HUNTON & WILLIAMS

Client Alert

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Delaware Supreme Court Addresses Outside Director Liability in Interested Transactions

The Delaware Supreme Court recently issued an important decision in *In re Cornerstone Therapeutics Inc. Stockholder Litigation* that affects outside directors' potential liability in conflict of interest transactions. The court held that, even if a conflict of interest transaction is subject to the stringent entire fairness standard of review, a plaintiff must still plead that an outside director breached the duty of loyalty. Otherwise, the outside director can seek a dismissal from the proceedings before the transaction is reviewed for entire fairness.

The Delaware Supreme Court's Opinion

The Delaware Supreme Court's opinion was in response to appeals filed from two separate rulings of the Court of Chancery.[1] The cases involved freeze-out mergers in which controlling stockholders acquired the outstanding minority interests. Both mergers were subject to the entire fairness standard of review. The outside directors, however, filed motion to dismiss, arguing that the plaintiffs had failed to plead non-exculpated breach of fiduciary duty claims against them. The lower courts concluded that, under existing Delaware precedent, a determination of a director's liability had to be done after the transaction was tested for fairness. As a result, the outside directors could not escape the litigation prior to trial.

The Delaware Supreme Court reversed the lower courts' rulings, holding that a plaintiff must still plead non-exculpated breaches of fiduciary duty against the outside directors.[2] Chief Justice Leo E. Strine, Jr., writing for the court, explained 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 nonexculpated claim against each director who moves for dismissal*" (emphasis added). He further stated that "each director has a right to be considered individually when the directors face claims for damages" and that Delaware law presumes directors are "motivated to do their duty with fidelity." The court also indicated that its holding was not limited to entire fairness cases and thus also applies to challenges to a sale of the corporation or the adoption of takeover defenses under *Revlon* and *Unocal*, respectively.

Conclusion

The Delaware Supreme Court's decision is protective of well-motivated, independent directors. Under prior case law, it appeared that all of the directors had to remain defendants through trial as long as the plaintiff successfully invoked the entire fairness standard – even if the well-pled loyalty claims were made only against the interested parties. This increased the cost of litigation by requiring the outside directors to

[1] *In re Cornerstone Therapeutics Inc., S'holder Litig.*, No. 564, 2014 (Del. May 14, 2015); *Leal v. Meeks*, No. 706, 2014 (Del. May 14, 2015).

[2] Under Section 102(b)(7) of the Delaware General Corporation Law, a corporation's certificate of incorporation can eliminate directors' personal liability for breaches of the duty of care. Thus, a non-exculpable breach of duty means a breach of the duty of loyalty at a corporation with a Section 102(b)(7) provision.

be parties to the litigation. More importantly, it cast a cloud of potential liability over the outside directors as the litigation worked its way through the courts.

Under *Cornerstone*, outside directors can now seek dismissal at early stages of the litigation, even if there will be a trial against the interested parties to determine the fairness of the interested transaction. Those outside directors should be dismissed unless the plaintiff sufficiently alleges that they acted in bad faith or were otherwise disloyal. This ruling should give comfort to independent directors who negotiate and review interested transactions. In that regard, the court noted that Delaware wants independent directors to review such transactions and does not want to discourage them from such service.

Contact

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