

Delaware Courts Update: Supreme Court Issues Decision on Exculpatory Clauses

Delaware Supreme Court Confirms Exculpatory Clauses Have Teeth, and Can be Used by Director Defendants at the Pleading Stage

In a decision with important implications for directors of public companies, the Delaware Supreme Court overturned two Chancery Court opinions—*In re Cornerstone Therapeutics Inc. Stockholder Litigation*¹ and *Leal, et al. v. Meeks et al.*²—and ruled that independent directors facing breach of duty of care claims arising from interested-party transactions are entitled to dismissal based on the company’s exculpatory clause. This decision is applicable to any independent directors or special committees involved in negotiating and approving transactions, particularly interested-party transactions. Historically the invocation of the entire fairness standard in an interested party transaction has had a powerful “pro-plaintiff effect,” but this decision demonstrates that such cases remain a dynamic area of Delaware law.

Under Delaware law, a company’s adoption of a charter provision in accordance with Section 102(b)(7) “bars the recovery of monetary damages from directors for a successful shareholder claim that is based exclusively upon establishing a

violation of the duty of care.”³ However, when a director is protected by a Section 102(b)(7) exculpatory charter provision, a plaintiff can only survive a director defendant’s motion to dismiss by pleading a non-exculpated claim—in other words, a breach of duty of loyalty claim or “facts supporting a rational inference that the director harbored 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 independent, or acted in bad faith.”

While exculpatory provisions have been consistently utilized by director defendants at the motion to dismiss stage, in both underlying opinions, the Court of Chancery denied the defendants’ motions to dismiss because it read the precedent of the Delaware Supreme Court to require doing so, regardless of the exculpatory provision in each company’s certificate of incorporation. Like so many interested-party transaction cases, both cases involved damages actions by stockholder plaintiffs arising

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out of mergers in which the controlling stockholder, who had representatives on the board of directors, acquired the remainder of the shares that it did not own in a Delaware public corporation. In both mergers, special committees of independent directors negotiated the transactions, which were ultimately approved by a majority of the minority stockholders and were at substantial premiums to the pre-announcement market price. Under the Chancery Court's analyses, the independent director defendants would be "along for the ride" and would remain in the case until the end of litigation regardless of whether a claim was stated against them.

Reversing two Delaware Chancery Court decisions on interlocutory appeal, the Delaware Supreme Court held that plaintiffs are not entitled to any automatic inference that a director facilitating an interested transaction is disloyal. Instead, "plaintiffs must plead a non-exculpated claim for breach of fiduciary duty against an independent director protected by an exculpatory charter provision, or that director will be entitled to be dismissed from the suit." This principle holds true regardless of the underlying standard of review for the transaction. Thus, "even if a plaintiff has pled facts that, if true, would require the transaction to be subject to the entire fairness standard of review, and the interested parties to face a claim for breach of their duty of loyalty, the independent directors do not automatically have to remain defendants." The Court reasoned that, "the mere fact that a plaintiff is able to plead facts supporting the application of the entire fairness standard to the transaction, and can thus state a duty of

loyalty claim against the interested fiduciaries, does not relieve the plaintiff of the responsibility to plead a non-exculpated claim against each director who moves for dismissal."

As the Court noted, its decision makes sense because of policy reasons. Negotiating efforts of independent directors can help secure interested party transactions that are favorable to the minority. Indeed, interested transactions subject to special committee approval are often priced on terms that are attractive to minority stockholders. Based on such policy rationales, the Court "declin[ed] 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." The cases were thus remanded to allow the Court of Chancery to determine if the plaintiffs have sufficiently pled non-exculpated claims against the independent directors.

All in all, the Delaware Supreme Court's decision has important implications for director defendants at the pleading stage.

—BY THE SECURITIES LITIGATION GROUP
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NOTES

1. *In re Cornerstone Therapeutics Inc, Stockholder Litigation*, 2015 WL 2394045 (Del. 2015).
2. *Leal, et al. v. Meeks et al.* (No. 706, 2014 Del.).
3. See *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001); 8 Del. C. § 102(b)(7).