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Frances S. Fendler

University of Arkansas at Little Rock William H. Bowen School of Law, fsfendler@ualr.edu

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DIRECTOR-EXCULPATION CLAUSES UNDER THE
ARKANSAS BUSINESS CORPORATION ACT OF 1987

*Frances Fendler Rosenzweig**

In the early 1980s, at the height of the merger and acquisition activity of those rambunctious times, corporate America was faced with a special type of insurance crisis. Insurers, reacting to the increased litigation associated with corporate takeover activity, simply quit selling liability insurance for officers and directors, reduced the scope of coverage, or significantly raised their premiums and deductibles.¹ Then, in 1985, the Delaware Supreme Court—the most influential corporate law court—dropped a bombshell. In *Smith v. Van Gorkom*,² the court held that well-respected, prominent outside directors of Trans Union were personally liable for “gross negligence” for

* Associate Professor, University of Arkansas at Little Rock School of Law. B.A. 1979, J.D. 1982, University of Arkansas at Little Rock.

1. E.g., James J. Hanks, Jr. & Larry P. Scriggins, *Let Stockholders Decide: The Origins of the Maryland Director and Officer Liability Statute of 1988*, 18 U. BALT. L. REV. 235, 235-37 (1989); Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection From Liability*, 12 DEL. J. CORP. L. 25, 82-83 (1987); E. Norman Veasey et al., *Delaware Supports Directors With a Three-Legged Stool of Limited Liability, Indemnification and Insurance*, 42 BUS. LAW. 399, 400-01 (1987).

2. 488 A.2d 858 (Del. 1985).

approving a merger at what may have been an inadequate price.³ Spurred by predictions that Delaware corporations would no longer be able to attract qualified directors, the Delaware legislature quickly responded by passing an amendment to its Corporation Code.⁴ Under that amendment, Delaware corporations were permitted to adopt a director-exculpation clause — a charter clause that would limit or eliminate the personal liability of corporate directors in cases like *Smith v. Van Gorkom*.⁵

Arkansas, like many other states, followed Delaware's lead to try to stem the tide of director liability suits.⁶ The 1987 Arkansas Business Corporation Act (1987 Act), while largely modelled on the 1986 version of the American Bar Association's Revised Model Business Corporation Act ("RMBCA"), incorporated the Delaware approach authorizing optional director-exculpation clauses in articles of incorporation

3. The Delaware court held that the Trans Union directors had breached their fiduciary duties by approving, upon a mere two hours consideration, a cash-out merger without adequately informing themselves about the intrinsic value of the company or about the controlling director's role in forcing the sale and establishing the price. *Id.* at 874.

4. See Official Synopsis & Commentary to DEL. CODE ANN. tit. 8, § 102(b)(7), reprinted in 1 E. FOLK ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 102.15 (3d ed. 1992); R. Franklin Balotti & Mark J. Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 6-11 (1987); Harvey Gelb, *Director Due Care Liability: An Assessment of the New Statutes*, 61 TEMP. L. REV. 13, 23-24 (1988); Pease, *supra* note 1, at 90.

5. The Delaware statute provides, in pertinent part:

(b) [T]he certificate of incorporation may . . . contain any or all of the following matters . . .

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under section 174 of this title [Liability of Directors for Unlawful Payment of Dividend or Unlawful Stock Purchase or Redemption]; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective.

DEL. CODE ANN. tit. 8, § 102(b)(7) (1991).

6. For discussions of legislative responses by other states, see, e.g., Gelb, *supra* note 4, at 28-46; James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988); Marc I. Steinberg, *The Evisceration of the Duty of Care*, 42 SW. L.J. 919 (1988); Jeffrey P. Weiss, *The Effect of Director Liability Statutes on Corporate Law and Policy*, 14 J. CORP. L. 637 (1989).

filed under the 1987 Act.⁷ This article will analyze the Arkansas provision, describing the scope of the protection afforded corporate directors in light of other Arkansas and federal law.

I. BACKGROUND — FIDUCIARY DUTIES AND THE BUSINESS JUDGMENT RULE

In Arkansas, as in other states, corporate directors are fiduciaries.⁸ As the Supreme Court of New York so elegantly put it over fifty years ago,

It is clear that a director owes loyalty and allegiance to the company—a loyalty that is undivided and an allegiance that is influenced in action by no consideration other than the welfare of the corporation. Any adverse interest of a director will be subjected to a scrutiny rigid and uncompromising. He may not profit at the expense of his corporation and in conflict with its rights; he may not for personal gain divert unto himself the opportunities which in equity and fairness belong to his corporation. He is required to use his independent judgment. In the discharge of his duties a director must, of course, act honestly and in good faith, but that is not enough. He must also exercise some degree of skill and prudence and diligence.⁹

7. The 1987 Arkansas Business Corporation Act was the product of efforts by Arkansas business leaders who believed that Arkansas corporations, to function effectively, needed the ability to protect their directors from potential liabilities of the sort imposed in *Smith v. Van Gorkom*. In addition, these leaders believed that Arkansas' existing corporation act was too restrictive and cumbersome and made it difficult for Arkansas corporations to take advantage of modern techniques of corporate finance and corporate structuring. Accordingly, the Rose Law Firm of Little Rock was retained to draft a new corporation act, and this draft eventually became the 1987 Act. Interviews with David Knight, Esq., Rose Law Firm partner in charge of the drafting effort, Little Rock, Arkansas (1986-87).

Ironically, if the business leaders had not moved so promptly, they might have been able to persuade the Arkansas legislature to enact markedly broader protections for corporate directors. On June 16, 1990, the American Bar Association's Committee on Corporate Laws amended section 2.02 of the Revised Model Business Corporation Act to include an optional director-exculpation charter clause as RMBCA § 2.02(b)(4). 46 BUS. LAW. 319 (1990). The Revised Model Act provision is more far-reaching than the Delaware/Arkansas provision. It permits a corporation to include in its articles:

a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which he is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33 [concerning directors' liability for unlawful distributions]; or (D) an intentional violation of criminal law.

See 1 MODEL BUSINESS CORP. ACT ANNOTATED § 2.02 (3d ed. 1990) [hereinafter MBCA ANN.].

8. See, e.g., *Hall v. Staha*, 303 Ark. 673, 681, 800 S.W.2d 396, 401 (1990).

9. *Litwin v. Allen*, 25 N.Y.S.2d 667, 677-78 (Sup. Ct. 1940).

The fiduciary duty of a director is comprised of at least two broad "sub-duties": the duty of care and the duty of loyalty. In Arkansas, it has long been held that a director has a duty to exercise reasonable care in discharging his duties of managing, or overseeing the management of, the corporation.¹⁰ A director also has a duty to act in good faith for the benefit of the corporation, a duty which, in certain circumstances, includes the duty to place the corporation's interests above his own selfish interests.¹¹

The 1987 Arkansas Business Corporation Act contains several provisions relating to the fiduciary duties owed by directors. Section 4-27-830 sets out the general standard applicable to directors and provides that if that standard is met, the director is free from liability:

A. A director shall discharge his duties as a director, including his duties as a member of a committee:

1. In good faith;
2. With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
3. In a manner he reasonably believes to be in the best interests of the corporation.

....

D. A director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section.¹²

The primary thrust of this statute is the duty of care. Other provisions of the Act govern conflict of interest transactions (a transaction with the corporation in which a director has an interest),¹³ loans to directors,¹⁴ and liability for unlawful distributions.¹⁵ All of these provisions are copied from the Revised Model Business Corporation Act version in effect in 1986.¹⁶

10. *E.g.*, *Johnson v. Coleman*, 179 Ark. 1087, 1094, 20 S.W.2d 186, 188 (1929); *Sternberg v. Blaine*, 179 Ark. 448, 452, 17 S.W.2d 286, 288 (1929).

11. *See generally* Susan Webber [now United States District Judge Susan Webber Wright], *Arkansas Corporate Fiduciary Standards — Interested Directors' Contracts and the Doctrine of Corporate Opportunity*, 5 U. ARK. LITTLE ROCK L.J. 39 (1982).

12. ARK. CODE ANN. § 4-27-830 (Michie 1991). *See generally* 2 MBCA ANN. § 8.30 (Official Comment).

13. ARK. CODE ANN. § 4-27-831 (Michie 1991).

14. *Id.* at § 4-27-832.

15. *Id.* at § 4-27-833.

16. The drafters of the RMBCA have since replaced the provisions on director conflict of interest transactions and loans to directors in the RMBCA with a new subchapter F comprised of new section numbers 8.60 through 8.63.

What of a director who fails to comply with the statutory duty? The 1987 Arkansas Act, like the Revised Model Business Corporation Act, does not purport to codify the business judgment rule, which operates to protect directors against suits alleging breach of the duty of care.¹⁷ In 1990, the Arkansas Supreme Court held that the business judgment rule is the law in Arkansas.¹⁸ Quoting at length from a decision of the Ohio Supreme Court, the Arkansas Supreme Court said,

The business judgment rule is a principle of corporate governance that has been a part of the common law for at least one hundred and fifty years. It has traditionally operated as a shield to protect directors from liability for their decisions. If the directors are entitled to the protection of the rule, then the courts should not interfere with or second-guess their decisions. If the directors are not entitled to the protection of the rule, then the courts scrutinize the decision as to its intrinsic fairness to the corporation and the corporation's minority shareholders. The rule is a rebuttable presumption that directors are better equipped than the courts to make business judgments and that the directors acted without self-dealing or personal interest and exercised reasonable diligence and acted with good faith.¹⁹

The Arkansas court went on to elaborate:

Two elements must be satisfied in order for the rule to be invoked. First, its protections can only be claimed by disinterested directors whose conduct otherwise meets the tests of business judgment. Second, to invoke the rule's protection, directors have a duty to inform themselves of all material information reasonably available to them prior to making a business decision. Having become so informed, they must then act with requisite care in discharge of their duties.²⁰

It is against this background of a statutorily articulated duty of

17. The Official Comment to RMBCA § 8.30 explains:

Even before statutory formulations of directors' duty of care, courts sometimes invoked the business judgment rule in determining whether to impose liability in a particular case. In doing so, courts have sometimes used language similar to the standards set forth in section 8.30(a). The elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts. In view of that continuing judicial development, section 8.30 does not try to codify the business judgment rule or to delineate the differences, if any, between that rule and the standards of director conduct set forth in this section. That is a task left to the courts and possibly to later revisions of this Model Act.

2 MBCA ANN. § 8.30 (Official Comment).

18. Hall v. Staha, 303 Ark. 673, 678, 800 S.W.2d 396, 399 (1990).

19. *Id.* (quoting Gries Sports v. Cleveland Browns Football, 496 N.E.2d 959 (Ohio 1986)).

20. *Id.* (citing Aronson v. Lewis, 473 A.2d 805 (Del. 1984)).

care, a duty of loyalty partly articulated by statute and largely delineated by case law, and the business judgment rule that section 4-27-202(B)(3) of the *Arkansas Code Annotated* must be analyzed. Section 4-27-202(B)(3) is a near-verbatim copy of title 8, section 102(b)(7) of the *Delaware Code Annotated*.²¹ This statute authorizes a corporation by optional charter provision to limit or eliminate the personal liability of directors to shareholders for certain kinds of breaches of fiduciary duty. This provision reads, in full:

§ 4-27-202. ARTICLES OF INCORPORATION.

....

B. The articles of incorporation may set forth:

....

3. A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director:

(i) For any breach of the director's duty of loyalty to the corporation or its stockholders;

(ii) For acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;

(iii) Under § 4-27-833 of this chapter [concerning directors' liability for unlawful distributions];

(iv) For any transaction from which the director derived an improper personal benefit; or

(v) For any action, omission, transaction, or breach of a director's duty creating any third-party liability to any person or entity other than the corporation or stockholder.

No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this subsection to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock.²²

The effect of a charter provision adopted under the authority of this statute²³ is to abridge, to some degree, a director's liability for failure

21. DEL. CODE ANN. tit. 8, § 102(b)(7) (1991).

22. ARK. CODE ANN. § 4-27-202 (Michie 1991).

23. Such a charter provision might simply track the statute, for example, "A director of the corporation shall not be liable to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director except that this provision shall not eliminate or limit the liability of a director for" Alternatively, a charter provision might be cast in general terms,

to meet the standard of care prescribed in section 4-27-830.

Director-exculpation clauses have become common in the charters of American corporations generally²⁴ and are likely to become common in the charters of Arkansas corporations. A director-exculpation clause, however, provides only limited relief for directors beyond the protection already afforded by the business judgment rule. The statute is drafted in such a way that the scope of permitted exculpation is relatively narrow, confined to breaches of the duty of care untainted by self-dealing or bad faith. In most cases, the effect of the clause will be simply to relieve directors of liability for negligently failing to inform themselves adequately before making decisions, and for abdication of the duty to keep themselves informed about corporate affairs and to carry out their duties of oversight.

II. ANALYSIS OF THE PERMISSIBLE SCOPE OF AN OPTIONAL DIRECTOR-EXCULPATION CLAUSE

On its face, section 4-27-202(B)(3) appears to give corporations the authority to exculpate directors from liability for many different kinds of conduct. In fact, however, the permissible scope of exculpation is relatively narrow.

Obviously, to the extent that federal law prohibits a corporation from eliminating or limiting directors' liability, the federal law preempts the state law permitting corporations to do so.²⁵ Thus, a registered investment company cannot include a director-exculpation clause in its charter because of a prohibition in the Investment Company Act of 1940.²⁶ By contrast, while federal banking law does not prohibit such clauses, the Financial Institutions Reform, Recovery and Enforcement Act preempts the effect of the clause to the extent that the clause would otherwise absolve directors of liability to the financial institution for gross negligence. In other words, despite the existence of such a charter provision, if the Federal Deposit Insurance Corporation

for example, "To the fullest extent permitted by law, a director of the corporation shall not be liable for breach of fiduciary duty." If the corporation wished merely to limit, and not to eliminate, directors' liability, the charter provision might prescribe a dollar cap on liability. *See generally* Balotti & Gentile, *supra* note 4, at 19-22.

24. *See* Stroud v. Grace, No. CIV. A. 10719, 1990 WL 176803, at *8-9 (Del. Ch. Nov. 1, 1990, amended Dec. 11, 1990) (stating that director-exculpation clauses "are now common in corporate affairs"), *aff'd in part, rev'd in part*, 606 A.2d 75 (Del. 1992); Hanks, *supra* note 6, at 1211.

25. *See generally, e.g.*, Cipollone v. Liggett Group, Inc., 112 S. Ct. 2608, 2617 (1992).

26. 15 U.S.C. § 80a-17(h) (1987); *see* Balotti & Gentile, *supra* note 4, at 13.

has taken over a failed bank, it may sue a bank director for gross negligence in managing the bank.²⁷ And of course, the Arkansas legislature is free to restrict the availability of exculpatory charter clauses in subsequent legislation.²⁸

Beyond the limits placed by federal (or possible future state) preemption on the availability or effectiveness of director-exculpation clauses, the scope of such clauses is limited by the very language of section 4-27-202(B)(3). These limitations fall into two categories: conduct that is expected by virtue of the definition of what general type of conduct may be the subject of exculpation ("definitional exceptions"), and conduct that is expressly excepted from exculpation ("express exceptions"). These two categories will be discussed in turn.

A. Definitional Exceptions

The "definitional exceptions" to the scope of permitted exculpation arise because the statute varies the common-law rule that directors *are* liable to the corporation and its shareholders for breach of fiduciary duty. It is elementary that a statute in derogation of the common law is strictly construed.²⁹ Thus, only the potential liabilities precisely defined in the statute can be "taken out" of the common-law rule of liability.³⁰

27. 12 U.S.C. § 1821(k) (1989); *FDIC v. Canfield*, 967 F.2d 443 (10th Cir. 1992). See generally, e.g., Edward Brodsky, *Bank Officials' Liability Under FIRREA*, 206 N.Y.L.J., July 10, 1991, at 3.

28. E.g., 1A NORMAN J. SINGER, *SUTHERLAND STATUTORY CONSTRUCTION* § 23.16 (Sands 4th ed. 1985).

29. E.g., *White v. State*, 290 Ark. 130, 136, 717 S.W.2d 784, 787 (1986); *Simmons First Nat'l Bank v. Abbott*, 288 Ark. 304, 305, 705 S.W.2d 3, 4 (1986); 3 NORMAN J. SINGER, *SUTHERLAND STATUTORY CONSTRUCTION* § 61.01 (5th ed. 1992).

30. Section 4-27-202(B)(2)(iii) of the *Arkansas Code Annotated*, which permits the articles of incorporation to set forth "provisions not inconsistent with law regarding: . . . Defining, limiting, and regulating the powers of the corporation, its board of directors, and shareholders;" does not affect this analysis. While a provision limiting or eliminating the right of shareholders or of the corporation to sue directors might be viewed as a "definition" or "limitation" of the rights of the corporation or its shareholders, such provisions are "inconsistent with" the common-law rule that directors are subject to personal liability to the corporation and its shareholders for damages caused by breach of fiduciary duty.

It is true that courts in some jurisdictions have upheld charter provisions that conflict with common-law principles that would otherwise apply. E.g., *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107 (Del. 1952) (charter provision permitting interested directors to be counted toward a quorum not forbidden by Delaware law); *Everett v. Phillips*, 43 N.E.2d 18 (N.Y. 1942) (charter clause authorizing directors to vote on matters in which they have dual interests relevant to level of scrutiny given transaction attacked on ground of directors' conflicting interests). But the principle that directors are subject to personal liability for breach of fiduciary duty is so fundamental to corporate law, it seems highly unlikely that a court would give effect to a director-exculpation

1. *The Statute Applies Only To Breach of Fiduciary Duty by a Director.*

Only directors acting as directors can be absolved of liability for breach of fiduciary duty. Other corporate actors, officers and controlling shareholders, also owe fiduciary duties to the corporation and its shareholders.³¹ Unlike some other states' statutes,³² the Arkansas statute does not permit shareholders to absolve non-directors of personal liability for breach of fiduciary duty. Thus, directors who are also corporate officers or controlling shareholders cannot be absolved of liability for breaches of the fiduciary duty that, in their other roles, they owe the corporation and its shareholders.³³

2. *The Statute Applies Only To Suits For Monetary Damages.*

The statute does not authorize charter provisions protecting directors against requests for relief other than monetary damages. Suits for an injunction, for an accounting, for an order removing a director from office, or for other kinds of equitable relief³⁴ are outside the scope of the statutorily permitted exculpation clause.³⁵ Similarly, a suit by a shareholder or the corporation against a director seeking restitutionary relief in the form of money damages should not be affected by the stat-

clause that purported to broaden the scope of exculpation beyond the statutory limits. See Hanks & Scriggins, *supra* note 1, at 246.

31. Regarding the fiduciary duties owed by corporate officers, ARK. CODE ANN. § 4-27-842 prescribes a standard of conduct for corporate officers "with discretionary authority" virtually identical to that prescribed for corporate directors in ARK. CODE ANN. § 4-27-830. In a case decided before the enactment of the 1987 Act, the Arkansas Supreme Court stated that a person who is both a director and an officer in a company has an even greater fiduciary duty. *Raines v. Toney*, 228 Ark. 1170, 1178-79, 313 S.W.2d 802, 808 (1958). For a recent analysis of the nature of the fiduciary duties of corporate officers, see A. Gilchrist Sparks, III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 BUS. LAW. 215 (1992).

The Arkansas courts have apparently not addressed in any published decision the question of fiduciary duties owed by controlling stockholders. For a general discussion of the topic, see, e.g., 12B WILLIAM M. FLETCHER, *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* §§ 5810, 5811 (Cynthia Van Swearingen, ed., 1984 & Supp. 1991).

32. E.g., LA. BUS. CORP. LAW § 12:24(C)(4) (Supp. 1991); MD. GEN. CORP. LAW §§ 2-104(b)(8), 2-405.2 (Supp. 1992); NEV. REV. STAT. § 78.037(1) (1987).

33. Balotti & Gentile, *supra* note 4, at 12; Veasey et al., *supra* note 1, at 403. Cf. 1 MBCA ANN. § 2.02 (Official Comment) (analogous RMBCA provision does not apply to actions taken by a director in some other capacity, such as officer, employee, or controlling shareholder).

34. See generally, e.g., Howard W. Brill, *Equity and the Restitutionary Remedies: Constructive Trust, Equitable Lien, and Subrogation*, 1992 ARK. L. NOTES 1.

35. E.g., Gelb, *supra* note 4, at 32; Veasey et al., *supra* note 1, at 403.

ute.³⁶ A suit "for monetary damages for breach of fiduciary duty" seeks to compensate the plaintiff for the harm the defendant has caused him, without regard to whether the defendant reaped a personal benefit from his injurious conduct.³⁷ By contrast, a suit for restitutionary relief seeks to recover benefits the director acquired wrongfully. "[T]he underlying principle is that one person should not unjustly enrich himself at the expense of another."³⁸ Even if the corporation was not harmed by the breach of fiduciary duty, the corporation (directly or through a shareholders' derivative action) should be permitted to recover any gains the wrongdoer secured by the breach.³⁹ In sum, a suit for restitutionary relief is an alternative to a suit for "monetary damages," and an action to recover gains that a director secured through breach of fiduciary duty should not be barred by a director-exculpation clause.⁴⁰

3. *The Statute Applies Only To Suits For Breach of Fiduciary Duty.*

The statute permits exculpation only for a director's breach of fiduciary duty. It does not apply to suits brought by the corporation or the shareholders which arise under other state or federal laws.⁴¹ For example, a director who fails to prove the "due diligence" defense is personally liable for misstatements in a registration statement filed under the Securities Act of 1933; the liability runs to persons who pur-

36. See Dale A. Oesterle, *The Effect of Statutes Limiting Directors' Due Care Liability on Hostile Takeover Defenses*, 24 WAKE FOREST L. REV. 31, 33 n.9 (1989).

37. "Compensatory damages are awarded for the purpose of making the injured party whole, as nearly as possible." *Dunaway v. Troutt*, 232 Ark. 615, 626, 339 S.W.2d 613, 620 (1960).

38. *Dews v. Halliburton Indus., Inc.*, 288 Ark. 532, 536, 708 S.W.2d 67, 69 (1986). As Professor Brill points out, "Regardless of whether monetary restitution or equitable restitution is sought, the elements of the underlying cause of action are the same." Brill, *supra* note 34, at 2.

39. See, e.g., *Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969) (officers and directors can be compelled to account to corporation for profits derived through insider trading, even though corporation may not have been harmed by the breach of fiduciary duty).

40. See, e.g., HOWARD W. BRILL, ARKANSAS LAW OF DAMAGES § 33-2, at 450 (2d ed. 1990) (recovery under a contract implied in law "is not based upon damages, but is restitutionary in nature"). The Restatement of Restitution supports this view of damages and restitution as alternative remedies. "A fiduciary who commits a breach of his duty as fiduciary is guilty of tortious conduct and the beneficiary can obtain redress either at law or in equity for the harm done. As an alternative, the beneficiary is entitled to obtain the benefits derived by the fiduciary through the breach of duty." RESTATEMENT OF RESTITUTION § 138 cmt. a (1937).

41. E.g., Oesterle, *supra* note 36, at 32-33; see *Sandberg v. Virginia Bankshares, Inc.*, 979 F.2d 332, 342 n.8 (1992) (holding Virginia's statutory director-liability cap did not limit plaintiff shareholders' recovery on their federal securities law claim).

chased shares registered under that registration statement.⁴² The Arkansas Securities Act contains a somewhat analogous provision. Under the Arkansas Securities Act, a director of a corporation that offers or sells a security in violation of the registration provisions of the Act or by means of a materially misleading misstatement or omission is liable to one who purchases stock unless the director can prove "that he did not know, and in the exercise of reasonable care could not have known, of the existence of facts" on which the violation is predicated.⁴³ In both of these instances, the director is not liable because he breached a fiduciary duty; he is liable because he failed to meet the standard of conduct prescribed by the securities laws, and a director-exculpation clause will not protect him.

Similarly, a director-exculpation clause should not protect a director from liability for breach of a nonfiduciary or quasi-contractual duty.⁴⁴ In other words, a director who engages in conduct that would be actionable even if committed by a non-director should not be permitted to escape liability simply because the wrongful conduct also amounted to a breach of his fiduciary duty as a director. For example, if a director tortiously interferes with a contract between the corporation and a third party, in circumstances under which even a stranger to the corporation would be liable in tort to the corporation, the director should not be permitted to rely on a director-exculpation clause to escape liability.⁴⁵ Similarly, if a director negligently misrepresents material facts about the corporation directly to a shareholder, and the director should have known that the shareholder would likely rely on those statements, a director-exculpation clause should not protect the director

42. 15 U.S.C. § 77k (1934); e.g., *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967); *Abbey v. Computer Memories, Inc.*, 634 F. Supp. 870 (N.D. Cal. 1986).

43. ARK. CODE ANN. § 23-42-106(c) (Michie 1987).

44. See *Hanks*, *supra* note 6, at 1210 n.17 (several states enacting charter option statutes omitted the word "fiduciary" from their statutes, perhaps "to permit corporations to limit or eliminate the personal liability of directors for breach of nonfiduciary or quasi-contractual duties as well"). Of course, to the extent that a claim is brought on the theory of quasi-contract and seeks restitutional relief, the suit should not be characterized as one "for money damages." See discussion at part I.A.2, *supra*.

45. While tortious interference with contractual relations is an intentional tort, e.g., *Mid-South Beverages, Inc. v. Forrest City Grocery Co.*, 300 Ark. 204, 778 S.W.2d 218 (1989), and might be outside the scope of an exculpation clause because it is an act or omission "not in good faith or which involve[s] intentional misconduct," ARK. CODE ANN. § 4-27-202(B)(3)(ii), that issue need not be addressed, because the director's liability is not liability for breach of fiduciary duty, but rather liability for the independent tort.

from liability.⁴⁶

4. *The Statute Applies Only To Suits Asserting Liability to the Corporation or To Stockholders.*

The statute does not permit any restriction of a director's liability to persons other than the corporation or its shareholders. This is both a definitional exception and an express exception. The Arkansas legislature underscored this limitation by adding a sentence to the statute that does not appear in the Delaware statute which served as a model. This sentence states that a corporation cannot limit or eliminate a director's liability "[f]or any action, omission, transaction, or breach of a director's duty creating any third-party liability to any person or entity other than the corporation or stockholder."⁴⁷ The legislature's desire to emphasize this point is a bit curious, because most cases involving a third party's claim against a director will not be founded on a breach of fiduciary duty theory. Ordinarily, directors do not owe fiduciary duties to outsiders, but only to the corporation and its shareholders.

a. *Directors' Liability to Third Parties—Non-Fiduciary Bases of Liability*

Directors' liability to third parties is usually founded on non-corporate law principles, including the laws of contract and of agency.⁴⁸ For example, a director who guarantees a corporate debt is liable to the creditor upon the contract of guaranty. And under general agency law principles, a director who makes a contract for and in the name of the corporation, but who lacked actual or apparent authority to do so, is personally liable on the contract absent ratification by the corporation or knowledge by the other party of the director's lack of authority.⁴⁹

Moreover, while a director is ordinarily not responsible for the

46. This discussion assumes that negligent misrepresentations made in circumstances such as this are actionable in Arkansas. To date, the Arkansas Supreme Court has not recognized the tort of negligent misrepresentation. *Cf.* RESTATEMENT (SECOND) OF TORTS § 552 (1977).

47. ARK. CODE ANN. § 4-27-202(B)(3)(v) (Michie 1991).

48. *E.g.*, Schlater v. Haynie, 833 S.W.2d 919, 924 (Tenn. App. 1992) ("Ordinarily, a director of a corporation is an agent of the corporation and is liable only to the corporation. To become directly liable to a [corporate] creditor, there must be some violation of statutory duty or other conduct which establishes a privity of contract with or tortious injury to the creditor for which an action *ex delicto* will lie.").

49. *E.g.*, 3A WILLIAM M. FLETCHER, FLETCHER'S CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1123 (Stephen M. Flanagan & Charles R. P. Keating, eds., perm. ed. rev. vol. 1986 & Supp. 1992); *see also* Dale v. Donaldson Lumber Co., 48 Ark. 188, 2 S.W. 703 (1887).

torts or other wrongs of the corporation,⁵⁰ the director is liable for wrongs that he personally commits against third parties, even though the director is acting on behalf of the corporation.⁵¹ In addition, a director is personally liable for wrongful action in which he participates, either directly or by authorizing or instructing others to commit, or in which he knowingly acquiesces.⁵² The factual scenarios are, of course, infinitely variable, and it is far from clear how close the connection must be, in order for personal liability to attach, between the director's action or inaction and the actual commission of the wrongful act. The battleground today lies primarily in the realm of federal regulation, as plaintiffs (including the government) seek deep pockets to pay for environmental cleanup costs,⁵³ underfunded pension plans,⁵⁴ patent, trade-

50. *E.g.*, *L.B. Indus., Inc. v. Smith*, 817 F.2d 69, 71 (9th Cir. 1987); 3A FLETCHER, *supra* note 49, § 1137.

51. *E.g.*, *United States v. Northeastern Pharmaceutical & Chemical Co.*, 810 F.2d 726, 744 (8th Cir. 1986), *cert. denied*, 484 U.S. 848 (1987); *Vaske v. DuCharme, McMillen & Assoc., Inc.*, 757 F. Supp. 1158, 1166 (D. Colo. 1990); *In re Mills*, 111 B.R. 186, 195 (Bankr. N.D. Ind. 1988); 3A FLETCHER, *supra* note 49, § 1135; HENRY W. BALLANTINE, BALLANTINE ON CORPORATIONS § 112 (rev. ed. 1946); WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 2.11 (4th ed. 1988 & Supp. 1991). *See also, e.g.*, *Myers v. Martin*, 168 Ark. 1028, 272 S.W. 856 (1925) (bank president held liable for fraudulent misrepresentations made to purchaser of bank stock about financial condition of bank). *Cf. Godwin v. Churchman*, 305 Ark. 520, 529-30, 810 S.W.2d 34, 38-39 (1991) (shareholder-officers of corporation were subject to personal liability for conversion where they misappropriated corporate property).

52. *E.g.*, 3A FLETCHER, *supra* note 49, § 1137; *L.B. Indus., Inc.*, 817 F.2d at 71; *Transgo, Inc. v. Ajac Transmission Parts Corp.*, 768 F.2d 1001, 1021 (9th Cir. 1985), *cert. denied*, 474 U.S. 1059 (1986); *Mozingo v. Correct Mfg. Corp.*, 752 F.2d 168 (5th Cir. 1985).

53. *E.g.*, Comprehensive Environmental Response, Compensation, and Liability Act of 1980, § 107(a), 42 U.S.C. § 9607(a); Resource Conservation and Recovery Act of 1976, § 7003(a), 42 U.S.C. § 6973(a). *See generally, e.g.*, *Nurad, Inc. v. William E. Hooper & Sons Co.*, 966 F.2d 837, 844 (4th Cir. 1992) (individual defendants who were directors, officers, and shareholders of corporation liable under CERCLA were not personally liable under CERCLA because their father, president and majority shareholder, exercised ultimate authority over plant); *United States v. Northeastern Pharmaceutical & Chemical Co.*, 810 F.2d 726, 742-46 (8th Cir. 1986), *cert. denied*, 484 U.S. 848 (1987) (two individuals who were shareholders and, respectively, president and vice-president of corporation held personally liable; president, who was major shareholder, was liable even though he was not personally involved in decision to transport and dispose of hazardous substances, because as the individual in charge of and directly responsible for all corporate activities, he had the ultimate authority to control the disposal of the corporation's hazardous substances); *Kelley ex rel. Michigan Natural Resources Comm'n v. ARCO Indus. Corp.*, 723 F. Supp. 1214, 1220 (W.D. Mich. 1989) (test for imposing personal liability under CERCLA on actor in close corporation is "whether the individual . . . could have prevented or significantly abated the release of hazardous substances").

Amidst the torrent of recent law review commentary on environmental law liabilities are several recent articles discussing the personal liability of corporate directors and other actors. *E.g.*, Michael P. Healy, *Direct Liability for Hazardous Substance Cleanups Under CERCLA: A Com-*

mark, and copyright infringements,⁵⁵ and a host of other public and private wrongs.⁵⁶ Again, these asserted liabilities are founded not on a

prehensive Approach, 42 CASE W. RES. L. REV. 65, 104-09 (1992); Gregory P. O'Hara, *Minimizing Exposure to Environmental Liabilities for Corporate Officers, Directors, Shareholders and Successors*, 6 SANTA CLARA COMPUTER & HIGH TECH. L.J. 1 (1990); William S. Biel, Comment, *Whistling Past the Waste Site: Directors' and Officers' Personal Liability for Environmental Decisions and the Role of Liability Insurance Coverage*, 140 U. PA. L. REV. 241 (1991); S.D. Morgan, Recent Developments, 66 TUL. L. REV. 1554 (1992). See also Jose R. Allen & Robert P. Doty, *Toxic Shock: Personal Liability of Corporate Officers Under CERCLA*, in *Hazardous Wastes, Superfund, and Toxic Substances* 31 (ALI-ABA Study Materials, Oct. 31-Nov. 1, 1991).

54. For a discussion of the various approaches courts have taken to the question of officer and director liability under ERISA, 29 U.S.C. §§ 1001-1461 (1990), see *Rockney v. Blohorn*, 877 F.2d 637, 639-43 (8th Cir. 1989) (holding that corporate officers are not personally liable for unpaid plan contributions unless there is a basis for piercing the corporate veil); *accord*, *Pipe Fitters Health & Welfare Trust v. Waldo, R., Inc.*, 969 F.2d 718, 721 (8th Cir. 1992) (refusing to hold individual who owned all the stock of two corporations liable for corporations' failure to make ERISA contributions, because individual had shown proper respect for corporate formalities and there was no basis for piercing the corporate veil). See generally EDWARD BRODSKY & M. PATRICIA ADAMSKI, *LAW OF CORPORATE OFFICERS AND DIRECTORS* §§ 18:10-11 (1984); KNEPPER & BAILEY, *supra* note 51, ch. 9.

55. See generally, e.g., *Orthokinetics, Inc. v. Safety Travel Chairs, Inc.*, 806 F.2d 1565, 1579 (Fed Cir. 1986) (upholding verdicts of personal liability against individuals who were sole officers, directors, and shareholders of corporation which infringed plaintiff's patent; individuals "were directly responsible for the design and production of the infringing chairs and . . . were the only ones who stood to benefit from sales of those chairs."); *Rilting Music, Inc. v. Speakeasy Enterprises, Inc.*, 706 F. Supp. 550 (S.D. Ohio 1988) (president of corporation which owned nightclub was jointly and severally liable with corporation for infringement of copyrights on music publicly performed at club, where president was dominant influence on nightclub's operation, knew of ongoing infringement, and benefitted financially from the infringing activity); *United States Surgical Corp. v. Hospital Products Int'l Pty. Ltd.*, 701 F. Supp. 314, 352 (D. Conn. 1988) (personal liability imposed on individual who was moving force behind infringement by virtue of his activities as officer, director, and controlling shareholder of the infringing corporations); *Polo Fashions, Inc. v. Branded Apparel Merchandising, Inc.*, 592 F. Supp. 648, 652-53 (D. Mass. 1984) (if corporate officer is a moving, active force behind corporation's infringement of trademark, officer will be held personally liable even if officer did not know his acts would result in infringement); *Ned L. Conley & Eric P. Mirabel, The Expanding Personal Liability of Corporate Officers and Directors for Patent Infringement*, 28 IDEA J.L. & TECH. 225 (1988); Joshua L. Cohen, Note, *Corporate Officers and Directors: Likely Targets in Patent Infringement Actions*, 16 DEL J. CORP. L. 1327, 1356-57 (1991); Gary M. Ropski, *Enforcement Defense*, in *Securing and Enforcing Patent Rights* 441, 466 (ALI-ABA Study Materials, Nov. 15-16, 1990).

56. See generally, e.g., *Cintrone-Mobile Gathering, Inc. v. Herrington*, 826 F.2d 16, 23-28 (Temp. Emer. Ct. App. 1987), *cert. denied*, 484 U.S. 943 (1987) (individual who was president, director, and major stockholder of corporations involved in crude oil transfers held personally liable for violation of domestic crude oil pricing laws); *L.C.L. Theatres, Inc. v. Columbia Pictures Indus., Inc.* 619 F.2d 455, 457 (5th Cir. 1980) (individual who was corporation's president and principal shareholder held personally liable for corporation's breach of contract by fraudulently underreporting movie box office receipts, because act was done with his authorization, participation, and approval); *Tillman v. Wheaton-Haven Recreation Ass'n, Inc.*, 517 F.2d 1141, 1142-46 (4th Cir. 1975) (directors of nonprofit corporation which operated a swimming pool held personally liable for violation of civil rights laws for adopting a whites-only policy); KNEPPER &

theory of breach of fiduciary duty, but rather upon asserted violations of specific substantive laws.

b. Directors' Liability to Third Parties—Fiduciary Bases of Liability

The question of whether and when directors owe fiduciary duties to persons other than the corporation and its shareholders is a particularly murky one. Corporate creditors may claim that directors owe a fiduciary duty to them under certain circumstances. The generally accepted rule is that the rights of corporate creditors are purely contractual, and directors owe no fiduciary duty to creditors and need not consider the interests of creditors in making corporate decisions.⁵⁷ However, some states, including Delaware, have recognized an exception to the general rule: when a corporation becomes insolvent, the directors have a fiduciary duty to the creditors to conserve the assets of the corporation so that the assets are available to pay the creditors' claims.⁵⁸ In these states, a director who breaches this fiduciary duty is personally liable to the creditors for damages caused by the breach.⁵⁹

Arkansas law on this point is quite confusing, and arguably supports the proposition that corporate directors owe a fiduciary duty to

BAILEY, *supra* note 51, §§ 10.09-.12 (employment-related liability), ch. 12 (financial institutions and their management); Wilson McLeod, *Shareholders' Liability and Workers' Rights: Piercing the Corporate Veil Under Federal Labor Law*, 9 HOFSTRA LABOR L.J. 115 (1991); David W. Evans & Paul S. Cohen, *Professional Liability Targets in Cases of Insolvency: Directors and Officers, and Accountants, in Insurance Company Solvency—Capital Adequacy, Regulatory Developments, and Liability Issues* 157 (PLI 1991); Vincent J. Vitkowski & James H. Irish, *Liability of Directors and Officers and Accountants of Insolvent Insurance Companies, in Insurance Company Solvency—Capital Adequacy, Regulatory Developments, and Liability Issues* 101 (PLI 1991).

57. E.g., Lewis U. Davis, Jr. et al., *Corporate Reorganization in the 1990s: Guiding Directors of Troubled Corporations Through Uncertain Territory*, 47 BUS. LAW. 1, 2 (1991).

58. A recent Delaware Chancery Court decision, *Geyer v. Ingersoll Publications Co.*, reviewed Delaware law concerning a director's fiduciary obligations to corporate creditors and concluded that, in Delaware, "the general rule is that directors do not owe creditors duties beyond relevant contractual terms absent 'special circumstances' . . . , e.g., fraud, insolvency, or a violation of a statute" No. CIV. A. 12406, 1992 WL 13647, at *3 (Del. Ch. June 18, 1992) (quoting *Harff v. Kerkorian*, 324 A.2d 215, 222 (Del. Ch. 1974), *rev'd in part on other grounds*, 347 A.2d 133 (Del. 1975)). The *Geyer* court noted that Delaware courts had recently defined a fourth category of "special circumstances": the institution of dissolution proceedings. *Id.* In *Geyer*, the chancery court interpreted the special circumstance of "insolvency" to mean insolvency in fact and not to require a showing that statutory proceedings such as bankruptcy proceedings had been instituted. *Id.* at *3-4.

59. See, e.g., Gregory V. Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239 (1992); Davis, Jr., et al., *supra* note 57.

corporate creditors not merely to conserve assets when the corporation becomes insolvent, but also a duty to manage the corporation with due care so that it does not become insolvent. Creditors can sue to impose personal liability on directors who breach this duty.⁶⁰ The leading Arkansas case is *Sternberg v. Blaine*,⁶¹ decided in 1929, in which the Arkansas Supreme Court announced:

It may therefore be stated as the settled rule in this State that any failure of a director to exercise diligence or good faith which results in loss to a stockholder or creditor, entitles such stockholder or creditor to require the directors whose negligence has caused the loss to pay. In other words, the director whose negligence causes loss is liable for such loss to stockholders and creditors.⁶²

Stenberg was followed in two later decisions handed down in 1929⁶³ and in 1934.⁶⁴

There were no other reported decisions on the question until 1963, when Judge Gordon E. Young of the United States District Court for the Eastern District of Arkansas rendered a decision in *Hi-Pro Fish Products, Inc. v. McClure*.⁶⁵ In an extensively researched and reasoned opinion, Judge Young concluded that "such a cause of action in favor of the individual creditor no longer exists in Arkansas."⁶⁶ However, in 1979, in *Smith v. Citation Manufacturing Co.*,⁶⁷ the Arkansas Supreme Court quoted with approval the "settled rule" enunciated in *Sternberg*.⁶⁸ The court did not refer to Judge Young's opinion in *Hi-Pro*, and given the fact that *Smith* involved a claim that a director had breached his fiduciary duty to the corporation (and not a claim that the director owed or had breached any fiduciary duty to a corporate creditor), the issue remains open.⁶⁹

60. See Harry Meek, *Changes Needed in the Present Arkansas Corporation Act*, 10 ARK. L. REV. 1, 2 (1955) (acknowledging possibility that a corporate creditor can sue directors for general mismanagement through a creditor's bill if the corporation becomes insolvent).

61. 179 Ark. 448, 17 S.W.2d 286 (1929).

62. *Id.* at 453, 17 S.W.2d at 288.

63. *Johnson v. Coleman*, 179 Ark. 1087, 1094, 20 S.W.2d 186, 188 (1929).

64. *Milburn v. Martin*, 190 Ark. 16, 23, 76 S.W.2d 952, 955 (1934).

65. 224 F. Supp. 485 (E.D. Ark. 1963), *rev'd on other grounds*, 346 F.2d 497 (8th Cir. 1965).

66. 224 F. Supp. at 491.

67. *Smith v. Citation Mfg. Co.*, 266 Ark. 591, 587 S.W.2d 39 (1979).

68. *Id.* at 597, 587 S.W.2d at 41.

69. The extent of the current uncertainty on this issue is underscored by a 1984 opinion of the United States Bankruptcy Court for the Western District of Arkansas in which the court reiterated the *Sternberg* rule as having "long been the law in Arkansas." *In re Ozark Restaurant*

The issue is an important one, because a director-exculpation clause may prevent a trustee in bankruptcy from suing corporate directors for mismanagement. The trustee succeeds to all the rights of the corporation to sue directors for mismanagement.⁷⁰ If the corporation's charter contains a director-exculpation clause, then the corporation has no right to impose personal liability upon its directors for simple negligence. If, however, the directors owe a duty to corporate creditors to exercise due care in the management of the corporation, a director-exculpation clause does not affect directors' liability for breach of that duty,⁷¹ and creditors should be able to assert the claim in their own right.⁷²

B. Express Exceptions

The most striking feature of section 4-27-202(B)(3) is its list of exceptions. To recap, the corporation is not permitted to limit or eliminate a director's liability to the shareholders or the corporation:

- For "any breach of the . . . duty of loyalty";
- For "acts or omissions not in good faith";
- For acts or omissions "which involve intentional misconduct";
- For acts or omissions which involve "a knowing violation of law";

Equip. Co., 41 B.R. 476, 480 (W.D. Ark. 1984), *rev'd on other grounds*, 61 B.R. 750 (W.D. Ark. 1986), *aff'd*, 816 F.2d 1222 (8th Cir.), *cert. denied*, 484 U.S. 848 (1987).

70. *E.g.*, *In re Ozark Restaurant Equip. Co.*, 816 F.2d 1222, 1225 (8th Cir.), *cert. denied*, 484 U.S. 848 (1987).

71. *See Geyer v. Ingersoll Publications Co.*, No. CIV. A. 12406, 1992 WL 136473, at *3 (Del. Ch. June 18, 1992) (recognizing that if a corporation's charter contained a director-exculpation clause, it is possible that a director may be held liable to a creditor for breach of fiduciary duty even though the director could not be held liable to a shareholder).

72. *In re Ozark Restaurant Equip. Co.*, 816 F.2d 1222 (8th Cir.), *cert. denied*, 484 U.S. 848 (1987), the eighth circuit held that a trustee in bankruptcy has no standing to assert a claim based on obligations or liabilities that, under state law, run to corporate creditors personally rather than to the corporation. *Id.* at 1225. The court held further that a trustee in bankruptcy cannot bring an alter ego action against corporate principals, because "the obligations and liabilities of an action to pierce the corporate veil in Arkansas do not run to the corporation, but to third parties, *e.g.*, creditors of the corporation." *Id.*

Of course, an alter ego action differs from a suit for damages based on breach of fiduciary duty, and *Ozark* should not be read to mean that Arkansas corporations and their shareholders have no right to sue their directors for breach of fiduciary duty. (For an explanation of the difference, see District Judge Waters' thoughtful opinion in the *Ozark* case, *In re Ozark Restaurant Equip. Co., Inc.*, 61 B.R. 750, 755 (W.D. Ark. 1986)). The point is that while a director-exculpation clause may bar such a suit by shareholders in a derivative suit or by a trustee or receiver acting on behalf of the corporation, the same clause should not bar an action brought by creditors even if it is based on the same type of director misfeasance or nonfeasance.

— For liability arising from making distributions in violation of section 4-27-833;

— For “any transaction from which the director derived an improper personal benefit”;

— For acts or omissions “creating any third-party liability”; and

— For “any act or omission occurring prior to the date when” the director-exculpation clause became effective.⁷³

The biggest problem with the express exceptions are their vagueness.⁷⁴ What is a “breach of the director’s duty of loyalty”?⁷⁵ The 1987 Act does not define the “duty of loyalty.” Presumably, it extends beyond the “conflict of interest transaction” regulated by another section of the act⁷⁶ to reach also usurpation of corporate opportunity, wrongful competition with the corporation, unfair treatment by majority shareholders of a minority shareholder in corporate acquisition and reorganization transactions, use of corporate funds to perpetuate control, and insider trading.⁷⁷ Moreover, the duty of loyalty tends to blur into the duty of care, especially when it is alleged that directors took arguably imprudent action motivated in part by a desire to keep their positions or protect themselves from potential liability.⁷⁸

What are “acts or omissions not in good faith”? “Good faith” is not defined in the act. What is “intentional misconduct”? Is it different from lack of “good faith”? Would “recklessness” satisfy one or both of

73. ARK. CODE ANN. § 4-27-202(B)(3) (Michie 1991).

74. See generally Committee on Corporate Laws, *Changes in the Revised Model Business Corporation Act—Amendment Pertaining to the Liability of Directors*, 45 BUS. LAW. 695, 697-98 (1990); Gelb, *supra* note 4, at 38 (“Indeed, because of situations where it will be necessary to litigate questions of law and fact regarding the application of the various exceptions in the anti-liability statutes, an anti-liability charter provision will not always lead to the quick and easy elimination of breach of duty suits. The need for such litigation and its costs and uncertainties make it clear that such provisions offer no panacea for directors.”).

75. “The duty of loyalty exception is a particularly likely subject for litigation since the line between the duty of care and duty of loyalty is not always completely clear.” Stephen A. Radin, *The Director’s Duty of Care Three Years After Smith v. Van Gorkom*, 39 HASTINGS L.J. 707, 746 n.279 (1988).

76. ARK. CODE ANN. § 4-27-831 (Michie 1991).

77. 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 4.9, at 204-05 (2d ed. 1990).

78. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). In an attempt to fend off hostile takeover, the directors entered into a “lock-up” agreement with a competing bidder that was designed, in part, to shore up the market value of notes the corporation had previously issued in order to protect directors from suit by irate noteholders. The court first characterizes this a breach of the duty of loyalty owed by the directors to the stockholders, *id.* at 182, but later characterizes it as a breach of the duty of care, *id.* at 185. See generally Hanks, *supra* note 6, at 1212; Oesterle, *supra* note 36, at 43-47.

these tests?⁷⁹ Would "gross negligence"?⁸⁰ Does a series of negligent acts extending over a considerable period of time amount to "intentional misconduct"?⁸¹

What is a "knowing violation of law"? Must the director know that his conduct is unlawful, or must he simply know that he is engaging in the conduct?⁸² Is the "law" restricted to criminal law? Does it include violations of federal antitrust, securities,⁸³ fair election,⁸⁴ occupational safety,⁸⁵ and other federal laws regulating commercial conduct? Might breaches of contract and common-law torts constitute "violations of law"?⁸⁶

What is an "improper personal benefit"? Under what circumstances would a benefit be "improper" if it did not involve a breach of the duty of loyalty or "bad faith"? The statute does not say that the benefit must be a pecuniary one. Might the "improper personal benefit" include business goodwill, personal friendship, social reputation, or continued tenure on the board?⁸⁷ It is worth noting that in the federal insider trading context, in which a tipper's personal benefit determines

79. See Balotti & Gentile, *supra* note 4, at 16; Gelb, *supra* note 4, at 34-35; Veasey et al., *supra* note 1, at 403.

80. The Delaware statute on which the Arkansas statute is modelled permits exculpation of directors for gross negligence. Veasey et al., *supra* note 1, at 402. Gross negligence is the standard of liability for directors in Delaware. Committee on Corporate Laws, *Changes to the Revised Model Business Corporation Act—Amendment Pertaining to the Liability of Directors*, 45 BUS. LAW. 695, 695 (1990). In Arkansas, by contrast, the standard is simple negligence. See, e.g., *Hi-Pro Fish Products, Inc. v. McClure*, 224 F. Supp. 485, 489-91 (E.D. Ark. 1963) (in Arkansas, corporate director is required to use ordinary care in the management of corporate affairs), *rev'd on other grounds*, 346 F.2d 497 (8th Cir. 1965); *Johnson v. Coleman*, 179 Ark. 1087, 1094, 20 S.W.2d 186, 188 (1929); *Sternberg v. Blaine*, 179 Ark. 448 453-54, 17 S.W.2d 286, 288-89 (1929). Will the statute be construed so as to permit exculpation only for conduct meeting the minimum culpability test for liability under Arkansas law?

81. See *Bailey v. O'Neal*, 92 Ark. 327, 333-34, 122 S.W. 503, 505 (1909); Franklin D. Arey III, *Bank Directors' Duties Under the Common Law of Arkansas*, 11 U. ARK. LITTLE ROCK L.J. 629, 644-46 (1988-89).

82. Under the Arkansas Criminal Code, a person commits a crime "knowingly" as long as he has knowledge with respect to his conduct; knowledge or ignorance of the law is generally immaterial. ARK. CODE ANN. §§ 5-2-202(2), -203(d), -206(b), (c) (Michie 1987).

83. The fourth circuit recently held that where directors had approved a proxy statement without actual knowledge as to whether the statements made therein were true or false, thereby committing fraud in violation of the Securities Exchange Act, they had knowingly violated the law and therefore were not protected by Virginia's director-protection statute. *Sandberg v. Virginia Bankshares, Inc.*, 979 F.2d 332, 344-46 (4th Cir. 1992).

84. See *Miller v. AT&T*, 507 F.2d 759 (3d Cir. 1974).

85. See, e.g., *United States v. Cusack*, 806 F. Supp. 47 (D.N.J. 1992).

86. Gelb, *supra* note 4, at 36.

87. Hanks, *supra* note 6, at 1213.

whether or not he breached his fiduciary duty so as to become liable for a violation of the insider trading laws, the benefit may consist of simply an enhanced reputation or the satisfaction of having made a gift to a relative or friend.⁸⁸

What is an act or omission "occurring prior to the date when" the director-exculpation clause becomes effective?⁸⁹ What of a continuing course of simply negligent conduct by a director, with some acts or omissions occurring before the clause's effective date, and some occurring after? Is the injured corporation or shareholder permitted to recover all of its damages, or merely damages directly attributable to the negligence that occurred before the effective date?

III. CONCLUSION

The substantive effect of a director-exculpation clause adopted under the authority of section 4-27-202(B)(3), given the exceptions discussed above, is rather limited. It is impossible to predict how many claims brought against directors will fall squarely within the scope of the exculpation clause. As discussed above, it appears that only claims alleging negligence—simple negligence, and perhaps "aggravated negligence"—and unalloyed by any hint of self-dealing or bad faith are covered by the exculpation clause.

Until the 1980s, it was difficult to find a reported decision in which a director was held liable for a "pure" breach of the duty of care.⁹⁰ With increasing takeover activity in the 1980s, however, courts began to characterize directors' quick-response defensive actions as breaches of the duty of care. *Smith v. Van Gorkom*⁹¹ was such a case. However, in most "director negligence" cases a skillful pleader should be able to characterize the directors' actions as colorable "bad faith" or a breach of the duty of loyalty.⁹² The question is whether the courts will play

88. See e.g., *Dirks v. SEC*, 463 U.S. 646, 662-64 (1983). The Securities and Exchange Commission has been quite aggressive in arguing for an expansive definition of "personal benefit." See John C. Coffee, Jr., *Disclosures to Analysts Are Risky*, NAT'L L.J., Feb. 1, 1993, at 20, 22.

89. The clause becomes effective when articles of incorporation, or an amendment to the articles of incorporation, are filed with the Secretary of State, or at a later date if the document so specifies. ARK. CODE ANN. § 4-27-123 (Michie 1991).

90. See e.g., John W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1095 (1968); Mark A. Sargent, *Two Cheers for the Maryland Director and Officer Liability Statute*, 18 U. BALT. L. REV. 278, 284 (1989).

91. 488 A.2d 858 (Del. 1985).

92. E.g., Hanks, *supra* note 6, at 1212-13.

along.⁹³

Those cases that do involve "pure negligence" almost certainly involve, at bottom, a claim that the directors used poor judgment. Of course, the business judgment rule is supposed to protect directors against liability for simple mistakes of judgment in making business decisions. But there is a condition that even disinterested directors must satisfy before they can claim the protection of the business judgment rule: they must "inform themselves of all material information reasonably available to them prior to making a business decision."⁹⁴ The substantive effect of an exculpatory provision in the charter of an Arkansas corporation will probably operate most often to protect directors who "flunk" this procedural prong of the business judgment rule test. It will also, of course, protect directors who negligently *fail* to make a business judgment—conduct not protected by the business judgment rule at all.⁹⁵

Where a complaint by a shareholder or the corporation states a claim that falls squarely within the exculpatory zone, the defendants should be able to obtain a dismissal under Rule 12(b)(6) of the *Arkansas* or *Federal Rules of Civil Procedure*. An early dismissal, of course, results in considerable savings of litigation costs and reduces the pressure to settle. These savings may well inure to the corporation itself, if the corporation would otherwise elect to indemnify the defendant directors against litigation costs and the amount of any settlement.⁹⁶

93. See Oesterle, *supra* note 36, at 40-50.

94. Hall v. Staha, 303 Ark. 673, 678, 800 S.W.2d 396, 399 (1990). This "procedural" facet of the duty of care has become the predominant theme in Delaware decisions addressing claimed breaches of the duty of care. See, e.g., Douglas M. Branson, *Intracorporate Process and the Avoidance of Director Liability*, 24 WAKE FOREST L. REV. 97 (1989). It was to protect directors who "flunk" this test that the Delaware legislature enacted the statute that served as the model for section 4-27-202(B)(3).

95. See, e.g., Steinberg, *supra* note 6, at 924 (discussing Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981)).

96. See ARK. CODE ANN. § 4-27-850 (Michie 1991).

The dismissal benefit is illustrated by a recent Delaware case, *In re Dataproducts Shareholders Litigation*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,227 (Del. Ch. Aug. 22, 1991). In *Dataproducts*, the board of directors of Dataproducts approved a tender offer by and second stage merger with Hitachi at a price of \$10 per share. Hitachi promptly announced the tender offer at that price. Four days later, Hitachi's offer and Dataproducts' Schedule 14D-9 recommending the transaction were sent to Dataproducts' shareholders. These documents disclosed that Dataproducts had higher earnings in the third quarter than had been projected, and predicted that fourth quarter earnings would exceed prior projections as well. Some two and one-half weeks later, Dataproducts announced its fourth quarter earnings, confirming its earlier, optimistic prediction and disclosing that the net loss for the entire year was significantly lower than had been expected by either the company or analysts. The takeover was consummated twelve days

While the director-exculpation mechanism provided by section 4-27-202(B)(3) enables Arkansas corporations to protect their directors and their corporations against the necessity of expending corporate or personal resources to litigate claims alleging corporate mismanagement, we may question whether the benefits outweigh the costs. There is little indication in the reported cases that Arkansas corporations are plagued by suits of this nature. This may be because honest directors of Arkansas corporations take their duties seriously, or it may be because the difficulties of proof—especially proof of causation⁹⁷—are so great. But to the extent that a director negligently fails to inform himself to a reasonable degree before making a business decision, or wholly abdicates his duty to oversee the management of the corporation, and his negligence is proved to be the proximate cause of the corporation's or the shareholders' loss, it is hard to see any justification for absolving the director of liability for the consequences of his dereliction of duty. As between a negligent director and the shareholders who trusted him to look after their investment in a prudent manner, it hardly seems fair that the shareholders should suffer the consequences.

It might be argued that a person need not invest in a corporation with a director-exculpation clause in its charter. This argument overlooks the fact that a director-exculpation clause can be added to the articles of incorporation through an amendment to the articles. Under the 1987 Act, there is no automatic super-majority voting requirement for amendments to the articles of incorporation.⁹⁸ Unless the articles of

later, with over 90% of Dataproducts' shares being tendered, followed by a merger.

Former Dataproducts shareholders brought a class action suit against the directors. Their theory was that Dataproducts' management, by announcing the Hitachi proposal before disclosing detailed information about the better-than-expected earnings, thereby "capped" the market price for Dataproducts' stock at \$10 per share. In other words, the \$10 per share acquisition price looked better than it would have if the favorable earnings information had been disseminated first. The shareholders alleged that while the directors had not personally committed the improper acts, the directors had acquiesced in management's actions and had therefore breached their fiduciary duty by abdicating their obligations to the shareholders. Similarly, the shareholders argued that the directors breached their fiduciary duties by transmitting a Schedule 14D-9 that was materially misleading and designed to induce shareholders to tender at the \$10 offering price.

The Delaware Chancery Court held that Dataproducts' director-exculpation charter provision barred the suit. It viewed the shareholders' claims as stating, at most, a claim of gross negligence by the directors. In the absence of any allegations that the directors had acted in bad faith or in breach of their duties of loyalty, the case fell squarely within the scope of conduct for which the corporation had chosen to exculpate directors from any liability.

97. See, e.g., *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924); Principles of Corporate Governance § 7.18 (ALI Proposed Final Draft 1992).

98. Cf. ARK. CODE ANN. § 4-26-302(a)(4) (Michie 1991) (1965 Arkansas Business Corpo-

incorporation or the board of directors raise the voting requirement, the amendment will be approved if the affirmative votes exceed the negative votes (assuming a quorum is present).⁹⁹ Shares owned or controlled by the directors who will benefit from the exculpatory clause will, presumably, be counted, because an amendment to the articles of incorporation is not a "transaction with the corporation" requiring approval by only "disinterested shareholders" under the conflict of interest provision of the 1987 Act.¹⁰⁰ And a shareholder who votes against the amendment adding the director-exculpation clause has no dissenters' rights and cannot force the corporation to buy out his shares, absent a special provision in the articles, bylaws, or board resolution,¹⁰¹ or a buy-out agreement among shareholders.

If the corporation is publicly held, this should not matter too much, because the unhappy shareholder who has seen the corporation adopt a director-exculpation clause can simply sell his shares and invest his money elsewhere. But the vast majority of corporations in Arkansas are closely held, and there may well be no market for the shares.¹⁰²

On balance, it appears that the 1987 Act fails to include sufficient protection for shareholders in closely held Arkansas corporations. Those in control of an existing corporation will be able easily to amend the articles to absolve directors from liability for negligence. This may be good for business, but if shareholders are to be given a meaningful choice with respect to the rules of the businesses in which they invest,

ration Act).

99. ARK. CODE ANN. §§ 4-27-1003(E), -725(C) (Michie 1991).

100. *Id.* § 4-27-831(A), (D).

101. *Id.* § 4-27-1302(4), (5).

102. For a general discussion of the vulnerability of minority shareholders in closely held corporations formed under the 1987 Act and strategies to reduce that vulnerability, see Frances Fendler Rosenzweig, *Protecting the Rights of Minority Shareholders in Close Corporations Under the New Arkansas Business Corporation Act*, 44 ARK. L. REV. 1 (1991).

the 1987 Act should be amended to provide dissenters' rights to shareholders who object to the change.¹⁰³

Frances Fendler Rosenzweig

103. This could be accomplished by adding a new subsection (A)(4)(vi) to section 4-27-1302, the "right of dissent" section of the 1987 Act. The new subsection might read, "(vi) Adds, deletes, or amends a provision permitted under § 4-27-202(B)(3) eliminating or limiting the personal liability of a director."