

Client Alert

Shareholder and Securities Litigation Practice Group

May 19, 2015

Delaware Supreme Court's *In re Cornerstone Therapeutics* Decision Allows Independent Directors To Utilize Section 102(b)(7) Defense In Actions Subject To Entire Fairness Review

A director's responsibilities in serving on a corporate board are attended by substantial personal financial risks—not least of which is the specter of shareholder litigation. Exculpatory charter provisions, such as Section 102(b)(7) of the Delaware General Corporation Law, provide a basis for dismissal of certain breach of fiduciary duty claims brought derivatively by shareholders.

On May 14, 2015, in *In re Cornerstone Therapeutics Inc. Stockholder Litigation*,¹ the Delaware Supreme Court considered interlocutory appeals from two cases² and held that a plaintiff bringing a damages action challenging an interested transaction subject to entire fairness review must plead a non-exculpated claim against disinterested, independent directors. Indeed, this pleading standard is required “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.”³

Specifically, if a director is protected by Section 102(b)(7)'s exculpatory charter provision, then a plaintiff must plead 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 [the director] could not be presumed to act independently, or acted in bad faith” in order to survive a motion to dismiss.⁴

Chief Justice Leo Strine, writing for the court, reasoned that *Malpiede v. Townson* should control, which held 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.”⁵ In addition, the opinion clarified that the seminal *Emerald Partners v. Berlin*⁶ decision must be understood in the context of the complicated fact pattern of that case, and should not be construed to preclude dismissal of claims even when plaintiffs have failed to plead non-exculpated claims.⁷ Accordingly, the Court reversed and remanded these cases to the Delaware Chancery to determine whether plaintiffs have sufficiently pled non-exculpated claims.⁸

In its analysis the Court acknowledged that the stringent entire fairness standard, which is applied when a board makes a decision under actual

For more information, contact:

Paul R. Bessette

+1 512 457 2050

pbessette@kslaw.com

Israel Dahan

+1 212 556 2114

idahan@kslaw.com

Michael J. Biles

+1 512 457 2051

mbiles@kslaw.com

Chelsea J. Corey

+1 212 556 2232

ccorey@kslaw.com

King & Spalding

Austin

401 Congress Avenue

Suite 3200

Austin, Texas 78701

Tel: +1 512 457 2000

Fax: +1 512 457 2100

New York

1185 Avenue of the Americas

New York, New York 10036-4003

Tel: +1 212 556 2100

Fax: +1 212 556 222

www.kslaw.com

conflicts of interest, has a “powerful pro-plaintiff effect against interested parties.”⁹ Yet, application of the entire fairness standard “does not relieve plaintiffs seeking damages of the obligation to plead non-exculpated claims against each of the defendant directors.”¹⁰ In addition, the Court declined to accept the plaintiffs’ assertion that they were entitled to an automatic inference that a director facilitating an interested transaction is disloyal.¹¹ Such an inference would not only contravene both a director’s right to be considered individually and the presumption of director loyalty, but it would also compromise minority stockholders’ rights in practice, as independent directors in conflicted transactions tend to negotiate more favorable deals for the minority.¹²

The Court took care to note the legislative purpose of Section 102(b)(7)¹³ and declined to validate an analytical framework, such as that adopted by the Chancery, that would incentivize independent directors to avoid serving on special committees considering transactions or to reject transactions for fear of personal involvement in protracted litigation.¹⁴

The Upshot

Expansively-written shareholder derivative complaints continue to entangle disinterested, independent directors. Yet the Delaware Supreme Court’s *Cornerstone* decision underscores the legislative purpose of exculpatory clauses by requiring, at the very least, the pleading of facts that create an inference that a director acted out of self-interest or in bad faith. Absent this pleading, individual directors will be entitled to dismissal of claims asserted against them. *Cornerstone* will cause courts to examine pleadings against individual directors and should provide some small measure of comfort to directors looking for an escape hatch from shareholder suits.

Celebrating more than 125 years of service, King & Spalding is an international law firm that represents a broad array of clients, including half of the Fortune Global 100, with 800 lawyers in 17 offices in the United States, Europe, the Middle East and Asia. The firm has handled matters in over 160 countries on six continents and is consistently recognized for the results it obtains, uncompromising commitment to quality and dedication to understanding the business and culture of its clients. More information is available at www.kslaw.com.

This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered “Attorney Advertising.”

¹ *In re Cornerstone Therapeutics Inc. Stockholder Litig.*, No. 564,2014 (Del. May 14, 2015)

² *In re Cornerstone Therapeutics Inc. Stockholder Litig.*, No. 8922-VCG, 2014 WL 4418169 (Del. Ch. Sept. 10, 2014) and *In re Zhongpin Inc. Stockholders Litig.*, No. 7393-VCN, 2014 WL 6735457 (Del. Ch. Nov. 26, 2014).

³ *Cornerstone*, No. 564,2014, at 1. (citing *Revlon v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (Del. 1986); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)).

⁴ *Id.* at 8.

⁵ *Id.* at 4 (citing *Malpiede v. Townson*, 780 A.2d 1075, 1083-84 (Del. 2001)).

⁶ The *Cornerstone* plaintiffs specifically relied on the Delaware Supreme Court’s statement in *Emerald Partners* that “when entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only after the basis for their liability has been decided” on a fully-developed factual record. *Emerald Partners v. Berlin*, 787 A.2d 85, 94 (Del. 2001). The *Cornerstone* plaintiffs asserted, and the Chancery agreed, that this precedent required that the directors’ motions to dismiss should be denied as a matter of law. *Cornerstone*, No. 564,2014, at 6.

⁷ *Id.* at 17.

⁸ *Id.* at 2.

⁹ *Id.* at 9.

¹⁰ *Id.* at 10.

¹¹ *Id.* at 11.

¹² *Id.* at 12-14.

¹³ “The purpose of Section 102(b)(7) was to ‘free[] up directors to take business risks without worrying about negligence lawsuits.’” *Id.* at 16 (quoting *Malpiede*, 780 A.2d at 1095).

¹⁴ *Id.* at 15.