

M&A Update

Delaware Supreme Court Issues Important Ruling Protecting Independent Directors

May 18, 2015

On May 14, 2015, the Delaware Supreme Court ruled that claims against independent directors must be dismissed when a company charter provision shields directors from monetary liability for breach of the duty of care and the plaintiffs are unable to plead facts establishing that the directors breached the duty of loyalty, acted in bad faith or gained an improper personal benefit. The decision, *In re Cornerstone Therapeutics Inc. Stockholder Litigation*, illustrates the power of so-called “exculpatory” charter provisions and emphasizes that plaintiffs bear the burden of pleading facts to support a “non-exculpated” claim against independent directors.

Background

The decision originated from two Chancery Court cases, *In re Cornerstone Therapeutics Inc. Stockholder Litigation* and *In re Zhongpin Stockholders Litigation*. These cases both involved a controlling stockholder taking the company private and the lower court held that the entire fairness standard of review applied.

The directors in both cases were protected by an exculpatory provision written into the company’s charter that insulated the directors against liability for a breach of the duty of care. The independent directors alleged that the plaintiffs had not adequately pled any non-exculpated claims against them (e.g., breach of the duty of loyalty), and thus, the case against them should be dismissed. Meanwhile, “[t]he plaintiffs argue[d] that they should be entitled to an automatic inference that a director facilitating an interested transaction is disloyal because the possibility of conflicted loyalties is heightened in controller transactions, and the facts that give rise to a duty of loyalty breach may be unknowable at the pleading stage.” The Chancery Court agreed with the plaintiffs in both cases, finding that because of the strict nature of entire fairness review, the plaintiffs should have the opportunity to explore the disinterested directors’ liability beyond the motion to dismiss stage, regardless of whether breach of the duty of loyalty had been adequately pled.

On appeal, the Delaware Supreme Court overturned the Chancery Court decisions, holding that unless plaintiffs have adequately pled a breach of the non-exculpated duty of loyalty against independent directors protected by an exculpatory provision, the claims against them should be dismissed, regardless of the standard of the review.

Takeaways

The decision should reassure independent directors and those who serve on special committees that Delaware law will not necessarily subject them to drawn out and costly litigation for monetary damages after a transaction has closed.

1. Delaware Courts Will Review Each Director's Conduct Individually and Will Presume Independent and Disinterested Directors Acted in the Interests of the Company Absent Facts to the Contrary. The Court explained that "to require independent directors to remain defendants solely because the plaintiffs stated a non-exculpated claim against the controller and its affiliates ... would also increase costs for disinterested directors, corporations, and stockholders, without providing a corresponding benefit." The decision confirms that each director has the right under Delaware law to be considered individually in a suit challenging board action and there can be no assumption that each director acted improperly. In fact, directors are "presumed to be motivated by their duty with fidelity."
2. The Decision Is Not Likely to Benefit Directors in Pre-Closing Litigation and Independent Directors Whose Cases Are Dismissed May Remain Involved as Important Witnesses. The case is premised on the applicability of exculpatory charter provisions which apply to suits for monetary damages only. Therefore, director conduct in suits seeking to enjoin a transaction before it has closed will continue to be subject to the applicable standards of review under Delaware law. Additionally, even when their cases are dismissed, independent directors will remain important witnesses for the case against the controlling stockholder and any conflicted directors.
3. If a Breach of the Duty of Loyalty is Adequately Pled, then an Exculpatory Provision's Impact Will Not be Determined Until **After Trial**. The Court explained that the dual decisions in the *Emerald Partners* cases, heavily relied on by plaintiffs, was still good law—it stood for the proposition that if an inference of a breach of the duty of loyalty by independent directors had been adequately pled, then the court could not decide until after trial what the effect of the exculpatory provision was. Here, however, the Court could in fact dismiss the claims against the independent directors if they were not adequately pled to begin with; "when the plaintiffs have pled no facts to support an inference that any of the independent

directors breached their duty of loyalty, fidelity to the purpose of [exculpatory charter provisions] requires dismissal of the complaint against those directors.”

4. Entire Fairness Review is Still Quite Stringent, and Companies Should Attempt to Avoid This Scrutiny if Possible. Even though the case is a victory for companies fighting off challenges to controlling stockholder transactions, the Court took care to include several reminders that it still does not review interested transactions lightly. It first noted that the “stringency of after-the-fact entire fairness review by the court intentionally puts strong pressure on the interested party and its affiliates to deal fairly before-the-fact when negotiating an interested transaction.” It also explained that, “[n]o doubt, the invocation of the entire fairness standard has a powerful pro-plaintiff effect against interested parties.” As always, boards should consider utilizing the dual protections measures explained in 2013’s *In re MFW Shareholders Litigation* (condition the transaction on approval of majority of the minority and an independent special committee from the start), in order for the transaction to be subject to less stringent business judgment review, while of course weighing the execution risks involved when making such a determination.

For a copy of the full opinion, click [here](#).

* * * *

If you have any questions, please contact any of the following attorneys or your Cadwalader contact:

Martin L. Seidel +1 212 504 5643 martin.seidel@cwt.com

William P. Mills +1 212 504 6436 william.mills@cwt.com

Brittany Schulman +1 212 504 6299 brittany.schulman@cwt.com