

INSIGHTS

Delaware Supreme Court Clarifies Pleading Standard For Claims Against Independent Directors

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Yesterday, in *In re Cornerstone Therapeutics, Inc. Stockholder Litigation*, the Supreme Court of Delaware held that plaintiffs seeking monetary damages against disinterested, independent directors must plead facts sufficient to support an inference that the directors engaged in a non-exculpated breach of fiduciary duty in order to survive a motion to dismiss. This ruling overturned two recent Delaware Court of Chancery decisions holding that prevailing Delaware precedent precluded the determination of independent director liability with respect to interested-party transactions until there was a fully-developed factual record – in other words, until after discovery or even trial. The Supreme Court clarified that, absent allegations supporting a non-exculpated duty of loyalty claim, independent directors may seek dismissal based on the exculpatory protection for duty of care violations permitted by Section 102(b)(7) of the Delaware General Corporation Law irrespective of the standard of review applicable to the underlying transaction.

Case Summary

In *Cornerstone*, C.A. No. 8922-VCG (Del. Ch. Sept. 10, 2014), a minority shareholder challenged a controlling shareholder freeze-out transaction, asserting that the price negotiated by a special committee and approved by the full board was unfair to the minority shareholders even though it represented a substantial premium to the pre-announcement market price. Similarly, in *In re Zhongpin Inc. Stockholders Litig.*, C.A. No. 7393-VCN (Del. Ch. Nov. 26, 2014), the shareholder plaintiff challenged the price received by minority shareholders in a going-private transaction between the company and its Chairman and CEO that was negotiated and approved by a special committee. Given the interested nature of both transactions, they were reviewed under the entire fairness standard of review, rather than the deferential business judgment rule.

In both cases, the independent directors sought dismissal of the claims based on exculpatory provisions in the companies' charters adopted pursuant to Section 102(b)(7). The independent directors argued that, notwithstanding the application of the entire fairness standard of review, the claims against them should be dismissed in the absence of pleaded facts supporting an inference that they committed a non-exculpated breach of their duty of loyalty. In contrast, the plaintiffs contended that controlling Delaware precedent required the court to deny the motions to dismiss because the transactions were reviewed under the entire fairness standard. Essentially, the plaintiffs urged that the courts were required to adopt an inference of director *disloyalty*, even with respect to independent, disinterested directors, because controller transactions implicate a heightened possibility of conflicted loyalties.

The *Cornerstone* court (V.C. Glasscock) denied the independent directors' motions to dismiss, expressing that, while it did not necessarily agree with the result, it believed it was compelled by controlling precedent. The court subsequently granted certification of an interlocutory appeal to the Supreme Court. Following the *Cornerstone* decision, the *Zhongpin* court (V.C. Noble) likewise denied the independent directors' motions to dismiss, but granted an application for interlocutory review. The Supreme Court accepted both appeals, reversed and remanded.

The Supreme Court's Decision

The Supreme Court held that "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 Section 102(b)(7) requires dismissal of the complaint against those directors" regardless of the applicable standard of review. In so holding, the court resolved a perceived conflict between *Malpiede v. Townson*, a case decided under the *Revlon* standard of review, and the *Emerald Partners* series of entire fairness cases. In *Malpiede*, the court held that, even under the enhanced *Revlon* standard of review applicable to change-of-control transactions with non-controllers, Section 102(b)(7) would bar a claim when a plaintiff pleads facts that do not rise above a due care violation. In *Emerald Partners*, on the other hand, the court stated that, with respect to a transaction presumptively reviewed under the entire fairness standard of review, the determination whether an independent director engaged in conduct implicating disloyalty or a mere lapse in care was best resolved after a trial. The Supreme Court harmonized this apparent conflict, reasoning that the claims in *Emerald Partners* were allowed to proceed because the duty of loyalty claims against those directors were "intertwined" with the duty of care claims. Thus, the Supreme Court reasoned that *Emerald Partners* did not require *automatic* denial of a motion to dismiss merely because the entire fairness standard of review was applied.

The Supreme Court squarely rejected the plaintiffs' argument that entire fairness review compels the court to adopt an inference of disloyalty on the part of the independent, disinterested directors. The court emphasized that adopting such an automatic inference not only would contravene established Delaware law that independent directors are "presumed to be motivated to do their duty with fidelity[,]," but also Delaware law's longstanding recognition that the negotiating efforts of independent directors can help secure transactions that are favorable to the minority shareholders. The court further emphasized that such an approach invariably would discourage independent director service and would undermine the intent of the Delaware General Assembly when it adopted Section 102(b)(7) in the first place.

Takeaways

While the *Cornerstone* decision undoubtedly represents a positive development for independent directors, whether it has a significant impact on the success of pleading stage motions remains to be seen. As in *Emerald Partners*, Delaware courts repeatedly have emphasized that it can be difficult to draw a clear line of demarcation between duty of care violations and non-exculpated duty of loyalty violations, particularly at the pleading stage. For example, Delaware courts recently have characterized boards as operating with a "controlled mindset," even in the absence of a specific, identifiable basis to assume that the directors favored the interests of a controller. Thus, there may be scenarios where the court is reluctant to grant a pleading stage dismissal to independent directors even though the complaint is devoid of allegations that identify some specific conflict of interest that may have impacted their judgment. Independent directors and their counsel will argue that this is not the right result, but the *Cornerstone*

decision appears to leave this door open. That said, *Cornerstone* clearly raises the bar for plaintiffs by requiring them to plead at least some facts that create a conceivable inference of disloyal conduct by independent directors in order to state a claim. Absent some reason to challenge their loyalty, independent directors should be afforded the protection of Section 102(b)(7) and should not be forced to endure discovery and trial before they can seek dismissal.