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Delaware Supreme Court Confirms Viable Path to Dismissal of Lawsuits Against Independent Directors

By Timothy R. Dudderar and Jaclyn C. Levy

In a highly anticipated decision issued last month, the Delaware Supreme Court resolved a perceived split in Delaware authorities and held that independent directors are entitled to dismissal of stockholder claims for monetary damages unless the stockholder plaintiff pleads a nonexculpated claim against those directors. The decision, *In re Cornerstone Therapeutics Inc. Stockholders Litigation*, No. 564,2014 (Del. May 14, 2015), clarified that plaintiffs must plead such claims regardless of whether the underlying standard of review of the board's conduct is entire fairness, enhanced scrutiny under *Revlon* or *Unocal*, or the business judgment rule. While it represents a significant clarification of Delaware law and though the *Cornerstone* decision will provide some comfort to independent directors who fulfill their duty of loyalty, it is unlikely to have a substantial impact on stockholder litigation. *Cornerstone* has no application to claims against nonindependent fiduciaries and plaintiffs can still seek discovery from independent directors and add them based on such discovery. Further, the Court in *Cornerstone* limited its holding to claims seeking monetary damages, leaving open the issue of whether the protections of an exculpatory provision extend to claims for equitable relief, such as rescission. While this issue remains open, plaintiffs may seek to avoid the impact of *Cornerstone* by drafting complaints seeking both monetary and equitable relief.

In *Cornerstone*, the Delaware Supreme Court decided two consolidated appeals from the Delaware Court of Chancery. In both actions, stockholder plaintiffs sought monetary damages arising out of mergers in which a controlling stockholder, who had representatives on the board of directors, acquired the remainder of the shares of the company that it did not own. Both mergers were negotiated by a special committee of independent directors, and both companies' charters contained an exculpatory provision enacted pursuant to 8 Del. C. § 102(b)(7). In both cases, neither plaintiff had alleged any specific wrongdoing against the special committee defendants, having alleged only that these individuals negotiated the challenged transaction.

In the Court of Chancery, the *Cornerstone* independent directors' dismissal arguments relied primarily upon the Delaware Supreme Court's decision in *Malpiede v. Townson*. Though not an entire fairness case, *Malpiede* held that where the heightened *Revlon* standard of review applies, plaintiffs are required to plead nonexculpated claims to avoid dismissal. The independent directors also relied upon a number of additional cases, including *In re Fredericks of Hollywood, Inc.*, where the Court of Chancery had dismissed claims against independent directors, notwithstanding the applicability of entire fairness to the underlying transaction, because the plaintiffs failed to plead a nonexculpated claim for breach of fiduciary duty against those directors.

Plaintiffs, on the other hand, argued that the Supreme Court's *Emerald Partners* line of decisions established that a plaintiff can defeat an independent director's motion to dismiss solely by establishing that the applicable standard of review is entire fairness, the most exacting standard of review under Delaware law. In the first *Emerald Partners* decision cited by plaintiffs (*Emerald Partners I*), the Court determined that plaintiffs had adequately pleaded duty of loyalty claims that were "intertwined" with duty of care claims. In the second *Emerald Partners* decision cited by plaintiffs (*Emerald Partners II*), the Court held that "when entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only after the basis for their liability has been decided" on a fully-developed factual record. Based on this language, the Court of Chancery in *Cornerstone* adopted the plaintiffs' reading of the *Emerald Partners* decisions and held that, if the underlying transaction is subject to entire fairness review, and plaintiffs state nonexculpated claims against the interested parties and their affiliates, all of the directors are required to remain defendants through trial.

Although the Court of Chancery ruled in the plaintiffs' favor, it made clear that the defendants' view of the law was preferable from a policy standpoint. The Court of Chancery expressed concern that a rule providing an "automatic inference that a director negotiating or facilitating a transaction with a controller, without more, is a conflicted or disloyal director makes service on a special committee risky, and thus unattractive to qualified and disinterested directors." Additionally, the Court explained that the pleading rule advocated by defendants would "have little adverse effect on the minority stockholders, to whom the controller would still be liable absent entire fairness."

In the second of the two cases decided, *In re Zhongpin Stockholders Litigation*, the plaintiffs and defendants made similar arguments as in *Cornerstone* and the Court of Chancery largely deferred to the *Cornerstone* Court's reasoning in reaching the same result. Also as in *Cornerstone*, the Court of Chancery in *Zhongpin* expressed a concern regarding the policy implications of its decision, which the Court explained it was compelled to make based upon the Supreme Court's *Emerald Partners* decisions. In both cases, the Court of Chancery did not address the sufficiency of the plaintiffs' duty of loyalty claims, having held that there was no need to plead such claims in order to defeat the motions to dismiss.

Defendants in both cases sought, and were granted, permission to appeal the Court of Chancery's interlocutory orders denying their motions to dismiss. In reversing both decisions, the Delaware Supreme Court explained that plaintiffs as well as certain members of the Court of Chancery had misread its decisions in *Emerald Partners*. The Court explained that the *Emerald Partners* decisions had narrowly and unremarkably held that where the applicable standard of review is entire fairness, and plaintiffs have pleaded facts supporting the inference that each director breached *both* the duty of loyalty and duty of care, the determination of whether any failure of the putatively independent directors was the result of disloyalty or a breach of the duty of care must be determined after trial. According to the Supreme Court, when read in its proper context, the sentence from *Emerald Partners II* that the Court of Chancery found case dispositive clearly refers to a viable loyalty claim – not just a duty of care claim – precluding dismissal of the independent directors in that case. Thus, as explained by the *Cornerstone* Court, when read in context, the *Emerald Partners* decisions stand for the proposition that a defendant cannot obtain dismissal on the basis of an exculpatory provision where there is evidence that he or she committed a nonexculpated breach of fiduciary duty.

The *Cornerstone* Court also emphasized that the *Emerald Partners II* Court cited *Malpiede* – decided between *Emerald Partners I* and *Emerald Partners II* – with approval:

> The rationale of *Malpiede* constitutes judicial cognizance of a practical reality: unless there is a violation of the duty of loyalty or the duty of good faith, a trial on the issue of entire fairness is unnecessary because a Section 102(b)(7) provision will exculpate director defendants from paying monetary damages that are exclusively attributable to a violation of the duty of care. The effect of our holding in *Malpiede* is that, in actions against the directors of Delaware corporations with a Section 102(b)(7) charter provision, a shareholder's complaint must allege well-pled facts that, if true, implicate breaches of loyalty or good faith.

Thus, consistent with both *Emerald Partners* and *Malpiede*, when a director is protected by an exculpatory charter provision, a plaintiff must plead facts supporting a rational inference that the director harbored a self-interest adverse to the stockholders' interests, 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 *Cornerstone* Court explained that to hold otherwise would be inconsistent with the policy reasons that led the Delaware General Assembly to first enact Section 102(b)(7). The Delaware General Assembly enacted Section 102(b)(7) in 1989 in response to the Delaware Supreme Court's seminal decision in *Smith v. Van Gorkom*, which established director liability for a breach of the duty of care. Following *Van Gorkom*, the General Assembly was concerned that directors would be wary of making decisions that benefit stockholders if the directors faced such a low threshold of potential personal liability for making them. Section 102(b)(7) was therefore enacted to "free[ ] up directors to take business risks without worrying about negligence lawsuits." In light of this history, the *Cornerstone* Court reasoned that establishing a rule requiring directors to remain as parties in litigation involving a transaction with a controlling stockholder solely because plaintiffs stated a nonexculpated claim against the controller and its affiliates would undermine the purpose of Section 102(b)(7) by creating "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."

Implications for Practitioners and Boards of Directors

There is no question that the *Cornerstone* decision is a positive development for Delaware law and those individuals who serve as fiduciaries of Delaware corporations. By clarifying the existence of a viable path to dismissal of stockholder suits, the decision will encourage qualified men and women to serve as independent directors without fear that they will be subject to many of the burdens of stockholder litigation and potential liability merely because they performed their roles.

That said, the *Cornerstone* decision will likely have little practical effect on stockholder litigation in general. Stockholder claims against interested fiduciaries and controlling stockholders will not be impacted at all. As the *Cornerstone* Court explained, "[i]nterested fiduciaries, often the proverbial deep-pocketed defendants, will continue to be required to prove that the transaction was entirely fair to the minority stockholders. . . ." Moreover, though the decision allows for the dismissal of suits against independent directors at the pleading stage, such directors will still be subject to some of the more significant burdens of litigation even though they may not remain as parties. Independent directors, because of their involvement in the transaction at issue in the litigation, will be required to participate in the discovery process by serving as document custodians and fact witnesses. And if, during discovery, the plaintiff discovers facts that would support a duty of loyalty or bad faith claim against the independent directors, plaintiffs are free to amend their complaint to add them as defendants. Accordingly, even if they are dismissed, independent directors will still likely require counsel to represent them throughout discovery and in the event they are required to testify at trial.

Further, though it definitively established a path to dismissal of claims for damages against independent directors, the *Cornerstone* decision explicitly left unresolved the effect of a Section 102(b)(7) provision on claims seeking equitable relief:

> We focus here on damages because that is the issue before us. The entire fairness doctrine also has a potent effect in cases where equitable relief, such as rescission, is a viable remedy, but the existence of a Section 102(b)(7) charter provisions might not have the same case-dispositive effect under those circumstances.

In making this statement, the Court cited to *London v. Tyrell*, a case where the Court of Chancery denied a motion to dismiss by a Special Litigation Committee (the "SLC"). In *Tyrell*, the plaintiff sought to rescind stock options granted to defendants. After its investigation, the SLC recommended dismissal of the claim that defendants had breached the duty of care in approving the options because the defendants were protected by the company's Section 102(b)(7) exculpatory provision. The Court found this recommendation unreasonable because the SLC failed to consider that the "requested relief in plaintiffs' complaint is not limited to money damages," but also sought rescission of the stock options. Citing precedent, the Court of Chancery explained that exculpatory provisions do not bar duty of care claims where the plaintiff seeks equitable remedies, such as an injunction or rescission. Thus, the Court held in *Tyrell* that if it "became convinced at the summary judgment stage or after a trial on the merits that defendants breached their duty of care the exculpatory provision in [the company's] charter would not preclude [the Court] from ordering rescission of the [options]."

If the Delaware Supreme Court were to adopt *Tyrell's* reasoning and decide that a Section 102(b)(7) exculpatory provision has no effect on claims seeking equitable relief, at least some of the benefit to independent directors provided by *Cornerstone* could be lost. Plaintiffs could potentially avoid dismissal of claims against independent directors by including in their complaints claims seeking equitable relief, such as rescission or the imposition of a constructive trust, in addition to monetary damages. For this reason, the ultimate usefulness of *Cornerstone* is not fully settled and will not be until the Delaware Supreme Court has occasion to rule on the applicability of Section 102(b)(7) to claims seeking equitable remedies.

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