

Delaware Supreme Court Makes Litigation Against Independent Directors More Difficult

On May 14, 2015, the Delaware Supreme Court held that independent directors protected by an exculpatory corporate charter provision are entitled to dismissal of an action for damages, where the plaintiff does not adequately plead a non-exculpated claim.¹

I. Background and Procedural Posture

In *In re Cornerstone Therapeutics Incorporated* (“*Cornerstone I*”), the Delaware Supreme Court consolidated two interlocutory appeals from the Court of the Chancery, each turning on the same legal issue. Both cases arose from “controlling mergers”, where a controlling shareholder purchased the balance of outstanding shares of a Delaware subsidiary. The transactions in each case were negotiated by a special committee of independent directors, approved by a majority of the minority shareholders and resulted in a “substantial premium” on the market price of the relevant shares.

After each transaction, shareholder plaintiffs filed suit in the Delaware Court of Chancery, claiming that the independent directors breached their fiduciary duty by approving an unfair transaction. In each case, these directors were protected from claims arising from a breach of the duty of care by an exculpatory corporate charter provision, adopted in accordance with 8 Del. Code §102(b)(7).² Nevertheless, the plaintiffs in each case sued the controlling stockholders and their related directors, as well as the independent directors that approved the transaction.

Because the companies in each case did not follow the Delaware “safe harbor” process established by *Kahn v. M&F Worldwide Corporation*³, which allows companies to invoke the business judgment rule in litigation arising from a self-interested transaction, the Chancery Court determined that the “entire fairness” standard applied to each case.

In the first case, *In re Cornerstone Inc. Stockholder Litigation* (“*Cornerstone I*”) the independent directors moved to dismiss, arguing that the plaintiff failed to plead any non-exculpated claims.⁴ In response, the plaintiffs argued that Delaware precedent, in particular, the *Emerald Partners v. Berlin* (“*Emerald Partners*”) line of cases, prohibited dismissal of *any* claims against independent directors in cases where the standard of review was entire fairness.⁵ The Court of Chancery, with significant reservations, agreed with the plaintiffs and denied the motion.

¹ *In re Cornerstone Therapeutics Incorporated*, Stockholder Litigation, No. 564, slip op. (Del. May 14, 2015) (“*Cornerstone I*”) available at <http://courts.delaware.gov/opinions/download.aspx?ID=223540>.

² This section permits a Delaware corporation to eliminate the personal liability of a director for any breach of fiduciary duty, other than (i) a breach of the director’s duty of loyalty, (2) intentional misconduct or knowing violations of the law, and (3) transactions where the director received an improper personal benefit. 8 Del. Code §102(b)(7) (“Section 102(b)(7)”).

³ See *Kahn v. M&F Worldwide Corporation*, 88 A.3d 635, 644 (Del. 2014) (“business judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned ab initio upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority shareholders.”)

⁴ *Cornerstone II*, at 4, citing *Cornerstone I*, 2014 WL 4418169, at *5.

⁵ The plaintiffs in *Cornerstone I* argued that, under *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001) and *Emerald Partners v. Berlin*, 727 A.2d 1215 (Del. 1999), the application of an exculpatory clause in a case governed by the entire fairness standard, must be determined after trial. *Id.* at 5.

In the second case, *In re Zhongpin Incorporated*, the Court of Chancery deferred to the holding in *Cornerstone I*, and denied defendant’s motion to dismiss.⁶ In both cases, the Court of Chancery declined to assess the plaintiff’s duty of loyalty claims, reasoning that the entire fairness standard required denial of the motions, regardless of the sufficiency of the pleadings.

Both defendants petitioned the Delaware Supreme Court for interlocutory review. The Court granted the petitions, and consolidated the cases to address the common question of law.

II. Analysis and Holding

On appeal, the plaintiffs argued that in a controlling merger, the entire fairness standard should bar dismissal of a non-exculpated claim against an independent director. In the view of the plaintiffs, facilitation of a controlled merger by independent directors creates a higher risk that the directors will breach their fiduciary duties to stockholders. Furthermore, the facts giving rise to a duty of loyalty claim may be “unknowable at the pleading stage”. Therefore, the plaintiffs argued for an “automatic inference” of disloyalty against any director who facilitated a controlling merger, sufficient to overcome an exculpatory charter provision.⁷

Citing longstanding Delaware precedent and the potential for higher costs, the Court disagreed. The Court began by noting that under Delaware law, each director named in a suit for damages arising from a Board decision has a right to be considered individually, and independent directors are presumed to be loyal. Departing from these principles, in the Court’s view, would “create more harm than benefit” for minority shareholders.⁸ Citing the practical benefits of allowing independent directors to negotiate controlled transactions, the Court also expressed reservations about compelling independent directors that approve a controlled merger to remain in litigation absent evidence of an impure motive. The Court also emphasized the purpose of Section 102(b)(7), which sought to “free[] up directors to take business risks without worrying about negligence lawsuits.”⁹

The Court also clarified the meaning of the *Emerald Partners* line of cases. The Court distinguished *Emerald Partners* from the present case, and limited the holding – that where entire fairness is the standard of review, a determination that directors are protected by exculpatory clause may be made only after basis for director liability has been decided – to cases involving a “viable, non-exculpated loyalty claim” against an independent director.¹⁰

Thus, the Court concluded that under Delaware law, plaintiffs seeking damages from independent directors protected by an exculpatory provision in a corporate charter must plead non-exculpated claims for breach of fiduciary duty to survive a motion to dismiss. The Court held that this rule “applies regardless of the underlying standard of review for the transaction.”¹¹ The Court thus remanded the cases to allow the Court of Chancery to determine if the plaintiffs adequately plead a non-exculpated claim.

⁶ *Cornerstone II*, at 7, citing *In re Zhongpin Incorporated*, Shareholders Litigation, 2014 WL 6735457, at *12.

⁷ *Id.*

⁸ *Id.* at 13.

⁹ *Id.* at 16.

¹⁰ *Id.* at 17-18.

¹¹ *Id.*

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The Court also provided guidance on what constitutes a non-exculpated claim. Henceforth, when an independent director is protected by an exculpatory charter provision, a plaintiff can only survive a motion to dismiss by pleading facts allowing a rational inference that *each named director* “harbored self-interest adverse to the stockholder’s interest”, sought to “advance the self-interest of an interested party from whom they could not be presumed to act independently,” or “acted in bad faith.”¹²

III. Enhanced Protection for Independent Directors

By establishing that plaintiffs in litigation arising from a controlled merger must adequately plead a non-exculpated claim against an independent director, *Cornerstone II* bolsters the protection of exculpatory charter provisions under Section 102(b)(7), and provides greater comfort to independent directors who negotiate controlled mergers.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com.

¹² *Id.*