The Influence of *Smith V. Van Gorkom* on Director's and Officer's Liability

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ABSTRACT

Smith v. *Van Gorkom* was decided in the Supreme Court of Delaware in 1985 and shortly thereafter began to receive considerable attention in legal and business communities and in journals of scholarship. The claim has been made that the case was a landmark decision which will cause nominees to refuse to serve on corporate boards, increase the difficulty of obtaining Director's and Officer's Liability (D&O) insurance, and provide a boon for investment bankers and outside consultants. This article provides a brief overview of the facts in the case and discusses the Court of Chancery and Delaware Supreme Court decisions, and the theory of liability which is central to the case. The effects which some commentators predicted would result from the decision are analyzed, and some of these conjectures are disputed. A positive result of the *Van Gorkom* case - the enactment of Section 102(b)(7) of the Delaware Code and similar state statutes - is identified. The *Van Gorkom* decision will have an impact primarily because it inspired the enactment of state statutes which limit director's liability.

Facts Leading up to Litigation

Trans Union Corporation was a publicly-traded, diversified holding company, the principal earnings of which were generated by its railcar leasing business. Trans Union enjoyed a cash flow of hundreds of millions of dollars annually, but had difficulty in generating sufficient taxable income to offset increasingly large investment tax credits (ITCs).

On August 27, 1980, Trans Union's Chairman, Jerome W. Van Gorkom, met with the company's senior management to discuss various solutions to the ITC problem. One solution suggested was a leveraged buy-out (LBO). A preliminary report indicated that a price of $50 to $60 per share would be needed to effect the LBO. However, this report did not purport to establish a fair price either for the company or for the stockholders. At this meeting, Van

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Gorkom vetoed the idea of an LBO, because it involved, in his opinion, a potential conflict of interest for management.

On September 13, 1980, Van Gorkom met with a potential buyer, Jay Pritzker, the Chairman of Marmon Group, Inc. to discuss a proposed per share price for the sale of Trans Union and a financing structure by which to accomplish the sale. Although the price of Trans Union's stock had fluctuated between 29-1/2 and 38-1/4 over the prior eight months, Van Gorkom discussed a proposed price of $55 per share. Pritzker did not make a proposal at this meeting.

Five days later, Pritzker again met with Van Gorkom. It was proposed that the number of treasury shares to be offered to Pritzker would be one million, and Pritzker insisted that the Trans Union board act on his merger proposal within three days (two days of which were weekend days).

The next day, September 19, Van Gorkom called a manager's meeting and a special meeting of the board. Management's reaction was negative, because they had the results of a new report which suggested a fair value between $55 and $65 per share. Nevertheless, Van Gorkom proceeded with the board meeting. The meeting opened with an oral presentation by Van Gorkom, but copies of the proposed merger agreement were delivered too late for study during the meeting.

In his presentation, Van Gorkom outlined the terms of the Pritzker offer, which included, 1) the offer had to be acted upon within 24 hours of the board meeting; 2) Trans Union could furnish only published information and not proprietary information to competing bidders; 3) the offer was subject to Pritzker obtaining the necessary financing by October 10, 1980; 4) if the financing contingency was met or waived by Pritzker, Trans Union was required to sell Pritzker one million newly-issued shared of Trans Union stock at $38 per share; 5) Pritzker would pay $55 in cash for all outstanding shares of Trans Union stock at which time Trans Union would be merged into a new corporation; and 6) for a period of 90 days after acceptance of the Pritzker offer, Trans Union could receive, but could not actively solicit, competing offers. An outside attorney hired by Van Gorkom advised the members of the board that they might be subject to suit if they failed to accept Pritzker's offer and that a fairness opinion was not required as a matter of law. Based upon this oral information and without seeing the proposed agreement in writing, the board approved the merger. The meeting lasted approximately two hours.

Three days later, on September 22, 1980, a press release was issued by Trans Union announcing that the company had entered into a merger agreement with an affiliate of the Marmon Group, Inc. Subsequently, several key officers threatened to resign. These threats resulted in several modifications to the proposed agreement. On October 8, 1980, Van Gorkom again met with the board to gain approval of these modifications. The board voted to authorize the modifications without seeing them in writing. The written modifications were received by Van Gorkom on October 10, 1980.

Trans Union issued a press release the next day indicating that Pritzker had obtained the financing necessary to consummate the merger, and Trans Union now was permitted to seek other offers. Only one suitor, a subsidiary of General Electric, came forward during the search for alternatives to the Pritzker offer, and it later terminated discussions.

On December 19, 1980, a class action was brought by shareholders of Trans Union Corporation seeking rescission of the proposed merger of the corporation into a new corporation. Alternate relief in the form of damages was sought against members of the board of directors, the new corporation, and the owners of the parent of the new corporation.

On January 21, 1981, the Proxy Statement for the February 10, 1981 shareholders meeting was mailed to shareholders. It contained no information regarding the proposed merger agreement with Pritzker. Subsequently, Trans Union's board met on January 26, 1981, and voted to proceed with the Pritzker proposal. A supplement setting forth information regarding the merger proposal was mailed to shareholders on or about January 27, 1981. At their February 10 meeting, the shareholders approved the Pritzker merger proposal. The vote was 69.9 percent in favor of the merger, 7.25 percent against, and 22.85 percent not voting.

The Trial Court

In July 1982, at a trial on the shareholders' class action suit, the Court of Chancery granted judgment for the directors by unreported letter opinion based on two findings: (1) that the Board of Directors had acted in an informed manner and was entitled to the protection of the Delaware business judgment rule in approving the proposed merger; and (2) that the shareholder vote approving the merger should not be set aside, because the stockholders had been "fairly informed" by the Board of Directors before the vote. The shareholder- plaintiffs appealed.

On appeal by shareholders, the Delaware Supreme Court in January, 1985 reversed the Court of Chancery's decision, with two justices dissenting. The Supreme Court held that the business judgment rule did not afford the directors protection and held them personally liable under a theory of gross negligence. The case was remanded to the lower court for a determination of the damages, i.e. the difference between the fair market value of the shares and $55 per share. Upon remand, the final determination was found to be $33.5 million, $10.0 million of which was covered by insurance. The remaining $23.5 million was assessed against the directors.

The Supreme Court offered several interesting legal conclusions in its decision. They found (1) that the board failed to obtain all material information before making its decision, relying instead on Van Gorkom's oral presentation; (2) that the board reached its decision to accept the Pritzker proposal without the benefit of "reports" for valuation purposes, as defined in Section 141(e) of the Delaware code; (3) that the board placed itself in a position whereby it could not renege on the Pritzker offer; and (4) that the directors failed to adequately inform shareholders of the merger prior to the annual meeting.

The thrust of the *Van Gorkom* decision is that inherent in the relationship between shareholders and directors is the assumption that the decisionmaking process will be an informed one. The directors specifically failed to be informed both by not seeing the merger proposal in writing prior to approval and by basing their decision on inappropriate reports. The court emphasized that the board reached its September 20 decision primarily on Van Gorkom's representations since none of the directors had any previous knowledge of the merger proposal. In addition, the court concluded that the board acted in a grossly negligent manner in approving amendments to an agreement which had not even been drafted when these amendments had the effect of further locking Trans Union into the Pritzker offer. The decision thus establishes that the directors failed to meet a necessary minimum standard of information gathering prior to their decision.

The Meaning of *Smith* v. *Van Gorkom*

Smith v. *Van Gorkom* has received attention in the literature of corporate law, by authors who attempted to predict its effects. Macey (1988), Miller (1988) and Hetzel (1986) argued that the decision effectively had created new Delaware law. Others (e.g., Maher, 1987; Roper, 1986) believed that the decision would cause nominees and directors to be unwilling to serve on corporate boards, result in increased unavailability of D&O insurance, and constitute a financial boon for investment bankers. The current authors believe these arguments do not appear to be well founded.

The *Van Gorkom* case is important because it holds that the board's decision to recommend the merger was not the product of informed business judgment. Although the decision appears to be the first case turning "solely on the basis of the board's decision making processes," it is actually a clarification of the existing due care requirement rather than an erosion of the rule's protection. The court found the board's action was taken without advance notice, without adequate consideration, without supporting staff work, without adequate valuation information, and without a complete understanding of the terms of the merger agreement. As a result, the directors were denied the protection of the business judgment rule. The court focused on how the directors, and particularly Van Gorkom, arrived at the $55 per share figure. Presumably, the $55 amount would not have been questioned had the directors made a reasonably proper business judgment as to the adequacy of the $55 offer. Since *Van Gorkom* essentially is a takeover case, the court's function is to monitor the target's response to certain types of takeover bids, namely "rush" offers with short time fuses. Seen in this light, the decision fits easily with other recent Delaware decisions.

Van Gorkom remains a coherent explanation of a long-existing, fundamental safeguard for corporate management. It is neither a departure from previous business judgment rule holdings nor a harbinger of judicial activism in the corporate sphere. Significantly, the dissenting justices in *Van Gorkom* do not contend the court misstated the law, rather they argue that the record did not support a finding of gross negligence. Thus it is an error to suggest that *Van Gorkom* is a radical decision or represents a significant change in Delaware law. *Van Gorkom* simply reaffirms and applies the well known legal principles of the need for informed business judgments.

Statutory Support

The *Van Gorkom* decision is consistent with the Delaware code. Section 251(b) addresses the requirements placed upon boards considering a merger. It provides that the board of directors of each corporation shall adopt a resolution approving an agreement of merger. Terms of the agreement of merger may be made dependent upon facts ascertainable outside of the agreement, provided that the manner in which such facts shall affect the terms of the agreement is clearly and expressly set forth in the agreement of merger. This section is relevant to *Van Gorkom* because the court found that the Trans Union directors did not disclose all material information in the merger agreement submitted to shareholders, specifically the lack of a financial basis for the $55 per share price offer.

Section 251(c) provides that an agreement required by subsection (b) shall be submitted to the stockholders of each corporation at an annual or special meeting for the purpose of acting on the agreement. Due notice of the time, place and purpose of the meeting shall be mailed to each holder of stock at least 20 days prior to the date of the meeting. The Trans Union board did not meet this requirement, since it sent the information on or about January 27, 1981, and the annual meeting was held February 10, 1981.

Section 141(e) provides that a member of the board of directors shall be fully protected in relying in good faith upon the books of accounts or reports made to the corporation by any of its officers, or by an independent certified accountant, or by an appraiser selected with reasonable care by the board of directors, or in relying in good faith upon other records of the corporation. However, the court deemed that there was no evidence that any report as defined under this section was presented to the Trans Union Board on September 20.

Thus it appears that the decision in *Van Gorkom* is consistent with the existing Delaware statutes. It is clear that the *Van Gorkom* case does not, as some commentators argue, make new Delaware law. Some other effects which have been predicted in the literature will be discussed now.

Directors Will not Serve on Corporate Boards

The most disturbing predicted consequence of the *Van Gorkom* decision is that competent persons will be deterred from serving on boards because of increased judicial scrutiny. It is feared that if a knowledgeable director makes an arguably sound business decision, but not within the minimum time and deliberations requirements, then that director can be found grossly negligent. This can result in a reduction in the number of qualified individuals willing to accept director positions because of a fear of being held personally liable for an otherwise sound business judgment.

Commentators have predicted dire consequences as directors come to realize how exposed they have become. However, these consequences seem to have been overstated.

Korn/Ferry International's 1987 survey (based on 1986 information) indicated that 22 percent of the responding companies had board candidates decline board service. Of these respondents, 14.2 percent indicated increased legal liability as the reason for declination (legal liability was cited by only 2.5 percent of respondents in the previous year). This was offered as a rationale to explain why nominees refused to serve. However, according to the 1988 Korn/Ferry survey, the issue of increased liability was given as a reason for declining to serve by only 2.7 percent of the candidates (Korn/Ferry International, 1988). The 1988 survey indicates that one explanation of this result may be that 71 percent of the respondents had taken advantage of new state laws limiting liability for directors (Korn/Ferry International, 1988).

Consistent with the Korn/Ferry finding is the fact that *Van Gorkom* does not furnish an automatic basis for director liability when an uninformed business decision is made. Rather, a finding of an uninformed judgment only deprives the directors of the presumption of the business judgment rule. The complaining stockholder must still carry the burden of proof by demonstrating gross negligence by the directors. Courts in post-*Van Gorkom* cases continue to shield directors by enjoining improper transactions rather than holding individual directors personally liable.

The author of a 1987 *Management Review* article disagrees that directors were leaving boards as a result of the *Van Gorkom* decision. He reports that directors were not leaving in large numbers and cites statistics to show that two-thirds of large public companies elected no new directors and only 12 percent added more than one new board member in 1986.

Director's & Officer's Insurance Unavailable

A 1985 Dallas Chartered Property Casualty Underwriter Chapter study noted that the increasing frequency of lawsuits against directors and officers, along with an apparent increase in both the number and the size of settlements, was beginning to have an impact upon the cost and availability of D&O insurance. In its 1984 survey, the Wyatt Company, which gathers annual survey data regarding D&O liability, insurance and claims, reported that 32 insurers offered D&O insurance. However, in its 1985 supplementary survey, Wyatt reported that 15.6 percent of these companies were no longer offering D&O insurance to new accounts. These insurers represented 11.9 percent of the primary market and 19.7 percent of the excess market for D&O insurance. (The Wyatt Company, 1985)

Some have argued that *Van Gorkom* was the catalyst for the increased unavailability of D&O insurance during the mid-1980s. Cited as proof of this conjecture was the fact that D&O insurance premiums increased more that 900 percent following the *Van Gorkom* decision. More specifically, premiums increased by 191 percent in the quarter of the decision (The Wyatt Company, 1987). It was believed that premiums skyrocketed when insurers realized directors could be held personally liable even when a corporation is sold at a huge profit (*Wall Street Journal*, 1986). However, these charges regarding *Van Gorkom* have not been sustained. In fact, the D&O insurance market availability problem was established prior to the *Van Gorkom* decision.

Premium rates for D&O insurance had soared within the six months prior to the *Van Gorkom* decision, and the availability of D&O insurance had been curtailed as insurers dropped out of the field and policies were cancelled. This timing is documented in a special report published in 1985 by The Wyatt Company which chronicles the decline of the market.

In the second quarter of 1984, the market experienced modest adjustment consisting of fairly moderate premium increases coupled with slightly higher corporate deductibles. In the third quarter of 1984, there was a modest tightening of the market with increased premiums and increased corporate deductibles. During the fourth quarter of 1984, the market adjustment was more significant with increased premiums and corporate deductibles, but there still was no real impact on availability or capacity. A dramatic change in premium and deductible increases (i.e., the average increase was approximately 200 percent for premiums and 300 percent for corporate deductibles) occurred in the first quarter of 1985. In the second quarter of 1985, increases seemed to have peaked, but there was a major change in availability of insurance and coverage limits (The Wyatt Company, 1985).

Furthermore, a Wyatt Company representative (Ronald Boggs) indicates that Wyatt does not know of any response in the market to *Van Gorkom*. The company's perspective is that the worsened market was self-generated. In this regard, the market was said to be responding to excessive premium reductions just prior to 1984-85 and was making a major move to correct itself.

It is well-known that most first quarter D&O insurance policies renew on January 1st. The reinsurance which insurers purchase to back up their policy limits is negotiated by the end of the prior quarter. Consequently, the true catalyst(s) for the D&O insurance market downslide – an increase in the frequency of lawsuits coupled with excessive premium reductions – already had occurred prior to the January 25, 1985 *Van Gorkom* decision.

A Boon for Investment Bankers

Another effect of *Van Gorkom* was thought to be a greater reliance on formalism and the need to secure more outside reports for use by board members. Formalism and outside reports generate significant costs in the form of fees for investment bankers and other outside experts. The *Van Gorkom* standard that requires directors to obtain all reasonably available information may also compel directors to retain, at a considerable cost, investment bankers to assist them with important business decisions accompanying fundamental changes in corporate control. No firm considering a fundamental corporate change will do so without obtaining a fairness letter or other similar documentation from outside consultants. Indeed, these outside consultants may be the biggest winners after *Van Gorkom*. The decision requires their participation as a type of insurance no matter how reliable their opinion may be or how much it will cost.

These conjectures, that the *Van Gorkom* court decision would be a boon for investment bankers, ignore the explicit language of the court's opinion. In this regard, the court stated:

> "We *do not apply* that an outside valuation study is essential to supporting an informed business judgment; nor do we state that fairness opinions by independent investment bankers are required as a matter of law. Often insiders familiar with the business of a going concern are in a better position than are outsiders to gather relevant information; and under appropriate circumstances, such directors may be fully protected in relying in good faith upon the valuation report of their management."

This language makes it clear that the nature of the board's information, not its source, is the determinative factor in deciding whether reliance is justified.

It is extremely unlikely that *Van Gorkom* will ever be applied outside the takeover context, because doing so would not serve its purposes, which are unique to that context. Even in takeover cases, it is unlikely that future boards will be held liable for rejecting or accepting takeover bids even when the level of deliberation might be questioned under a literal reading of *Van Gorkom*. As the bar and corporate boards begin to understand these facts, the amounts spent on protective legal and investment banker opinions can become more manageable.

Subsequent State Statute Enactment

While many of the predicted effects of the *Van Gorkom* decision have not occurred, the decision does appear to have brought about one very positive statutory effect on directors' liability. New state statutes have been enacted which limit or eliminate the liability of directors and/or officers. In 1986, the Delaware General Assembly responded to directors' fears of personal liability by adding provision 102(b)(7) to the Delaware corporate code. This provision permits a corporation, by shareholder vote, to amend its certificate of incorporation to limit or eliminate directors' liability for breach of the fiduciary duty of care. It is generally accepted that section 102(b)(7) was passed in direct response to *Van Gorkom*. The section was intended to allow shareholders to eliminate or limit the liability for violations of a director's duty of care and the provision applies only to directors, not to officers. It does not limit the availability of injunctive relief for breach of any fiduciary duty.

In addition to Delaware, other states have made similar responses. State legislatures have sought to provide substitute protection for directors by permitting a corporations to offer immunity or indemnification provisions. Forty-three states had acted before the end of 1990. Most of the new statutes are based on the Delaware law to some degree, but each has unique features. An outline of many of the state statutes and amendments are found in Table 1.

The statutes and amendments generally take one of two forms - providing relief from civil liability or broadening the range of corporate indemnification and liberalizing the types of insurance arrangements which may be used to provide financial protection to corporate managers. Although these statutes seek to provide additional protection to directors, some have the effect of limiting this protection by excluding certain types of acts from coverage under the statute. Some of the basic exclusions are criminal violations, acts resulting in personal benefit, corporate statutory violations, acts arising out of malicious intent, and acts involving conscious disregard for the interest of the corporation.

Some believe that the effect of the Delaware amendment will be to lessen the protection of shareholder interests and eliminate the likelihood of future decisions similar to *Van Gorkom*. Others believe that widespread enactment of Section 102(b)(7)-type provisions and a corresponding adoption of indemnity provisions by corporations could remove the need to secure costly indemnity insurance.

Summary and Conclusion

The authors review the *Van Gorkom* decision and the plethora of conjectures and predictions about its effect on directors' liability. Several of the prominent conjectures have been disputed. Thus, the *Van Gorkom* decision is minimized. Unfounded conjectures of new law being created, directors refusing to serve on corporate boards, unavailable D&O insurance, and a boon for investment bankers brought about much of the unwarranted attention. However, state statutes (e.g., Section 102(b)(7) in Delaware) limiting or eliminating director liability appear to have been the direct result of the *Van Gorkom* decision. These statutes are the primary effects of the *Van Gorkom* decision.

Table 1

State Statutes

State	Date Enacted	Coers Directors(D) Officers (O)	Important Features
Delaware	7/1/86	D	First Statute; requires charter amendment
Massachusetts	12/24/86	D	Identical to Delaware
Indiana	1986	D	One of most comprehensive statutes; narrows the standard of conduct for which a director may be held liable
Ohio	11/22/86	D	Requires evidence of deliberate intent to cause injury to corporation
Pennsylvania	1/27/87	D	Eliminates v. limits liability; requires shareholder by-law amendment
Wisconsin	6/13/87	D&O	One of most comprehensive statutes; requires indemnification of directors and officers; company may limit the scope in articles of incorporation
New York	1987	D	Requires indemnification if director is successful in law-suit; requires adoption by corporation
N. Carolina	10/1/87	D	Includes third party actions; requires corporate adoption
Virginia	2/87	D&O	Self-enacting; caps director's and officer's liability
New Jersey	2/4/87	D&O	Does not exclude "international misconduct"; allows purchase of insurance from captive
Florida	7/1/87	D	Eliminates personal liability of director for monetary damages to corporation or any other person for statement, vote, decision or failure to act
Nevada	1987	D&O	Does not specifically exclude receipt of an improper personal benefit
California	9/27/87	D&O	Expands indemnification; similar to Delaware law; requires amendment to Articles of Incorporation
Arkansas	1987	D&O	Expands indemnification; similar to Delaware law; not self-enacting
Tennessee	1986	D&O	Expands indemnification; similar to Delaware law; not self-enacting
S. Dakota	1987	D	Similar to Delaware law; not self-enacting

Source:Bailey, Dan A. and William E. Knepper, 1990

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