# Corporate Litigation:

# Disinterested Directors and 'Entire Fairness' Cases

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June 15, 2015

Under Delaware law, where a controlling shareholder stands on both sides of a corporate transaction that is challenged by minority stakeholders, the controller presumptively bears the burden of proving the entire fairness of the transaction, i.e. "both fair dealing and fair price." Conversely, disinterested directors—those with no financial stake in the transaction—may be liable for breach of fiduciary duty only where they have breached a non-exculpated duty in connection with the negotiation or approval of the transaction.

Delaware General Corporation Law §102(b)(7) authorizes corporations to include a provision in the certificate of incorporation exculpating their directors from money damages claims based on breach of the duty of care, but not the duty of loyalty. Delaware courts have long held that a §102(b)(7) charter provision "entitles directors to dismissal of any claims for money damages against them that are based solely on alleged breaches of the board's duty of care."[1] The overwhelming majority of Delaware corporations have adopted exculpatory provisions.

In lawsuits in which the entire fairness standard of review applies, however, the availability of the exculpatory charter defense at the pleading stage has been less than clear. There has been agreement that a minority shareholder asserting claims against a controlling shareholder who transacted with the corporation must "plead facts raising an inference that the defendant stockholder is a controller and that the transaction was not entirely fair to the majority" to survive the controller's motion to dismiss.[2] Until recently, however, Delaware courts have grappled with the pleading standard applicable to claims against disinterested directors alleged to have breached their fiduciary duties in connection with a controlling party transaction.

As the Delaware Court of Chancery framed the question, because the liability of disinterested directors depends on a "non-exculpated breach of duty," "must specific facts raising an inference of a non-exculpated breach be pled with respect to each director defendant, or is it enough at the motion-to-dismiss stage to have pled that a disinterested director facilitated a transaction with a controller that was not entirely fair, upon which pleading the actions of the director, as regards her personal liability must receive judicial scrutiny upon a fully developed factual record?"[3]

Last month, in an opinion written by Chief Justice Leo E. Strine Jr., the Delaware Supreme Court ruled that regardless of the underlying standard of review for the board's conduct, a plaintiff must plead a non-exculpated claim against disinterested directors to avoid dismissal at the pleading stage.[4] In so holding, the court in *In re Cornerstone Therapeutics Inc. Stockholder Litigation* reversed two decisions issued last year by the Court of Chancery and clarified the seminal *Emerald Partners v. Berlin* decision, which those decisions interpreted.

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## The Decisions Below

*In re Cornerstone Therapeutics* involved a minority shareholder challenge to an "acquisition of a company by a controlling stockholder, negotiated by a special committee" of independent directors and approved by a majority of the minority stockholders.[5] It was evident that the transaction would be subject to an entire fairness review with respect to the controller and the directors affiliated with the controller; however, the parties disputed the proper pleading standard for the claims brought against "the disinterested directors who served on the Special Committee appointed to negotiate with the controller, and the disinterested directors who voted in favor of the transaction."

The plaintiffs argued that where the transaction at issue is subject to an entire fairness standard of review, the court should not dismiss claims against disinterested directors on the basis that the plaintiffs failed to plead a non-exculpated breach of duty, "because 'entire fairness review exists, in part, to allow for thorough discovery and fact-finding in order to "uncover" possible violations of the duty of loyalty by "facially independent directors" who may be unduly influenced by a controller.'"

The defendants countered that "'the pendency of entire fairness claims against the controlling stockholder [does not] relieve the Plaintiffs of their obligation to plead a cognizable claim against each of the Special Committee members' and that, '[t]o the contrary, [t]o burden the Special Committee with proving entire fairness, [the Plaintiffs] must allege sufficiently that the committee members breached a non-exculpated fiduciary duty.'"[6]

The Court of Chancery in *Cornerstone Therapeutics* concluded that where "entire fairness is the standard of review ab initio, controlling case precedent directs that negotiating and facilitating directors must await a developed record, post-trial, before their liability is determined." The precedent referenced by the court was *Emerald Partners v. Berlin*, a complex case resulting in multiple written decisions. In 2001, the Delaware Supreme Court in *Emerald Partners* addressed "when it is appropriate procedurally to consider the substantive effect of a Section 102(b)(7) provision, in a shareholder challenge to a transaction that requires a trial pursuant to the entire fairness standard of judicial review."[7]

In its analysis, the court in *Emerald Partners* explained that where entire fairness is applicable, "injury or damages becomes a proper focus only after a transaction is determined not to be entirely fair" and thus, "the exculpatory effect of a Section 102(b)(7) provision only becomes a proper focus of judicial scrutiny after the directors' potential personal liability for the payment of monetary damages has been established."

The Court of Chancery in *Cornerstone* interpreted this language to mean that where entire fairness is the applicable standard of review, the issue of whether the director defendants breached a non-exculpated duty is reached only after a determination has been made at trial that the transaction was not entirely fair. The Chancery Court ruled, therefore, that because the plaintiffs sufficiently pleaded that (i) a controlling shareholder was on both sides of the transaction, and (ii) the transaction was not entirely fair to the minority shareholders, and (iii) that the director defendants "negotiated or facilitated the unfair transaction," under *Emerald Partners* the pleading was sufficient to withstand the directors' motion to dismiss.[8]

Less than three months after *Cornerstone*, the Court of Chancery in *In re Zhongpin Inc. Stockholders Litigation* again addressed whether an exculpatory provision mandated dismissal of a complaint that failed to allege "a non-exculpated claim, i.e. a claim alleging breach of the duty of loyalty or bad faith conduct."[9] The court followed *Cornerstone*, holding that because the plaintiffs challenged a corporate transaction with a controlling shareholder, which subjected the transaction to entire fairness review, and alleged that the transaction was not entirely fair, "the disinterested Special Committee Directors, who were protected by a §102(b)(7) provision, cannot prevail on a motion to dismiss, despite Plaintiffs' failure to plead a non-exculpated claim for breach of fiduciary duty against them with particularity."

## Delaware Supreme Court

On interlocutory appeal in *Cornerstone*, the Delaware Supreme Court resolved the "important and uncertain issue of corporate law" framed by the Court of Chancery in *Cornerstone* and *Zhongpin*, holding that "[a] plaintiff seeking only monetary damages must plead non-exculpated claims against a director who is protected by an exculpatory charter provision to survive a motion to dismiss, regardless of the underlying standard of review for the board's conduct."[10] Thus, even where the transaction at issue is subject to an entire fairness standard of review, disinterested directors who are protected by an exculpatory provision and who are not alleged to have violated any non-exculpated duties "do not automatically have to remain defendants" and "are entitled to have the claims against them dismissed."

The court noted that, of course, where the entire fairness standard is applicable, the plaintiffs could still survive a motion to dismiss by the interested fiduciaries "regardless of the presence of an exculpatory charter provision because their conflicts of interest support a pleading-stage inference of disloyalty." But this does not relieve plaintiffs of their obligation to plead non-exculpated claims against disinterested directors.

The Delaware Supreme Court emphasized that disengaging a shareholder-approved exculpatory provision whenever a controlling shareholder transaction is challenged would be "inconsistent with Delaware law." Directors are entitled to be considered individually and are presumed to have acted in accordance with their fiduciary duties. This presumption is not automatically overcome by "the mere fact that a director serves on the board of a corporation with a controlling shareholder," nor does the director lose the protection of the business judgment rule simply "because the controlling stockholder may itself be subject to liability for breach of the duty of loyalty if the transaction was not entirely fair to the minority stockholders."

The court also indicated that the plaintiffs' approach "would likely create more harm than benefit for minority stockholders in practice." The court observed that requiring independent directors who negotiated the transaction to remain defendants until the end of the ensuing litigation even where the plaintiffs did not plead non-exculpated claims against them "would create incentives for independent directors to avoid serving as special committee members, or to reject transactions" that may be in the best interests of minority stakeholders. Establishing a rule that prohibits dismissal of claims against disinterested directors merely because the entire fairness standard applies would therefore undermine §102(b)(7), which was specifically adopted to "free[ ] up directors to take [potentially value-maximizing] business risks without worrying about negligence lawsuits."[11]

Finally, addressing the language of *Emerald Partners* on which the lower courts had relied, the Supreme Court underscored that *Emerald Partners* was focused on a different question than that of *Cornerstone*—"namely, whether courts can consider the effect of a Section 102(b)(7) provision before trial when the plaintiffs have pled facts supporting the inference not only that each director breached not just his duty of care, but also his duty of loyalty, when the applicable standard of review of the underlying transaction is entire fairness."

The Supreme Court cautioned that the language that the plaintiffs and the Chancery Court considered dispositive must be understood in the context in which it was made, "as referring to a case where there was a viable, non-exculpated loyalty claim against each putatively independent director." Moreover, the Cornerstone court noted that *Emerald Partners* also contains language that is consistent with the conclusion that independent directors are entitled to dismissal where the plaintiffs failed to plead a non-exculpated claim against them. For example, *Emerald Partners* states 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."[12] Thus, the Cornerstone court clarified that statements in *Emerald Partners* in tension with *Cornerstone's* holding "should be read in their case-specific context and not for the broad proposition" advocated by the plaintiffs.

Having ruled that plaintiffs must plead facts supporting an inference that the disinterested directors breached a non-exculpated duty under §102(b)(7), the Cornerstone court remanded each of the cases for a determination of whether the plaintiffs have sufficiently pleaded such facts.

## Significance of 'Cornerstone'

The Delaware Supreme Court's decision in *Cornerstone* eliminates the uncertainty surrounding a basic issue of Delaware corporate litigation that arises relatively frequently. The ruling provides comfort to disinterested directors that they will not lose the benefit of the charter's exculpatory provision at the motion to dismiss stage if sued following a transaction with a controlling shareholder. It is now clear regardless of the standard of review to which the challenged transaction is subject, §102(b)(7) provisions will be enforced at the motion to dismiss stage unless the plaintiffs plead specific facts indicating that the independent directors breached their duty of loyalty or did not act in good faith—a high standard for plaintiffs to meet.

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### Endnotes:

[1] See *Malpiede v. Townson*, 780 A.2d 1075, 1095-96 & n.70 (Del. 2001); see also *DiRienzo v. Lichtenstein*, 2013 WL 55030, at *10-*16 (Del. Ch. Sept. 30, 2013) (dismissing claims against special committee members in the context of a self-dealing transaction where plaintiff failed to allege a non-exculpated breach of fiduciary duty); In *re Synthex, Inc. Shareholder Litig*., 50 A.3d 1022, 1032 (Del. Ch. 2012) (holding that where "the directors on the Board are protected by the §102(b)(7) provision exculpating them for personal liability stemming from a breach of the duty of care, the complaint must be dismissed against the directors unless the plaintiffs have successfully pled non-exculpated claims for breach of the duty of loyalty against them").

[2] In re Cornerstone Therapeutics Inc. Stockholder Litigation, 2014 WL 4418169, at *10 (Del. Ch. Sept. 10 2014), rev'd, 2015 WL 2394045 (Del. May 14, 2015).

[3] Id.

[4] *In re Cornerstone Therapeutics Inc. Stockholder Litig*., 2015 WL 2394045 (Del. May 14, 2015).

[5] *In re Cornerstone*, 2014 WL 4418169, at *5.

[6] Id. (internal quotations and citations omitted).

[7] 787 A.2d 85, 89-90 (Del. 2001).

[8] *In re Cornerstone*, 2014 WL 4418169, at *12.

[9] 2014 WL 6735457, at *11.

[10] *In re Cornerstone*, 2015 WL 2394045, at *1, *4.

[11] Id. at *9 (quoting *Smith v. Van Gorkom*, 780 A.2d 1075, 1095 (Del. 2001)).

[12] Id. (citing *Emerald Partners*, 787 A.2d at 92).

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