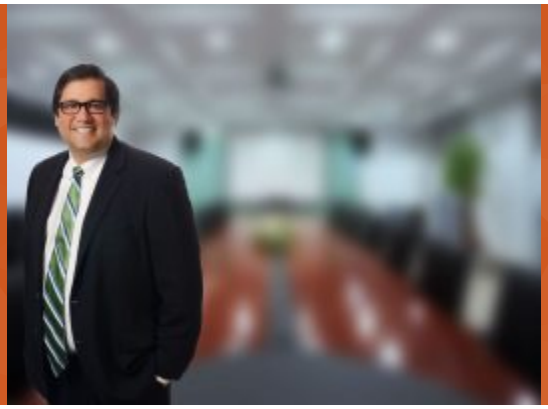
Delaware Clarifies Limited Liability of Independent Directors



By:Joseph R. Martinez
September 01, 2015

The Delaware Supreme Court recently issued an important decision about limitations of the liability of independent directors in an interested transaction. The opinion was a consolidation of two cases that revolved around the same question: where the plaintiff challenges an interested transaction with claims for damages against corporate fiduciaries, must the plaintiff plead a non-exculpated claim against the independent directors? The Delaware Supreme Court stated that the question raised in these appeals presented "a debate between two competing but colorable views of the law", but ultimately decided that, when a director is protected by an exculpatory charter provision, a plaintiff must plead a non-exculpated claim for breach of a fiduciary duty against an independent director, or that director will be entitled to be dismissed from the suit regardless of the underlying standard of review that applies to the transaction.

The two cases, *In re Cornerstone Therapeutics Inc. Stockholder Litigation and Leal v. Meeks*, both involved allegations relating to mergers associated with going private transactions in which the controlling stockholder, who had representatives on the board of directors, acquired the remainder of the shares of a Delaware public company. In both cases, (i) the merger was negotiated by special committees of independent directors, (ii) the transactions were ultimately approved by a majority of the minority stockholders and (iii) the price was at a substantial premium to the pre-announcement market price. Nonetheless, the plaintiffs filed suit, arguing that the directors had breached their fiduciary duty by approving transactions that were unfair to the minority stockholders. In both cases, it was undisputed that the companies did not follow the process laid out in *Kahn v. M&F Worldwide Corporation* as a safe harbor to invoke the business judgment rule in an interested transaction and, therefore, the entire fairness standard applied. Both companies in these disputes also had exculpatory provisions in their charters that insulated the companies' directors from liability for monetary damages for breaches of the fiduciary duty of care in accordance with Section 102(b)(7) of the Delaware General Corporation Law. Despite the provisions, the plaintiffs in both cases sued the independent directors as well as the controlling stockholders and their affiliated directors.

In both of the subject cases, the Delaware Court of Chancery denied the defendants' motions to dismiss because the Chancery Court believed the precedent required it to do so as long as the underlying transaction was subject to the entire fairness standard of review. The rationale of the lower court was that, if the plaintiffs were able to state non-exculpated claims against the interested parties and their affiliates, then all of the directors, including the independent ones, were required to remain defendants in the litigation.

Section 102(b)(7) of the Delaware General Corporation Law allows Delaware corporations to include exculpatory provisions in the company's charter that limit or eliminate the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not, among other things, limit the director's liability (i) for any breach of a director's duty of loyalty, (ii) for any acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, or (iii) for any

transaction from which the director derived an improper personal benefit. Such exculpatory provisions are meant to address fears of directors who faced personal liability for potentially "value-maximizing business decisions" which might dissuade them from making such decisions.

In this opinion, the Delaware Supreme Court declined to adopt an approach that it felt "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 stockholders would cause them to remain defendants until the end of any litigation challenging the transaction." The Court stated 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 – be it Revlon, Unocal, the entire fairness standard, or the business judgment rule."

This decision reinforces the importance of exculpatory charter provisions as provided in Section 102(b)(7) of the Delaware General Corporation Law. These provisions provide an important safeguard and incentive for independent directors to participate on independent special committees and act on behalf of minority stockholders. If a director is truly independent and does not have an interest in the subject transaction, the director can be secure in the belief that she will not be subject to personal liability.
A plaintiff's breach of the duty of loyalty or bad faith claims against directors must be addressed at the motion to dismiss stage of trial and, if they cannot independently survive a motion to dismiss, then those directors should be dismissed from the case, notwithstanding the fact that other directors may be interested in the transaction and are affiliates of a controlling stockholder. The Court's opinion does not change the rule that interested directors will continue to be required to prove that a transaction was entirely fair to minority stockholders, because plaintiff's well-pled claims against the interested parties in an interested transaction cannot be dismissed before trial.

For more information about this topic, please contact Joe Martinez.