Pepper Hamilton LLP
Attorneys at Law

CLIENT ALERT

COMMERCIAL LITIGATION

May 22, 2015

Delaware Supreme Court Preserves Benefit of Exculpatory Provisions for Independent Directors at Motion to Dismiss Stage

Joanna J. Cline | clinej@pepperlaw.com
Christopher B. Chuff | chuffc@pepperlaw.com
James H.S. Levine | levinejh@pepperlaw.com

Independent directors may seek dismissal under an exculpatory charter provision when the plaintiffs are seeking only monetary relief, even in a situation where entire fairness review applies.

Executive Summary

A recent decision by the Delaware Supreme Court provides independent directors, such as special committee members, with the ability to escape protracted fiduciary duty litigation during its initial stages. The court's decision reversed two Delaware Court of Chancery opinions holding that where plaintiffs sufficiently pled duty of loyalty claims against a majority of the board or a controlling stockholder, independent directors must remain part of the litigation until after trial, even if the plaintiffs have pled no facts to support a claim that the independent directors breached their duty of loyalty. The Delaware Supreme Court's ruling – which emphasizes that independent directors are presumed to carry out their duties with fidelity – requires plaintiffs to sufficiently plead duty of loyalty claims on a director-by-director basis. Specifically, to survive a motion to dismiss by independent directors protected by an exculpatory charter provision, plaintiffs must plead a non-exculpated claim by alleging facts showing that the directors were interested in the transaction, lacked independence or acted in bad faith. The court's decision reinforces the basic tenets of Delaware law concerning independent directors and confirms that, unless the plaintiff has pled such facts, directors of Delaware corporations will be able to discharge their fiduciary duties without becoming embroiled in years of litigation.

Introduction

The Delaware Supreme Court's recent decision in *In re Cornerstone Therapeutics Inc. Stockholder Litigation*, Nos. 564, 2014 & 706, 2014 (Del. May 14, 2015), gives teeth to section 102(b)(7) exculpatory provisions for disinterested and independent directors at the motion to dismiss stage, even where the business judgment rule has been rebutted. Indeed, the Delaware Supreme Court held that, even in a situation where entire fairness review applies *ab initio* (from the beginning), independent directors may seek dismissal under an exculpatory charter provision authorized by section 102(b)(7) of Delaware General Corporation Law where the plaintiffs are pursuing monetary relief. Thus, the court held that, to survive a motion to dismiss, a plaintiff seeking monetary damages must plead non-exculpated claims against a director, regardless of the underlying standard of review.

Background

The Delaware Supreme Court's decision resolved consolidated interlocutory appeals from two Court of Chancery decisions — *In re Zhongpin Inc. Shareholders Litigation*, C.A. No. 7393-VCN, 2014 Del. Ch. LEXIS 252 (Del. Ch. Nov. 26, 2014) and *In re Cornerstone Therapeutics Inc. Shareholder Litigation*, C.A. No. 8922-VCG, 2014 Del. Ch. LEXIS 185 (Del. Ch. Sept. 10, 2014). In each case, the company's controlling stockholder proposed cash-out mergers at substantial premiums to pre-announcement market prices. Each board formed a special committee of disinterested and independent directors to negotiate with the controlling stockholder. Each special committee retained independent legal and financial advisors, assessed the fairness of the transaction and approved the transaction. A majority of each company's minority stockholders voted in favor of the transaction. Nevertheless, dissenting stockholders challenged the transactions as not "entirely fair." The independent directors moved to dismiss on the ground that the company's exculpatory charter provisions barred the stockholders' claims.

The plaintiffs in each case claimed that, because the challenged transactions were subject to entire fairness review, even the facially independent and disinterested directors must remain parties to the lawsuits until the end of the litigation. The plaintiffs reasoned that entire fairness applies in situations where there is risk that independent directors might be more independent in appearance than in substance, and that entire fairness review helps uncover situations where facially independent and disinterested directors have failed to act loyally and in good faith to protect the interests of the corporation. The Court of Chancery agreed, refusing to dismiss the claims against the independent directors and holding that, where entire fairness review applies, exculpatory provisions may be employed to avoid monetary liability only after the court holds a trial to determine whether the underlying transaction was entirely fair.

The Delaware Supreme Court's Decision

The Supreme Court reversed the Court of Chancery's decisions in *Zhongpin and Cornerstone*, holding that a "plaintiff seeking only monetary damages must plead non-exculpated claims against a director who is protected by an exculpatory charter provision to survive a motion to dismiss, regardless of the underlying standard of review for the board's conduct—be it *Revlon*, *Unocal*, the entire fairness standard, or the business judgment rule." The court stated that, when a director is protected by an exculpatory provision, a complaint can survive a motion to dismiss by the director defendant only by pleading facts supporting a rational inference that the director was interested in the challenged transaction, acted to advance the self-interest of an interested party from whom they could not be presumed to act independently, or acted in bad faith. The mere fact that a plaintiff is able to plead facts supporting the application of the entire fairness review "does not relieve the plaintiff of the responsibility to plead a non-exculpated claim against each director who moves for dismissal."

The court explained that its holding is consistent with the “basic tenet[] of Delaware law” that “independent directors are presumed to be motivated to do their duty with fidelity” and that prohibiting independent directors from employing exculpatory provisions at the motion to dismiss stage, where the plaintiff fails to plead a non-exculpated claim, would be inconsistent with that principle.

The court also explained that section 102(b)(7) was adopted to allay “the fear that directors who faced personal liability for potentially value-maximizing business decisions might be dissuaded from making such decisions” and that it “decline[d] 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.”

Conclusion

The Delaware Supreme Court’s *Cornerstone* decision preserves important protections for independent directors in fiduciary duty litigation. Indeed, the court makes clear that, even in a situation where entire fairness applies *ab initio*, independent directors may seek dismissal under a section 102(b)(7) exculpatory charter provision where the plaintiffs are seeking only monetary relief. To survive dismissal, plaintiffs must plead non-exculpated claims against each director defendant by pleading facts that give rise to a rational inference that each director defendant was interested in the transaction, lacked independence or acted in bad faith.

Cornerstone demonstrates the emphasis the court places on director independence in assessing the fairness of a transaction and the potential harmful consequences of prohibiting independent directors from summarily applying section 102(b)(7) exculpatory provisions at the motion to dismiss stage. As the court explained, “[a]lthough it is wise for [Delaware] law to focus on whether the independent directors can say no [to a transaction], it does not follow that it is prudent to create an invariable rule that any independent director who says yes to an interested transaction subject to entire fairness review must remain as a defendant until the end of the litigation, regardless of the absence of any evidence suggesting that the director acted for an improper motive.”