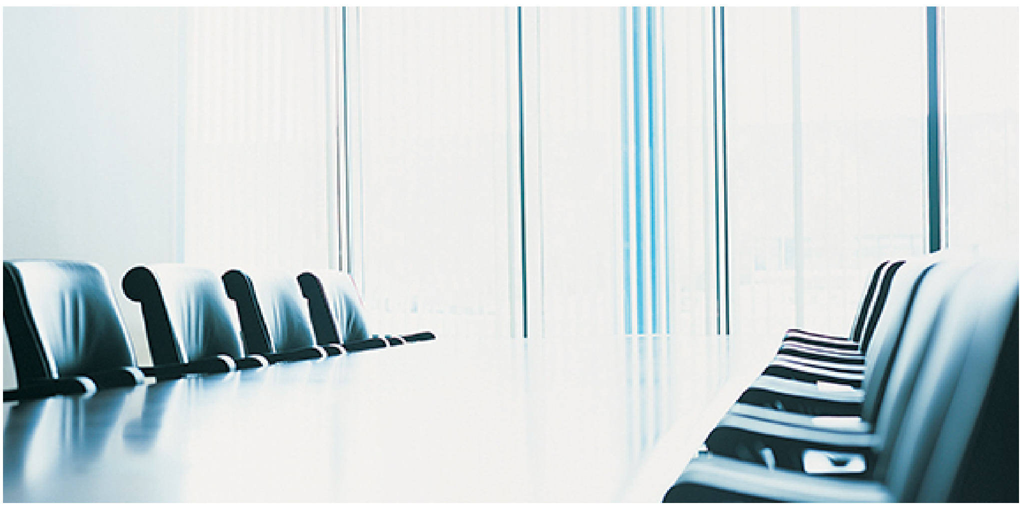
Delaware Supreme Court Rejects Presumption of Disloyalty for Independent Directors

June 24, 2015

In re. Cornerstone Therapeutics, Inc. S'holder Litig., In re. Zhongpin Inc. S'holders Litig. (May 14, 2015).



Public companies incorporated in Delaware frequently adopt a charter provision, pursuant to 8 Del. C. § 102(b)(7), that insulates their directors from monetary damages for breaches of the fiduciary duty of care. Those provisions are generally enforced. An issue that has not been clear, however, is how far a court should permit shareholder litigation when such a provision is present in the company charter and will inevitably be invoked by director defendants. Particularly, when an independent director is alleged *only* to have breached his or her duty of care to the corporation (as opposed to his or her duty of loyalty), but the transaction is one in which actual conflicts of interest exist, should such claims be allowed to proceed past the motion to dismiss stage and into discovery, where legal fees and other costs can mount? An earlier Delaware Supreme Court decision answered this question in the negative when the applicable standard of review of the board's conduct in considering the challenged transaction was the *Revlon* standard, but subsequent decisions in the series of *Emerald Partners* litigations cast some doubt on the issue when the applicable standard invoked was entire fairness.[1] A recent opinion, rendered by the Delaware Supreme Court in the course of resolving two appeals raising the same issue, definitively resolves the question under Delaware law. *In re Cornerstone Therapeutics,* *Inc. S'holder Litig.*, Case No. 564, 2014; *Leal, et al. v. Meeks, et al.*, Case No. 706, 2014 (Del. May 14, 2015). Those cases state that, regardless of the underlying standard of review for the board's conduct, to survive a motion to dismiss a shareholder plaintiff seeking only monetary damages must plead non-exculpated claims against a director who is protected by an exculpatory charter provision.

Background

Both of the decisions under review arose out of mergers in which the controlling shareholder acquired the remainder of shares it did not already own in the respective corporations. In each case, the controlling shareholder had representatives on the board of directors but the transactions were negotiated by special committees of independent directors. In both instances, the transactions were approved by a majority of the minority shareholders and delivered substantial premiums to market price. There was no dispute as to the standard of review applicable to the transactions, the entire fairness standard presumptively applied. In both cases, despite the fact that the defendant directors were protected by 102(b)(7) exculpatory provisions in their respective companies' charters, the plaintiffs sued the independent directors who negotiated and approved the mergers. The independent directors sought dismissal in both cases, arguing that because the only claims alleged against them were duty of care claims that were exculpated by the relevant charter provisions, the suits should not proceed against them. They relied on Delaware case law holding that when the *Revlon* standard was implicated, dismissal was appropriate as to directors who were only sued for exculpated claims. Plaintiffs countered that the *Emerald Partners* decisions stood for the proposition that the independent directors' motions to dismiss should be denied, because the entire fairness standard of review was implicated. The Court of Chancery denied the dismissal motions in both matters, but recommended certification of an interlocutory appeal. **Analysis**

The Delaware Supreme Court rejected plaintiffs' position and their interpretation of *Emerald Partners*. The Court held that a plaintiff shareholder must plead a non-exculpated claim against an independent director who is protected by an exculpatory charter provision. Otherwise, the court explained, dismissal of that director on the pleadings is appropriate. According to the Court, this rule applies regardless of the underlying standard of review for the transaction. The Court included one limitation: its rule only applies when the director is independent. If the director is interested in the challenged transaction, then a claim for a breach of fiduciary duty will survive a motion to dismiss even if that director is otherwise protected by an exculpatory clause. *See*, *e.g.*, *Gantler v. Stevens*, 965 A.2d 695 (Del. 2009) (an interested director's conflicts of interest support a pleading-stage inference of disloyalty). Although plaintiffs did not know the independent directors to be disloyal such that they could plead a separate non-exculpated claim against them in their complaint, they effectively sought an automatic inference that a director facilitating an interested transaction must be disloyal because the possibility is heightened in controller transactions. The court rejected this invitation, noting its inconsistency with Delaware law – each director has a right be considered individually – and the increased costs plaintiffs' theory would impose on the independent directors, the company, and the shareholders, without a corresponding benefit. The court found the potential chilling effect on independent directors salient:

> We decline to adopt an approach that would create incentives for independent directors to avoid serving as special committee members, or to reject transactions solely because their role in negotiating on behalf of the stockholders would cause them to remain as defendants until the end of any litigation challenging the transaction.

Impact on Director Action

This decision is significant in its impact on corporations considering interested transactions. As the court readily recognized, the chilling effect of automatically inferring disloyalty as to all directors, including independent directors, should now thaw. Not all interested transactions are necessarily negative, with controlling shareholders "winning" and the corporation and minority shareholders "losing." To the contrary, such deals may be as valuable to the corporation as any other potential transaction. And that is what the Delaware Supreme Court is protecting here: the independent directors' right to freely consider any and all transactions put before the board without fear of being included in – and then trapped in – a potentially costly lawsuit. ___ [1] The *Revlon* standard is implicated in reviewing certain transactions involving a sale of control. It imposes enhanced judicial scrutiny of that transaction. The entire fairness standard – which is the most onerous standard of review – applies when the board engages in the negotiation and analysis of a transaction under actual conflicts of interest. If it applies, the defendants must show that the transaction was the product of both fair dealing and fair price. An honest belief it was so is not enough; the transaction must be objectively fair, independent of the board's belief.

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