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The Reinvigorated Exculpation Clause for Independent Directors in Controlled Companies

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Last month, the Delaware Supreme Court held that in every case, including controlling stockholder squeeze-out merger cases, individual directors must be dismissed at the pleadings stage of a damages case if the plaintiffs are unable to plead a non-exculpated claim against them.[1] This pragmatic result is welcome news to independent directors, who should no longer find themselves defending against stockholder litigation through trial merely to establish what is apparent at the pleadings stage: the company's exculpation clause protects independent directors who act in good faith from having to pay damages. The applicability of *Cornerstone* will turn, as it should, on whether the plaintiff is able to plead non-conclusory facts making it reasonably conceivable that a given director violated his or her duty of loyalty; pleading that a putatively independent director serves at the behest of a controlling stockholder will not be enough.

The Supreme Court's *Cornerstone* decision addressed interlocutory appeals in the context of two similarly situated cases that were consolidated for purposes of appeal. Each case was filed by a minority stockholder seeking money damages in the context of a corporation's going-private merger with its controlling stockholder. The plaintiffs in each case asserted fiduciary duty claims against the controlling stockholder and its affiliates, as well as the independent directors who approved the merger, alleging that the premium deal was unfair to the minority stockholders.[2]

CONTINUED ON PAGE 4

Content HIGHLIGHTS

Complete Table of Contents listed on page 2.

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CONTINUED FROM PAGE 1

In each case, the merger was negotiated by a special committee of independent directors and approved by a majority of the minority stockholders, but the procedural prerequisites set forth in *Kahn v. M & F Worldwide Corporation* were not followed.[3] "Thus, the entire fairness standard presumptively applied" in each case, and "the defendant directors were insulated from liability for monetary damages for breaches of the fiduciary duty of care by an exculpatory charter provision adopted in accordance with 8 *Del. C.* § 102(b)(7)."[4]

Relying on *Emerald Partners*, the Court of Chancery denied the independent directors' motion to dismiss in each case,[5] and the Supreme Court reversed.[6] The Supreme Court's decision thus reinforces the protections afforded to independent directors of Delaware corporations in the form of exculpatory charter provisions adopted under Section 102(b)(7) of the DGCL and breathes new life into those protections in controlling stockholder squeeze-out cases and others invoking the entire fairness standard.[7] *Cornerstone* should specifically comfort independent directors of controlled companies and encourage their continued service and willingness to be involved in going-private transactions that, with the involvement of independent directors, often benefit the minority stockholders.

At the same time, *Cornerstone* should not meaningfully discourage stockholder plaintiffs from challenging going-private transactions, nor should it materially affect the plaintiffs' access to proof, burdens of persuasion or post-trial remedies available in a given case. Independent directors will remain involved in litigation as critically important non-party witnesses. Controllers will remain responsible for either disabling the exercise of their control from the outset of the negotiations, or proving the entire fairness of a challenged transaction after the fact. And where a plaintiff succeeds in an entire fairness case, the presence of independent directors as defendants is unlikely to affect their ultimate recovery after trial.

The Delaware Courts' View of Independent Directors in Controlled Companies Has Shifted

In 1984, the Delaware Supreme Court held, in the context of the demand requirement in a derivative suit, that "proof of majority ownership of a company does not strip the directors of the presumptions of independence, and that their acts have been taken in good faith and in the best interests of the corporation."[8] Accordingly, the independent directors of a controlled company are presumed capable of acting independently and in good faith, notwithstanding the unique governance structure in which they serve.

A decade later in *Kahn v. Lynch Communication Systems, Inc.*, the Delaware Supreme Court held, in the context of a controlling stockholder merger, that the transaction would be reviewed under the entire fairness standard notwithstanding the board's delegation of authority to a special committee of independent directors.[9] In doing so, the *Lynch* Court portrayed a "controlling stockholder as the 800–pound gorilla whose urgent hunger for the rest of the bananas is likely to frighten less powerful primates like putatively independent directors who might well have been hand-picked by the gorilla (and who at the very least owed their seats on the board to his support)."[10] Gone were the presumptions underlying *Aronson* that an ostensibly independent director of a controlled company was capable of acting independently and in good faith.

In 2001, in *Emerald Partners v. Berlin*, the Supreme Court reaffirmed *Lynch*'s skeptical view of putatively independent directors of controlled companies.[11] The Court held that in an entire fairness case, ostensibly independent directors were not entitled to summary judgment because "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."[12] Although *Emerald Partners* could fairly be read as a case in which there were viable, non-exculpated loyalty claims asserted against the putatively independent directors,[13] it also signaled a return to the *Lynch* refrain that putatively independent directors could not be trusted to act independently of a controlling stockholder.[14]

Viewed from a procedural perspective, this view loosely translated into a plaintiff-friendly inference that putatively independent directors in controlled companies are improperly influenced by the controller.[15] Accordingly, following *Emerald Partners*, the Court of Chancery frequently refused to dismiss putatively independent directors prior to trial in cases involving controlling stockholders, notwithstanding *Aronson*'s command that independent directors in controlled companies are entitled to the presumption of independence and good faith. This was the result reached, albeit reluctantly, by the Court of Chancery in *Cornerstone* as well as *Zhongpin*.[16]

The Supreme Court's decision in *Cornerstone* has suddenly breathed life back into the *Aronson* presumption of the capable, faithful independent director. In so doing, it has given independent directors a path to dismissal in a damages action challenging a controlling stockholder squeeze out.

At the same time, it has taken little from would-be stockholder plaintiffs. As *Southern Peru*[17] and *Rural Metro*[18] so powerfully demonstrate, damages in a merger case rarely depend on independent director defendants.[19] Stockholder plaintiffs will surely take discovery from dismissed directors, though technically non-parties, just as an appraisal petitioner takes robust discovery from the non-party acquiror and the non-party directors and officers of the respondent corporation. All that stockholder plaintiffs lose is the settlement leverage that comes with the threat of trial against independent directors whose likelihood of liability is low, but who nevertheless have reputational incentives, as well as litigation cost and distraction incentives, to agree to settlements that exceed the risk-adjusted expected value of the claims against them.

Standards of Review Now Apply on an Individualized Basis at the Pleadings Stage

By restoring the *Aronson* presumption that putatively independent directors act independently and in good faith notwithstanding the presence of a controlling stockholder, *Cornerstone* essentially restores the business judgment rule presumption to independent directors at the pleadings stage. But it does so in the context of what is, for the controller and its affiliates, an entire fairness case.

Cornerstone therefore builds on the analytical distinction between the application of transactional standards of review for purposes of injunctive relief and determining if any duties were violated, on the one hand, and adjudicating the potential imposition of liability against particular defendants, on the other.[20] The traditional transactional standards of review will still apply across the board to actions for injunctive relief,[21] including pre-closing motions for preliminary injunction, because exculpation clauses operate only to prevent the payment of damages by a covered director.[22] But by accelerating the director-by-director analysis to the pleadings stage, *Cornerstone* pragmatically avoids the forced march through trial for independent directors who, on the surface, appear highly unlikely to be found liable.

Conclusion

In recent years, *Kahn v. M&F Worldwide* and *In re CNX Gas Corp. Shareholders Litigation* gave guidance to controlling stockholders and their advisors contemplating going-private transactions.[23] Those two decisions created material incentives, in the form of litigation risk mitigation, for controllers to replicate arm's-length bargaining by self-disabling the exercise of their control with respect to a squeeze-out transaction. Now, *Cornerstone* completes the picture, arming independent directors and their advisors with a likely pleadings-stage dismissal even in going-private transactions with controlling stockholder squeeze-outs. As a result, the *Cornerstone* decision creates material incentives, in the form of litigation risk mitigation, for independent directors to take board positions in controlled companies and to approve wealth-enhancing going-private transactions.

NOTES

1. *In re Cornerstone Therapeutics Inc, S'holder Litig.*, ___ A.3d ___, 2015 WL 2394045, at *1 (Del. May 14, 2015) (hereinafter, "*Corner-*

stone"). The *Cornerstone* decision was a consolidated interlocutory appeal from two motions to dismiss brought by independent directors in entire fairness cases. Both motions were denied by the Court of Chancery, a decision reversed on appeal. The Supreme Court acknowledged that this was a suitable use of the interlocutory appeal mechanism. *Id.* at *4 ("These cases thus exemplify a benefit of careful employment of the interlocutory appeal process: to enable this Court to clarify precedent that could arguably be read in two different ways before litigants incur avoidable costs.").

2. *Id.* at *2.
3. *Id.* (citing *M&F Worldwide*, 88 A.3d 635, 644 (Del. 2014)).
4. *Id.*
5. *Id.* at *3-4.
6. *Id.* at *5.
7. *See* 8 *Del. C.* § 102(b)(7).
8. *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984).
9. 638 A.2d 1110 (Del. 1994).
10. *In re Pure Res., Inc. S'holders Litig.*, 808 A.2d 421, 436 (Del. Ch. 2002) (discussing *Lynch*).
11. 787 A.2d 85 (Del. 2001).
12. *Id.* at 93.
13. *Cornerstone*, at *9-10.
14. *Emerald Partners* involved an unusual situation in which there was a majority stockholder at the time the merger agreement was negotiated and signed who had divested much of his position between signing and closing. *See Emerald Partners*, 787 A.2d at 94-95. The Supreme Court never squarely determined the implications of this sell-off for controlling stockholder purposes because it maintained that entire fairness was the appropriate standard of review. *Id.*
15. By contrast, a plaintiff did not get the benefit of this inference in the context of a case invoking the business judgment rule or *Revlon*'s enhanced scrutiny. *See Cornerstone*, at *3 ("The independent directors noted that this Court held in *Malpiede v. Townson* that, in the analogous context of review under the *Revlon* standard, plaintiffs seeking damages must plead non-exculpated claims against each individual director or risk dismissal.") (citing *Malpiede v. Townson*, 780 A.2d 1075, 1083-84 (Del. 2001)).
16. *See In re Cornerstone Therapeutics Inc. S'holder Litig.*, 2014 WL 4418169, at *12 (Del. Ch. Sept. 10, 2014) ("I find, consistent with *Emerald Partners II,* that the Plaintiffs have made a sufficient pleading that a stockholder controlled the corporate machinery; that it used that machinery to facilitate a transaction of which it thus stood on both sides; that the transaction was not entirely fair to the minority; and that the Director Defendants negotiated or facilitated the unfair transaction. Such a pleading is sufficient, under controlling precedent, to withstand a motion to dismiss on behalf of the Director Defendants."); *In re Zhongpin Inc. S'holders Litig.*, 2014 WL 6735457, at *12 (Del. Ch. Nov. 26, 2014) ("Plaintiffs have sufficiently pled Zhu's status as a controlling stockholder, subjecting the Merger to entire fairness review. They have also pled facts supporting an inference that the Merger was not entirely fair to Zhongpin's unaffiliated stockholders. Therefore, 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."); *see also Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155, 194-95 (Del. Ch. 2014) ("What this means for purposes of Section 102(b)(7) is that when a case involves a controlling stockholder with entire fairness as the standard of review, and when there is evidence of procedural and substantive unfairness, a court cannot summarily apply Section 102(b)(7) on a motion to dismiss to enter judgment in favor of facially independent and disinterested directors."); *In re Orchard Enters., Inc. S'holder Litig.*, 88 A.3d 1, 38 (Del. Ch. 2014) ("It is premature in this case to make a [summary judgment] determination regarding exculpation under Section 102(b)(7) without first determining whether the transaction was entirely fair, determining whether liability exists and on what basis, considering the evidence as a whole, and evaluating the involvement of each of the individual directors."); *but see DiRienzio v. Lichtenstein*, 2013 WL 5503034, at *11 (Del. Ch. Sept. 30, 2013) ("DiRienzio seeks to bootstrap his entire fairness claim against Lichtenstein into an entire fairness claim against the Special Committee. This he cannot do. To burden the Special Committee with proving entire fairness, DiRienzio must allege sufficiently that the committee members breached a non-exculpated fiduciary duty."); *In re S. Peru Copper Corp. S'holder Deriv. Litig.*, 52 A.3d 761, 785 (Del. Ch. 2011) (awarding damages against controller for failure to prove entire fairness after trial despite having granted summary judgment to members of special committee "because the plaintiff had failed to present evidence supporting a non-exculpated breach of their fiduciary duty of loyalty"), *aff'd sub nom.*, *Americas Mining Corp. v. Theriault*, 51 A.3d 1213 (Del. 2012).
17. 52 A.3d 761 (awarding $1.26 billion damages after special committee defendants had been granted summary judgment on the basis of an

exculpatory clause pursuant to Section 102(b)(7)).

18. *In re Rural Metro Corp. S'holders Litig.*, 88 A.3d 54 (Del. Ch. 2014) (finding financial advisor liable for aiding and abetting after plaintiffs had reached pre-trial settlement with director defendants).

19. That is not to say, though, that the plaintiffs' bar will be happy with this result. The mere threat of a trial can lead even putatively independent directors (or their insurers) to settle cases in which they are unlikely to find themselves in the crosshairs. Such was the case in *Rural Metro*, as the independent special committee director defendants settled on the eve of trial for $6.8 million.

20. *See, e.g.*, J. Travis Laster, *Revlon is a Standard of Review: Why It's True and What It Means*, 19 Fordham J. Corp. & Fin. L. 5, 52 (2014) ("A transactional standard of review is, at its core, an inquiry designed to address whether the court should respect the *transaction itself* or whether, for equitable reasons, it should set it aside or impose an alternative remedy. The court's analysis of the transaction 'has only a crude and potentially misleading relationship to the liability of any particular fiduciary.' Director culpability is assessed and a potential damages remedy imposed on a director-by-director basis.") (quoting *Venhill Ltd. P'ship v. Hillman*, 2008 WL 2270488, at *22 (Del. Ch. June 3, 2008)); William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. Pa. L. Rev. 953, 996 (2003) (The momentum in favor of the independent director concept has, at times, led courts to be less than careful about terminology and about separating out a director's status for purposes of articulating the appropriate standard of review to apply to a transaction from the distinct question of whether that director in fact breached his fiduciary duties in a manner that subjects him to monetary liability. Not only that, many corporate decisions involve a court's examination of whether a particular transaction should be enjoined or rescinded, and do not involve claims for monetary damages against specific directors. The rhetoric used in such decisions is situation-specific and is of doubtful utility when extended to decisions requiring a director-by-director determination of culpability."); William T. Allen, Jack B. Jacobs, and Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 Bus. Law. 1287, 1318 (2001) ("In cases where the transaction cannot be undone, the court must conduct a director-by-director inquiry into which specific directors actually engaged in a breach of fiduciary duty sufficient to justify monetary liability. The fact that a transaction is found to be 'unfair' does not necessarily mean that all the directors have the same exposure to liability. Where the corporation has a charter provision that exculpates directors from monetary liability for breaching their duty of care, the plaintiff must establish that a director who had no conflicting self-interest in the transaction nonetheless acted in bad faith. If a director did not benefit from the unfair transaction, the plaintiff who seeks to subject that director to money damages liability should have the burden to prove that the director consciously breached his duties to the corporation.").

21. Of course, pre-closing injunction actions are generally of little relevance in controlling stockholder cases because of the availability of a post-closing damages action against the controller and its affiliates. *See, e.g.*, *In re CNX Gas Corp. S'holders Litig.*, 4 A.3d 397, 400 (Del. Ch. 2010) ("Because a fairness standard applies to the challenged transaction, any harm to the putative class can be remedied through a post-closing damages action."); *see generally Crest Fin. Ltd. v. Sprint Nextel Corp.*, C.A. No. 8099-CS (Del. Ch. Jan. 10, 2013) (TRANSCRIPT) (denying motion for expedited proceedings on the basis that entire fairness standard presumptively applied and colorable claims could be fully remedied by an award of money damages).

22. *See Rural Metro*, 88 A.3d at 85-89.

23. *See generally M&F Worldwide*, 88 A.3d 635 (establishing that business judgment rule governs going-private mergers with controlling stockholders that are conditioned on both the approval of an independent, adequately-empowered special committee, and the uncoerced, informed vote of a majority of minority stockholders); *CNX Gas*, 4 A.3d 397 (establishing that business judgment rule governs two-step going-private transactions with controlling stockholders that are conditioned on both the approval of an independent, adequately-empowered special committee, and the uncoerced, informed vote of a majority of minority stockholders).