipped to make business decisions and should not second-guess directors or substitute its judgment for that of directors."[39]

In 1984, the Delaware Supreme Court restated their working definition of the business judgment rule in the case of *Aronson v. Lewis*: "It is a presumption that in making a business decision the directors . . . acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[40]

Central to the fulfillment of the Board's generic mission is the duty to exercise due care. Each director owes a duty of care to each corporation he

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32 Leisner, *supra* note 3, at 37.

33 *Id.*

34 Nat'l A. of Corp. Directors, Minutes of the Advisory Board, AMA Headquarters, N.Y., (Apr. 5, 1981).

35 Kesner & Dalton, *Boards of Directors and the Checks and (Im)Balances of Corporate Governance*, 29 Bus. Horizons 17, 19 (Sept.-Oct. 1986).

36 Veasey & Seitz, *The Business Judgment Rule on the Revised Model Act, the Trans Union Case, and the ALI Project-A Strange Porridge*, 63 Tex. L. Rev. 1483, 1484 (1985).

37 *Id.* at 1485.

38 *Id.* at 1484.

39 *Id.* at 1485.

40 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

serves. As seen in the *Van Gorkom* case, the failure of the director(s) to exercise the required duty of care has two discrete areas of potential liability:[41] the failure to exercise care in decision making[42] and the failure to exercise due care in the performance of directors' responsibilities, other than decision making, such as delegation and oversight.[43]

The Revised Model Business Corporation Act (RMBCA), Section 8.30,[44] the American Law Institutes (ALI) Section 4.01 of tentative draft No. 5[45] and the National Association of Corporate Directors (NACD) Model Statute for the Standard of Conduct for Directors[46] are example codifications of standards of care for corporate directors.[47] Each model codification, all or in part, has been incorporated by the individual states. The most stringent standard of care is the RMBCA[48] and the least stringent is the NACD. The common area between the trio includes the belief that a director will execute his duties in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner he believes to be in the best interest of the corporation. This common ground is the area upon which liability may be based. The legislative adoptions and ramifications will be addressed later in this paper.

IV. THE EFFECTS OF *SMITH v. VAN GORKOM* on the Corporate World

Following the decision by the *Van Gorkom* court, shockwaves rocked the corporate establishment. Two of the most profound effects were the shrinking pool of available directors/officers and the limited availability and high cost of liability insurance.[49]

A. *The Disappearance of Outside Directors*

"Directorships were once symbols of honor and achievement that business leaders collected like club memberships."[50] Today, following the D & O liability insurance crisis which was compounded by the shareholder awakening in the *Van Gorkom* decision, corporations are finding it

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[41] Veasey & Seitz, *supra* note 36, at 1493.

[42] *Id.*

[43] *Id.*

[44] REVISED MODEL BUSINESS CORP. ACT § 8.30 (1984).

[45] A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (Apr. 12, 1985 as amended May 17, 1985).

[46] NAT'L A. OF CORP. DIRECTORS, MODEL STATUTE STANDARD OF CONDUCT FOR DIRECTORS (1987).

[47] Veasey & Seitz, *supra* note 36, at 1493-97.

[48] *Id.* at 1497.

[49] *See generally* Korn, *supra* note 10.

[50] *Id.* at 351.

harder to retain qualified directors and fill vacancies. This threatens one of the basic tenets of corporate governance.[51]

Companies are being forced to employ headhunters to obtain candidates to fill board vacancies.[52] Increasingly, opportunities to sit on boards are being declined.[53] Today, only two out of five offers for board positions are accepted according to a Spencer Stuart study.[54] Directors are being required to study more intricate management strategies.[55] In addition to the increased work, directors now have a one-in-five chance of being party to a shareholder suit.[56]

Greater attention is being paid to the selection of new board members. Candidates are being scrutinized more closely than ever before.[57] In selection of a new member, boards are paying less attention to personal compatibility and social connections.[58] However, outside directors are still drawn from three primary sources: executives from other companies, retired executives, and academicians.[59] The exodus of outside directors is due in part to increased time demands as well as the D & O liability insurance crisis.

To avoid accusations of gross negligence, many corporate directors have sought to become actively involved in the management and oversight of the corporation.[60] Many professional directors and other outside directors have cut down on their board memberships.[61] This reduces the pool of available, outside directors in many fields. Directors view their roles as overseers not managers.[62] Additionally, smaller boards of

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[51] *Id.* Outside directors became the majority in many of the major corporation boards during the 1970s. Those who are classified as outside board members include:

1. Former officers and employees;
2. Relatives of officers;
3. Officers, directors, employees or owners of significant suppliers or customers;
4. Creditors;
5. Attorneys; and
5. Investment and commercial bankers.

Any relationship that involves an economic or personal relationship between the director (or nominee) and management must be disclosed to the Securities and Exchange Commission via a 6(b) filing. The filing does not preclude the appointment of that individual.

[52] Baum & Byrne, *The Job Nobody Wants*, BUS. WEEK, Sept. 8, 1986, at 56.

[53] Korn, *supra* note 10, at 351.

[54] Baum & Byrne, *supra* note 52, at 56. The Spencer Stuart study is discussed in the Baum article. Spencer Stuart is a personnel services firm.

[55] *Id.*

[56] *Id.*

[57] Korn, *supra* note 10, at 351.

[58] *Id.*

[59] *Id.*

[60] Baum & Byrne, *supra* note 52, at 51.

[61] *Id.*

[62] *Id.* at 61.

directors,[63] fewer meetings, and more inside directors have been noticeable trends.

B. *The Climax-Director and Officer Liability Insurance Crisis*

"One-third of the over 1,100 directors of major U.S. corporations responding to the recent Touche Ross survey say that the increased liability to which they are exposed has caused them to consider resigning from their board positions."[64] This position has been a long time in coming. Back in 1984, pre-*Van Gorkom* directors of financial institutions were finding the availability of D & O insurance decreasing.[65] The most frequent targets of policy cancellations were the banking, oil and gas, and computer industries.[66] A number of companies in these industries have failed, thereby triggering lawsuits against directors.[67] In addition, companies involved in takeover fights, or big pollution/product liability claims are continuing to have difficulty in obtaining policies.[68]

Financial institutions' tenacity became vulnerable after the troubles at Continental Illinois and Penn Square Bank.[69] Major insurance firms have stopped writing new policies for financial institutions.[70] Many D & O policies for financial institutes exclude claims stemming from lawsuits by regulatory agencies, such as the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation, which file suits against the directors and officers of failed banks hoping to collect on D & O policies.[71]

Following *Van Gorkom*, D & O policies almost became extinct. Those policies which were still available were coupled with lower coverage that had more restrictions, and premiums that have escalated 200 percent or more.[72] Thus, defensive management became an everyday practice. The avoidance of claims became vital to non-cancellation.[73]

With the rise of litigation came an increasing awareness of the need for insurance by directors of smaller corporations.[74] Survey results released by The Wyatt Co., a Chicago research firm, showed that the closely-held

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[63] *Id.* at 56, 57.

[64] *Corporate Directors Seen Wary About Future*, J. of Acct., Feb. 1987, at 30.

[65] Taravella, *supra* note 6, at 1.

[66] Hilder, *Liability Insurance is Difficult to Find Now for Directors, Officers*, Wall St. J., July 10, 1985, at 1, col. 6.

[67] *Id.*

[68] *Id.*

[69] *Id.*

[70] *Id.* at 21, col. 1.

[71] *Id.*

[72] Olson, *The D & O Insurance Disaster*, Across the Board, July-Aug. 1986, at 38.

[73] *Id.*

[74] Taravella, *Many Small Businesses Ignore D & O Risk*, Bus. Ins., Dec. 10, 1984, at 30 [hereinafter *D & O Risk*].

companies, when compared to New York Stock Exchange members, exhibited the greatest growth in carrying D & O coverage during the 1974-84 period.[75] Despite the strong market interest in the product (D & O insurance coverage), the suppliers chose to cancel, place restrictions on, or refuse to issue the requested coverage following the Continental Illinois disaster.[76]

Many directors of small companies now feel their exposure to litigation is not sufficiently acute to justify the cost that is being asked for the insurance coverage.[77] The smaller companies which obtain insurance and have hopes of going public will most likely have to do so outside the umbrella afforded by their policy.[78] Insurers find small companies tend to be in a higher D & O risk category because they are, generally, closely held corporations.[79] Closely held corporations are often controlled by family members. In addition, smaller corporations tend to be prime takeover targets.[80] Currently, in almost every policy, a takeover exclusion is included to protect the insurance provider.[81] Thus, the awakening of small corporations to the threat of litigation did nothing more than wet their appetite for D & O coverage that they could not afford.

Adding to the skyrocketing premiums were activist judges with their theory of "cost spreading." In attempting to compensate victims, these courts look to deep pockets, i.e., those who could absorb the cost. The preferred pockets were those of insurance companies. The D & O policies in this scheme were used after the exhaustion of the firm's regular liability insurance.[82]

In some cases, directors have deeper pockets than the group they direct (for example, bankrupt companies, companies without D & O policies, churches, or schools). The *ad terreom* threat of personal liability can increase the settlement value of the claim by making key executives eager to quickly resolve their case.[83] Thus, the risk of losing his fortune is an effective deterrent to a candidate's accepting a board position.[84]

The ramifications created by one ruling, such as *Van Gorkom*, can be enormous. The inherent power of the Delaware Supreme Court in corporate America is unmatched. Its influence transcends to all industries and companies of every size.

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[75] Taravella, *Firms Hiked D & O Limits During 1984, Study Says*, BUS. INS., Jan. 21, 1985, at 24.

[76] *See generally* Taravella, *supra* note 6, at 1.

[77] *D & O Risk*, *supra* note 74.

[78] *Id.*

[79] *Id.* at 31.

[80] *Id.*

[81] *Id.*

[82] Olson, *supra* note 72, at 40.

[83] *Id.*

[84] *Id.* at 41.

One example resulting from the *Van Gorkom* decision is shown in the plight of the board of directors of the Detroit based Armada Corporation. The absence of liability insurance triggered the resignation of eight of the ten Armada Corporation directors.[85] The exodus of outside directors of corporations followed the *Van Gorkom* decision. Inability to fill vacancies with qualified people caused trends toward maintaining smaller boards.[86] Smaller boards offer attractive benefits for corporations, such as fewer directors with which to provide insurance coverage and increased awareness of board members because their duties will be enlarged.[87]

Another reaction to the *Van Gorkom* decision was the proliferation of offshore insurance subsidiary captives.[88] Corporations whose interest would go unprotected, since they were being priced out of the D & O insurance market, joined with others in the same predicament to form "captives" who would provide their parent(s) with reasonably priced insurance coverage.[89]

The captives are generally set up in the Caymen Islands, Barbados, or the Bahamas. The members of one captive called "CODA—Corporate Officer and Director Assurance"; which writes D & O coverage for companies with minimum net worths of $250 million, include Chase Investment Bank of New York, Dart and Kraft Inc. of Northbrook, Illinois, Squibb Corporation of Princeton, New York, Warner-Lambert Company of Morris Plains, New Jersey and Pfizer Inc. of New York.[90] Captives have been set up for higher educational institutions and chemical companies as well.[91]

V. Legislative Remedies Enacted to Counteract the Effects of *Smith v. Van Gorkom*

On June 18, 1986, Delaware Governor Michael N. Castle signed into law a provision which limits directors' presumed liability for their failure to fulfill their duty of due care obligation to the corporation.[92] In order for

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[85] Pawling, *The Crisis of Corporate Boards: Accountability vs. Misplaced Loyalty*, Bus. Q., Summer 1986, at 72, 73.

[86] Baum & Byrne, *supra* note 52, at 56.

[87] *See generally id.* at 56-61.

[88] Finlayson, *More Buyers Consider D & O Captive*, Bus. Ins., July 7, 1986, at 2. "Captives" are corporations who are wholly owned by one or more corporations. Captives such as those designed to provide insurance usually have a limited corporate purpose and are incorporated in jurisdictions like the Cayman Islands, which have laws more conducive to the goals of parent(s). This enables the parent(s) to circumvent the local restrictions or market conditions to achieve their goals.

[89] *Id.*

[90] *Id.*

[91] *Id.*

[92] Del. Code Ann. Title 8 Section 102(b)(1) (1983 & 1986 supplement).

a director to obtain the protection of 102(b)(7), the director must first obtain shareholder approval.[93] Anthony G. Flynn, Counsel-to-the-Governor, stated that allowing the shareholders to determine what they wanted to do about liability fits in with the concepts of corporate democracy and shareholder rights.[94] This provision was seen as a measure allowing corporations the discretion to decide whether to indemnify their directors. Prior to *Van Gorkom*, the board was automatically afforded the protection of the business judgment rule.[95]

By enacting this law, Delaware has helped to preserve its second largest source of revenue.[96] Hospitality to corporations brought $131 million in corporate fees and taxes for the fiscal year 1985-86. Since the law was enacted in July, 1986, incorporation filings have increased fifteen percent.[97] Many of the new filings are re-incorporations made by companies which are located in states less friendly to corporations.[98] Thus, Delaware has sustained its leading position as the "hot" place to incorporate, despite a monumental court decision, courtesy of the Delaware legislature.[99]

Thirty states, including Delaware, have recently enacted statutes which govern directors and/or officer liability.[100] Most of the state provisions are based on either the Delaware law, the RMBCA, ALI or the NACD Model Statute. Throughout the new provisions, directors are still subject to suits by shareholders if they breach their duty of loyalty, fail to act in good faith, are associated with "intentional misconduct," or commit known violations of the law.[101] Note that these statutes do not protect officers of the corporation from liability, with the exceptions of Louisiana and Nevada.[102]

To obtain the benefits of the newly enacted shield statutes, twenty-seven of the thirty states require an affirmative action to be made by the shareholders, thereby acknowledging their consent. The affirmative action required by existing domestic corporations is a filing which

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[93] Greenhouse, *Liability Curb Aids Directors*, N.Y. Times, August 12, 1986, at D2, col. 1.

[94] Lewin, *Delaware Law Allows Less Director Liability*, N.Y. Times, June 19, 1986, at D1, col. 1.

[95] Comment, *Statutory Limitations on Directors' Liability in Delaware: A New Look at Conflicts of Interest and the Business Judgment Rule*, 24 HARV. J. ON LEGIS. 527, 528 (1987).

[96] *Move to Delaware*, FORTUNE, Dec. 22, 1986, at 9.

[97] *Id.* at 8.

[98] *Id.* at 9.

[99] *Id.*

[100] C.T. CORPORATION, PROVISIONS RELATING TO THE LIMITATION OF DIRECTORS' AND/OR OFFICERS' LIABILITY, Nov. 2, 1987.

[101] *See id.*

[102] *Id.* at 5-9.

amends one of the following: Articles of Incorporation, Certificate of Incorporation, Corporation Bylaws or the Corporate Charter.[103]

Three states, Indiana, Ohio, and Virginia,[104] to a limited extent do not require an affirmative action by the shareholders in order to enact the indemnification provisions. Thus, all corporate directors can benefit from the statutes without seeking shareholder approval. The NACD Model Statute was based on the Indiana Statute. The Model Statute was later adopted in Ohio leaving Ohio with the most pro-director shield statute.

The official commentary on the NACD Model Statute states, "if it is desirable social policy to limit the liability of directors for certain types of misconduct, then appropriately that should be a uniform provision applicable across the board to corporations and should not depend upon the actions of shareholders."[105] This provision allows corporations to avoid the expense of placing this issue on proxy materials.

The Ohio statute provides the standard of clear and convincing evidence to be applied when determining if a director has violated his duty to the corporation. This standard is preferable considering the magnitude of personal liability that the director could face.[106]

The Ohio legislature, which was considering this legislation during the hostile takeover attempt of the Goodyear Tire and Rubber Company in November of 1986, chose to enact this landmark legislation to strengthen Ohio corporation law. The original aspects of this legislation, H.B. 902, included the limitation of monetary liability on a director as well as the strengthening of the business judgment rule.[107]

> At the request of Goodyear, H.B. 902 was amended to provide explicit statutory power (subject to fiduciary limits) for poison pills to be issued by directors of Ohio corporations traded on a national securities exchange and to expressly authorize the write-up of intangible assets. Additional amendments explicitly freed directors from per se personal guarantor liability upon the corporate backing of loans to Employee Stock Ownership Plans and expressly provided that directors of a target could consider long-range, as well as short-range, interests of the corporation

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[103] *Id.*

[104] *Id.* at 16. In Virginia, liability is limited to the lesser of $100,000 or the salary for one year preceding the wrongful act, unless the lower limit is specified in the articles of incorporation or the bylaws approved by the shareholders.

[105] NAT'L A. OF CORP. DIRECTORS, MODEL STATUTE STANDARD OF CONDUCT FOR DIRECTORS, OFFICIAL COMMENTARY (1987), at 3.

[106] *Id.*

[107] Shipman, *Corporate Takeovers: Legislation and Related Developments in Ohio*, OHIO LAW., May-June 1987, at 12.

and its shareholders in determining whether to oppose a hostile offer.[108]

Although the Goodyear amendments were initially sunset provisions which would expire during 1987, Substitute Senate Bill 50 was enacted in February, 1987, removing the sunset provision of H.B. 902 and extending these amendments indefinitely.[109] The Governor and the General Assembly were instrumental in giving Ohio the most avante guard corporate legislation in the country.

VI. PROACTIVE CORPORATE CLIENT COUNSELING

To prevent, or at least lessen the magnitude of a decision like *Van Gorkom*, a variety of preventive measures can be employed by corporate counsel.[110]

A. *Incorporation or Reincorporation*

When assisting your client in chosing one of the fifty states to incorporate, it is necessary to look to the nature of the corporation, the structure of the board of directors and officers as well as its size in the market.

A corporation which has assets in excess of $25 million may seek to incorporate in Delaware, rather than Ohio, due to the speed and expertise of the Delaware court system. In addition, it is clear that the intent of the Delaware legislature is to keep Delaware the number one choice for incorporation by businesses.[111] Thus, Delaware's law takes on the persona of a market-shaped product which is designed to attract incorporation/reincorporation business,[112] thereby presenting fresh, new, and improved packaging for the corporate conscience as new trends develop.

B. *Relations with Insurance Providers*

As corporate D & O insurance premiums escalate, despite becoming more readily available due to increased entrance into the market, the insurance broker becomes a vital ally to the corporate attorney.[113]

The counseling and initial incorporation of a fledgling corporation

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[108] *Id.*

[109] *Id.*

[110] This section is purely the author's viewpoint upon what her proactive approaches to client counseling in the corporate world would entail.

[111] Schaffer, *Delaware's Limit on Director Liability: How the Market for Incorporation Shapes Corporate Law*, 10 HARV. J. ON L. & PUB. POL'Y 665, 675 (Summer 1987).

[112] *Id.*

[113] Scheilba, *A Plague of Lawyers: Being Sued Is Still Corporate Directors' No. 1 Worry*, BARRON'S, Nov. 17, 1986, at 38.

includes the orientation of the client to the legal side of the business world. In most cases, the client is armed with technology and money. The client seeks counsel to handle the "details." A good relationship with at least one corporate insurance broker will enable the client to obtain the best policy available (if the client qualifies).

Discussing all aspects of your client's business with the broker will assist him in designing the appropriate coverage. The client and/or his board should be included in these discussions. The team effort between the broker and the attorney can impress upon the client his obligations under the law and the extent of the coverage needed through his insurance policy.

C. Counseling the Board of Directors

Whether your client is a Fortune 500 company or a "baby" (newly incorporated) corporation, the well-informed board of directors is an invaluable intangible asset. With the increasing difficulty in obtaining directors, a corporate attorney should resist the temptation, if possible, to take a board seat and seek to educate the board as to its options when a vacancy occurs.

Attorneys who act as counsel to the board should seek to be an ex-officio member of the board. This would allow them to sit in on board meetings and gain insight into possible legal complications stemming from the directors' proposed strategies before the action is commenced. Additionally, this allows the attorney to maintain an air of independence from the others.

The Board has many options when a vacant seat appears. Four of the typical options are mentioned here. First, it can choose to reduce the size of the board, thus eliminating the expense for a qualified chair-filler. Second, it can hire an executive search firm to identify qualified candidates. Third, it can seek a member of management to fill the chair. The final option is to find a young, aggressive go-getter who does not have a personal fortune to lose in the event of a liability suit, but rather has something to prove. The final option is the most viable for younger corporations. This could enable corporations to continue to add depth to their boards by adding a youthful perspective to corporate decisions, thus preventing stagnation.

The Board, while considering these candidates, should be reminded to question them as severely as if they were going to be hired for a management position. In addition to assisting with filling vacancies, the attorney should periodically send clippings and guidebooks with the latest legal news that affects the board. Since directors' duty of loyalty and care are always of concern, updates regarding statutory changes also should be sent on a regular basis.

Currently, several publications, such as those produced by the American Bankers Association and the United States League which are designed to help outside directors understand their duties, are key examples of what an attorney should make available to his client. Government publications, like the director's handbook for directors of national banks, which is produced by the Office of the Comptroller of the Currency, are excellent sources of tips and guidelines for board members.[114] The Institute of Chartered Accountants in England and Wales have developed video presentations, slides, and textual materials for instructing boards on how to direct a good company.[115]

Finally, the attorney can be at least one step ahead of litigation if he takes the time to cover each of the following points, which are suggested by the National Association of Corporate Directors, with each member of the board and then the Board as a whole. The points are:

1. Assess your exposure.
2. Attend meetings.
3. Keep up to date on the company.
4. Be inquisitive.
5. Place objections on the record.
6. Be frank with the CEO.[116]

Thus, by assisting the client in keeping his board filled with qualified directors and maintaining a continuing education program, the attorney has prevented lawsuits, unwarranted regulatory agency inquiries, unwarranted board resignations and, above all, has maintained job security.

VII. Conclusion

Proactive client counseling on the part of Jerome Van Gorkom's attorney could have prevented or at least delayed the havoc caused by the Delaware Supreme Court ruling in *Smith v. Van Gorkom,* had the attorney merely used a few techniques such as calling on a friendly investment banker, an accountant, and senior management. If the attorney would have followed these techniques, then the gross negligence theory could have been prevented. If those professionals noted above had given at least a ten-minute presentation at that infamous Saturday night board meeting, there is a high possibility that the Court would have ruled differently.

Proactive client counseling, which is a nonadversarial job, can produce a magnitude of positive results. By keeping boards of directors informed as to the changes in their charged missions, insurance law changes, and current legislation, a new facet of law is recognized—the corporate

114 Fitch, *The Heat is On,* U.S. Banker, June 1985, at 32, 34.
115 Woolf, *The Hazards of Being a Director,* Acct., Nov. 1986, at 81.
116 Mauro, *Staying on a Board and Out of Trouble,* Nation's Bus., May 1986, at 46.

counselor, not the corporate attorney. The mere word "attorney" brings connotations of the adversarial process.

Whether your client is large or small, the effects of litigation, frivolous or not, can be the same: disaster. Maintaining defenses and funding legal teams can drain all of the client's resources, thereby thrusting him into bankruptcy. This method is a profitable short-term way of increasing legal fees but the income from a long-term client relationship will be forgone. It should be noted that this Article does not purport to be conclusive on any point other than the need for proactive corporate counseling.

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