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Limiting Senior Officer Liability – Recent Developments

Recent Vote Outcomes, ISS & Glass Lewis Policy Updates and Other Developments

SUMMARY

In August, Delaware amended its General Corporation Law to permit a corporation to include in its certificate of incorporation a provision to eliminate or limit monetary liability of senior officers¹ for breach of the duty of care. Previously, the DGCL only permitted exculpation of directors from such claims. As a result, after the Delaware Supreme Court held that officers owe the same fiduciary duties as directors in *Gantler v. Stephens* in 2009, there have been a number of high-profile cases against officers involving duty of care claims for which a director would have been exculpated, particularly in connection with M&A transactions.²

The amendment of the DGCL allows exculpation of officers' liability and makes it easier for claims to be dismissed.³ A corporation will lower the cost (and settlement value) of lawsuits that are unlikely to enhance value for the broader shareholder base. In addition, as ISS has noted in its recommendations, officer exculpation arrangements are likely to become commonplace (as they are with directors) and the failure to provide such protections could potentially put a company at a disadvantage in recruiting or retaining executives.

If they want to take advantage of the DGCL amendment, existing Delaware corporations will need to amend their charters to extend exculpation to senior officers, which requires shareholder approval. To date, officer exculpation charter amendments under the DGCL have received very high votes at public companies (88% to 100% of votes cast). Certain private companies have also gone public with charters that include officer exculpation provisions. For issuers considering amending their charter this season, this note outlines some of the relevant considerations.

OFFICER EXCULPATION CONSIDERATIONS

- **What is the scope of the exculpation permitted under the DGCL?** Under Section 102(b)(7), the permitted scope of officer exculpation is more limited than director exculpation. Similar to directors, officers may not be exculpated for breaches of duty of loyalty, acts or omissions not in good faith or involving intentional misconduct or a knowing violation of law and transactions involving the receipt of an improper personal benefit.⁴ Unlike directors, officers may not be exculpated for any action by or in the right of the corporation, including derivative actions by shareholders. (However, most M&A suits take the form of direct class actions given the nature of the cause of action.)
- **What are the key institutional investors' and/or proxy advisors' voting policies?** Companies should review their key institutional shareholders and the proxy advisors used by their shareholder bases. Under ISS's 2023 policy updates,⁵ ISS will make its recommendations on a case-by-case basis. ISS seems to be focused on exculpation for duty of loyalty claims, which is not permitted by the DGCL,⁶ and has recommended in favor of each DGCL-aligned officer exculpation charter amendment voted thus far. In contrast, Glass Lewis's 2023 Policy Guidelines provide that Glass Lewis will generally recommend voting against officer exculpation proposals that eliminate monetary liability for breach of duty of care, unless the board has a "compelling rationale" and the provision is "reasonable."⁷ (Glass Lewis has not provided clarification on what would be a "compelling rationale" or a "reasonable" provision.)⁸ BlackRock, State Street and Vanguard have not yet released their 2023 voting policies.
- **What is the voting standard for the officer exculpation charter amendment, and will the company be likely to have a large number of broker non-votes?** Most Delaware corporations' voting standards for amending their charters align with the default rule under Section 242 of DGCL, which requires a majority of the outstanding stock entitled to vote on the amendment. (Some companies have adopted higher standards, such as 2/3 or 75% of the outstanding stock.) Because abstentions have the same effect as "against" votes under voting standards denominated in a company's outstanding stock, some companies have recently failed to obtain a passing vote on their officer exculpation charter amendments despite the amendments receiving high support among the votes cast. In each case, there was a high number of broker non-votes or shares not present at the meeting. Companies should check the historical level of broker non-votes and shareholder presence at meetings, which may not meaningfully impact the outcome of precatory shareholder proposals or routine management proposals, but could be outcome determinative for a charter amendment.
- **Does the company have a multi-class ownership structure?** Recent shareholder lawsuits have focused on the procedures companies with a non-voting stock class have used when adopting the officer exculpation charter amendment.⁹ In particular, plaintiffs allege that Section 242(b)(2) of the DGCL requires such charter amendment to be approved by each class, including any non-voting stock class. Companies with similar arrangements should pay particular attention to further legal developments on this topic.
- **Does the company's proxy timeline permit the filing of a preliminary proxy statement?** If a company decides to put an officer exculpation proposal to a shareholder vote at its upcoming shareholder meeting, the company will need to file a preliminary proxy statement for SEC review at least 10 days prior to distributing the definitive proxy statement to shareholders.

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ENDNOTES

- ¹ 10 Del. C. § 3114(b). The only officers that may be exculpated under Section 102(b)(7) are certain C-suite members, named executive officers and individuals who have consented to be identified as officers of the corporation. Covered C-suite members include the corporation's president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer or chief accounting officer. Covered named executive officers are those identified in the corporation's public filings with the SEC as one of the most highly compensated executive officers.
- ² *E.g., Morrison v. Berry*, C.A. No. 12808-VCG (Del. Ch. Dec. 31, 2019) (dismissing breach of fiduciary duty claims against directors but allowing duty of care claims against the CEO and general counsel to proceed); *In re Mindbody, Inc., Stockholders Litigation*, C.A. No. 2019-0442-KSJM (Del. Ch. Oct. 2, 2020) (declining to dismiss duty of care claims against the CFO in the absence of officer exculpation); *In re Baker Hughes Inc. Merger Litigation*, C.A. No. 2016-0638-AGB (Del. Ch. Oct. 27, 2020) (declining to dismiss the duty of care claim against the CEO/chairman in his capacity as the CEO).
- ³ See *In re Cornerstone Therapeutics Inc. Stockholder Litigation*, 115 A.3d 1173 (2015). The Delaware Supreme Court held that, regardless of the underlying standard of review for a transaction, plaintiffs must plead a non-exculpated breach of fiduciary duty claim against an independent director protected by an exculpatory charter provision, or the director is entitled to be dismissed from the litigation.
- ⁴ 8 Del. C. § 102(b)(7).
- ⁵ Effective for meetings on or after February 1, 2023.
- ⁶ In particular, ISS focused on Nevada law, which permits exculpation in connection with a breach of the duty of loyalty.
- ⁷ Effective for meetings on or after January 1, 2023.
- ⁸ Companies may have conducted a similar assessment of their shareholder bases' alignment with ISS versus Glass Lewis policies if they considered the adoption of federal exclusive forum bylaws after ISS and Glass Lewis adopted conflicting policies on federal exclusive forum bylaws in 2020, after the Delaware Supreme Court upheld such provisions in *Salzberg v. Sciabacucchi*, No. 346, 2019 (Del. Mar. 18, 2020).
- ⁹ *Electrical Workers Pension Fund, Local 103, I.B.E.W. v. Fox Corp.*, C.A. No. 2022-1007, compl. (Del. Ch. Nov. 4, 2022); *Karen Sbroglio v. Snap, Inc.*, C.A. No. 2022-1032, compl. (Del. Ch. Nov. 16, 2022); *Sherrie Dembrowski v. Snap, Inc.*, C.A. No. 2022-1042, compl. (Del. Ch. Nov. 17, 2022).

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