Delaware Supreme Court Reaffirms Important Protections for Corporate Directors

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A trio of opinions from the Delaware Supreme Court, each authored by Chief Justice Leo E. Strine, Jr., has reaffirmed Delaware's deference to the business judgment of disinterested corporate decision-makers and restored important protections for directors that had been weakened by prior court decisions.

C&J Energy Services, Inc. v. City of Miami General Employees' & Sanitation Employees' Retirement Trust

First, in late 2014, in *C&J Energy Services, Inc. v. City of Miami General Employees' & Sanitation Employees' Retirement Trust*, 107 A.3d 1049 (Del. 2014), the Delaware Supreme Court vacated an injunction issued by the Court of Chancery and held on an expedited appeal that a board of directors was not per se required "to conduct a pre-signing active solicitation process" in order to satisfy its fiduciary duties under *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

In a bench ruling, the Court of Chancery had issued an injunction ordering the board of directors of defendant C&J Energy Services, Inc. to shop the company to third parties for a period of 30 days before proceeding with a negotiated merger. The Court of Chancery found that C&J's directors were disinterested, but nevertheless found it reasonably likely that they had breached their fiduciary duty of care by, among other things, not conducting a pre-signing market check prior to agreeing to the merger.

Writing for the Supreme Court *en banc*, Chief Justice Strine vacated the Court of Chancery's injunction. The Supreme Court held that the Court of Chancery's decision "rested on an erroneous understanding of what *Revlon* requires." Specifically, it held that "Revlon does not require a board to set aside its own view of what is best for the corporation's stockholders and run an auction whenever the board approves a change of control transaction." Nor does *Revlon* require directors to have "impeccable knowledge" to justify the absence of a market check. Instead, *Revlon* permits a board "to pursue the transaction it reasonably views as most valuable to stockholders, so long as the transaction is subject to an effective market check under circumstances in which any bidder interested in paying more has a reasonable opportunity to do so."

C&J Energy confirms that the Delaware courts will not lightly interfere with a disinterested board's decisions about how to pursue a change of control transaction.

In re Cornerstone Therapeutics Inc., Stockholder Litigation

A few months later, again writing for the court en banc, Chief Justice Strine authored *In re Cornerstone Therapeutics Inc., Stockholder Litig.*, 115 A.3d 1173 (Del. 2015), which removed a cloud on the effectiveness of exculpatory charter provisions under 8 Del. C. 102(b)(7).

The Delaware legislature added Section 102(b)(7) to the Delaware General Corporation Law in 1986 in response to concerns about a perceived expansion in director liability. Section 102(b)(7) authorizes Delaware corporations to include in their certificates of incorporation provisions eliminating director liability for breach of fiduciary duty except for any breach of the duty of loyalty, acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, and claims of an unlawful dividend, stock repurchase or redemption. In *Emerald Partners v. Berlin*, the Delaware Supreme Court stated 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 full record. 787 A.2d 85, 94 (Del. 2001). Thereafter, opinions of the Court of Chancery

were split as to whether a director could be dismissed when the standard of review was entire fairness.

In *Cornerstone*, plaintiffs argued that this language from *Emerald Partners* required any motion to dismiss by disinterested directors to fail so long as the complaint pleads facts demonstrating that a transaction was subject to entire fairness. Defendants disagreed, arguing that Delaware law has always required plaintiffs to plead non-exculpated claims against each individual defendant in order to survive a motion to dismiss. While the Court of Chancery considered defendants' view of the law preferable, it held that the language of *Emerald Partners* required it to deny the motion to dismiss.

On interlocutory appeal, the Supreme Court acknowledged the difficulty of dealing with the "complex circumstances of the *Emerald Partners* litigation," but clarified that the language of *Emerald Partners* should be read in its case-specific context: In *Emerald Partners*, plaintiffs had already pled facts supporting the inference that each director defendant breached his duty of loyalty. Thus, the language of *Emerald Partners* merely stands "for the mundane proposition that a defendant cannot obtain dismissal on the basis of an exculpatory provision when there is evidence that he committed a non-exculpated breach of fiduciary duty," because *Emerald Partners* must be read in its "case-specific context" where the defendant directors could not rely on the "102(b)(7) charter provision by virtue of their conduct." Accordingly, the Delaware Supreme Court reversed the denial of the *Cornerstone* motion to dismiss.

The *Cornerstone* opinion helpfully resolved the uncertainty created by *Emerald Partners* and clarified that Delaware courts will dismiss claims for money damages against a corporate director who is protected by an exculpatory charter provision, unless the plaintiff pleads facts supporting a rational inference that the director breached the duty of loyalty (or engaged in other non-exculpated conduct), even when the underlying standard of review is entire fairness.

Corwin v. KKR Financial Holdings, LLC

Most recently, the Delaware Supreme Court's opinion in *Corwin v. KKR Financial Holdings LLC*, No. 629, 2014 (Del. Oct. 2, 2015), again authored by Chief Justice Strine for the court *en banc*, held that an uncoerced, fully informed vote of disinterested stockholders in favor of a challenged transaction provides an independent basis to invoke the business judgment rule, thereby eliminating uncertainty on this question that had existed following the Delaware Supreme Court's opinion in *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

In the opinion below, the Court of Chancery held that a stock-for-stock merger between KKR & Co. L.P. (KKR) and KKR Financial Holdings LLC (Financial Holdings) was subject to business judgment review. Plaintiffs' had argued that KKR was a controlling stockholder of Financial Holdings because, even though KKR owned less than 1 percent of Financial Holdings, KKR managed Financial Holdings through an affiliate under a contractual management agreement that could only be terminated by Financial Holdings if it paid a termination fee.

The Court of Chancery noted the "unusual existential circumstances," but observed that "Financial Holdings had real assets its independent board controlled and had the option of pursuing any path its directors chose." As a result, the Court of Chancery found KKR was not a controlling stockholder and entire fairness did not apply. The Court of Chancery also found that enhanced scrutiny under *Revlon* did not apply because "the transaction was approved by an independent board majority and by a fully informed, uncoerced stockholder vote" and dismissed the case under the business judgment rule. The Court of Chancery held that the Delaware Supreme Court's opinion in *Gantler* did not bar this result. On appeal, the Delaware Supreme Court affirmed all the holdings.

On the question of whether *Revlon* enhanced scrutiny applied to the transaction, the court held that "the Chancellor was correct in finding that the voluntary judgment of the disinterested stockholders to approve the merger invoked the business judgment rule standard of review and that the plaintiffs' complaint should be dismissed. For sound policy reasons, Delaware corporate law has long been reluctant to second-guess the judgment of a disinterested stockholder majority that determines that a transaction with a party other than a controlling stockholder is in their best interests."

Addressing the policy considerations at issue and plaintiffs' argument that affirming the Court of Chancery's holding would "impair the operation of *Unocal* and *Revlon* or expose stockholders to unfair action by directors without protection," the Delaware Supreme Court articulated several factors that supported the result:

> First, *Unocal* and *Revlon* are primarily designed to give stockholders and the Court of Chancery the tool of injunctive relief to address important M&A decisions in real time, before closing. They were not tools designed with post-closing money damages claims in mind, the standards they articulate do not match the gross negligence standard for director due care liability under *Van Gorkom*, and with the prevalence of exculpatory charter provisions, due care liability is rarely even available. …
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> Second and most important, the doctrine applies only to fully informed, uncoerced stockholder votes,

and if troubling facts regarding director behavior were not disclosed that would have been material to a voting stockholder, then the business judgment rule is not invoked. …

Finally, when a transaction is not subject to the entire fairness standard, the long-standing policy of our law has been to avoid the uncertainties and costs of judicial second-guessing when the disinterested stockholders have had the free and informed chance to decide on the economic merits of a transaction for themselves. There are sound reasons for this policy. When the real parties in interest — the disinterested equity owners — can easily protect themselves at the ballot box by simply voting no, the utility of a litigation-intrusive standard of review promises more costs to stockholders in the form of litigation rents and inhibitions on risk-taking than it promises in terms of benefits to them.

The Delaware Supreme Court also clarified that *Gantler* was "a narrow decision focused on defining a specific legal term, 'ratification,' and not on the question of what standard of review applies if a transaction not subject to the entire fairness standard is approved by an informed, voluntary vote of disinterested stockholders."

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These three opinions provide helpful guidance to Delaware practitioners and corporate planners and reinforce the power and ability of a disinterested board of directors to exercise its business judgment without fear of liability, regardless of the standard of review.