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**IN THE SUPREME COURT OF THE STATE OF DELAWARE**

| IN RE CORNERSTONE THERAPEUTICS INC. STOCKHOLDER LITIGATION | No. 564, 2014<br><br>Court Below:<br>The Court of Chancery of The State of Delaware<br>Consol. C.A. No. 8922-VCG |
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# TABLE OF CONTENTS

Page

NATURE OF PROCEEDINGS .......... 1

SUMMARY OF ARGUMENT .......... 4

STATEMENT OF FACTS .......... 7

ARGUMENT .......... 10

QUESTION PRESENTED .......... 10

SCOPE OF REVIEW .......... 10

MERITS OF ARGUMENT .......... 11

I. Rule 8 Requires Plaintiffs to Plead Facts to Support an Inference that Each Director Defendant Breached a Non-Exculpated Duty. .......... 11

II. *Emerald Partners* Did Not Change the Pleading Requirement for a Breach of Fiduciary Duty Claim in Controlling Stockholder Transactions. .......... 18

III. Fundamental Principles of Delaware Corporate Law and Policy Considerations Require that Plaintiffs Plead a Non-Exculpated Breach Against Each Director Defendant. .......... 29

CONCLUSION .......... 35

Memorandum Opinion, dated Sept. 10, 2014 .......... Exhibit A

## TABLE OF CITATIONS

Page(s)

### Cases

*Aronson v. Lewis*,
473 A.2d 805 (Del. 1984) ........................................................................14

*Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*,
845 A.2d 1040 (Del. 2004) ........................................................................30

*Citron v. E.I. DuPont de Nemours & Co.*,
584 A.2d 490 (Del. Ch. 1990) ........................................................................14

*Clinton v. Enter. Rent-A-Car Co.*,
977 A.2d 892 (Del. 2009) ........................................................................10

*DiRienzo v. Lichtenstein*,
2013 WL 5503034 (Del. Ch.) ........................................................................ 24, 27, 28

*Emerald Partners v. Berlin ("Emerald Partners I")*,
726 A.2d 1215 (Del. 1999) ........................................................................ *passim*

*Emerald Partners v. Berlin ("Emerald Partners II")*,
787 A.2d 85 (Del. 2001) ........................................................................ *passim*

*Emerald Partners v. Berlin*,
1993 WL 545409 (Del. Ch.) ........................................................................20

*Emerald Partners v. Berlin*,
1995 WL 600881 (Del. Ch.) ........................................................................ 19, 20

*Emerald Partners v. Berlin*,
2001 WL 115340 (Del. Ch.) ........................................................................22

*Emerald Partners v. Berlin*,
2003 WL 21003437 (Del. Ch.) ........................................................................24

*Emerald Partners v. Berlin*,
2003 WL 23019210 (Del.) ........................................................................24

Page(s)

*Frank v. Elgamal*,
2014 WL 957550 (Del. Ch.) ........................................................................29

*Gantler v. Stephens*,
965 A.2d 695 (Del. 2009) ..........................................................................15

*Gassis v. Corkery*,
2014 WL 3565418 (Del. Ch.) ......................................................................12

*In re BHC Communications Shareholder Litigation*,
789 A.2d 1 (Del. Ch. 2001) ................................................................ 28, 34

*In re Frederick's of Hollywood, Inc.*,
2000 WL 130630 (Del. Ch.) ........................................................................29

*In re General Motors Class H Shareholders Litigation*,
734 A.2d 611 (Del. Ch. 1999) ............................................................ 22, 28

*In re Lukens Inc. S'holders Litig.*,
757 A.2d 720 (Del. Ch. 1999) ............................................................ 15, 28

*In re MFW S'holders Litig.*,
67 A.3d 496 (Del. Ch. 2013) ......................................................................30

*In re NYMEX S'holder Litig.*,
2009 WL 3206051 (Del. Ch.) ......................................................................16

*In re Orchard Enters., Inc. S'holder Litig.*,
88 A.3d 1 (Del. Ch. 2014) ..........................................................................29

*In re Southern Peru Copper Corp. Shareholder Derivative Litigation*,
52 A.3d 761 (Del. Ch. 2011) ............................................................... 16-17

*In re Southern Peru Copper Corp. Shareholder Derivative Litigation*,
Del. Ch., C.A. No. 961-VCS, Strine (Dec. 21, 2010) (TRANSCRIPT) ................26

*In re Synthes, Inc. S'holder Litig.*,
50 A.3d 1022 (Del. Ch. 2012) ....................................................................16

Page(s)

*Kahn v. Lynch Commc'ns Sys., Inc.*,
638 A.2d 1110 (Del. 1994) .....13

*Kahn v. M & F Worldwide Corp.*,
88 A.3d 635 (Del. 2014) ..... 13, 30, 31

*Malpiede v. Townson*,
780 A.2d 1075 (Del. 2001) ..... *passim*

*McMullin v. Beran*,
765 A.2d 910 (Del. 2000) .....15

*Monroe Cnty. Employees' Ret. Sys. v. Carlson*,
2010 WL 2376890 (Del. Ch.) .....14

*Nelson v. Frank E. Best Inc.*,
768 A.2d 473 (Del. Ch. 2000) .....12

*Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*,
2004 WL 1949290 (Del. Ch.) .....32

*O'Reilly v. Transworld Healthcare, Inc.*,
745 A.2d 902 (Del. Ch. 1999) .....29

*Ramirez v. Murdick*,
948 A.2d 395 (Del. 2008) .....10

*Shandler v. DLJ Merchant Banking, Inc.*,
2010 WL 2929654 (Del. Ch.) .....28

*Trenwick Am. Litig. Trust v. Ernst & Young LLP*,
906 A.2d 168 (Del. Ch. 2006) .....15

*Turner v. Bernstein*,
1999 WL 66532 (Del. Ch.) .....12

Page(s)

## Statutes

8 *Del. C.* § 102(b)(7) ........................................ *passim*

## Rules

Court of Chancery Rule 1 ........................................ 12

Court of Chancery Rule 8(a) ........................................ *passim*

Court of Chancery Rule 12(b)(6) ........................................ *passim*

Court of Chancery Rule 56(c) ........................................ 12

## Miscellaneous

Bryan Ford, *In Whose Interest: An Examination of the Duties of Directors and Officers in Control Contests*,
26 ARIZ. ST. L.J. 91 (1994) ........................................ 30

E. Norman *Veasey*, *The Defining Tension in Corporate Governance in America*,
52 Bus. Law. 393 (1997) ........................................ 31

S.B. 533, 133rd Gen. Assembly (DE 1986) ........................................ 34

## NATURE OF PROCEEDINGS

Defendants-Appellants Christopher Codeanne, Michael Enright, James A. Harper, Michael Heffernan, Laura Shawver, Craig Collard and Robert Stephan (collectively, the "Director Defendants") bring this interlocutory appeal from the Court of Chancery's September 10, 2014 Memorandum Opinion (the "Opinion" or "Op.") denying their motions to dismiss (the "Motions") the Consolidated Amended Class Action Complaint (the "Complaint").

On September 18, 2013, Plaintiff Edwin Myruski filed a putative class action in the Court of Chancery against Chiesi Farmaceutici S.p.A. ("Chiesi"), Chiesi U.S. Corp. ("Chiesi U.S."), Anton Giorgio Failla, Marco Vecchia, Cornerstone Therapeutics Inc. ("Cornerstone" or the "Company"), and the Director Defendants, asserting claims relating to Cornerstone's going-private merger with its then-controlling stockholder Chiesi. After consolidation with other related actions, Plaintiffs filed the operative Complaint on December 11, 2013.

On January 31, 2014, Chiesi U.S. and the Chiesi-affiliated directors of Cornerstone (Failla and Vecchia) filed an answer to the Complaint.

On the same day, the Director Defendants (*i.e.*, the Cornerstone directors not affiliated with Chiesi) moved to dismiss the Complaint pursuant to Court of Chancery Rule 12(b)(6) for failure to state a claim upon which relief could be granted and based on the exculpatory charter provision adopted pursuant to

8 *Del. C.* § 102(b)(7) in Cornerstone's Certificate of Incorporation. The Director Defendants argued that Plaintiffs had failed to plead non-exculpated breaches of fiduciary duty against them because, even if the transaction were subject to entire fairness review for purposes of evaluating Chiesi's liability, the Complaint failed to set forth facts sufficient to support an inference that the Director Defendants were not disinterested, not independent, or had not approved the merger in good faith.[1]

The Court below denied the Motions, holding that, based on this Court's decision in *Emerald Partners v. Berlin ("Emerald Partners II")*, 787 A.2d 85 (Del. 2001), the exculpatory effect of a charter provision adopted by a company pursuant to 8 *Del. C.* § 102(b)(7) cannot be considered at the pleading stage when the transaction at issue is subject to entire fairness review for purposes of evaluating the controlling stockholder's liability. In this respect, the Court below adopted a *per se* rule to the effect that, even where a complaint contains no well-pled facts alleging that disinterested and independent director defendants engaged in non-exculpated conduct (and therefore fails to state a claim for liability against them) such directors will be subjected to the burden and expense of defending the suit through trial (and further that they cannot invoke an exculpatory Section 102(b)(7) charter provision until after the entire fairness of the transaction is determined at trial).

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[1] A93-113 (Special Committee Br. at 19-39); A347 (Collard and Stephan Br. at 1).

Recognizing that its decision determined a substantial issue, established a legal right, and conflicted with other decisions of the Court of Chancery, the Court below certified the Opinion for interlocutory appeal to this Court by Order dated September 26, 2014.

The Director Defendants filed their Notice of Appeal from Interlocutory Order on October 1, 2014. This Court accepted the interlocutory appeal by Order dated October 9, 2014.

## SUMMARY OF ARGUMENT

This interlocutory appeal concerns a discrete legal question — whether the fact that a challenged transaction is subject to entire fairness review *ab initio* for purposes of evaluating a controlling stockholder's liability creates an exception to a plaintiff's obligations under Rule 8(a) to separately plead a claim against a company director who is also named as a defendant.

The Court below denied the Motions because Plaintiffs had "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." (Op. at 31-32.) The Motions thus were denied not because Plaintiffs stated a claim for bad faith or breach of loyalty as against the Director Defendants, but because they were held to have stated a viable entire fairness claim as against the controlling stockholder.

In reaching this result, the Court held that this Court's decision in *Emerald Partners II* created a *per se* rule that a plaintiff need not plead a non-exculpated breach of fiduciary duty against each director defendant when a controlling stockholder transaction is subject to entire fairness review for purposes of evaluating the controlling stockholder's liability. In that context, director

defendants must litigate the action through trial to have their liability determined and before they can invoke an exculpatory charter provision.

The *per se* rule set forth in the Opinion conflicts with the pleading standards set forth in Court of Chancery Rule 8(a), which require a plaintiff to identify the conduct of *each* defendant giving rise to his claims so that each defendant is given fair notice of the *particular* wrong that he is alleged to have committed.

Moreover, in *Malpiede v. Townson*, 780 A.2d 1075, 1094 (Del. 2001) this Court held that a complaint must plead a *non-exculpated* breach of fiduciary duty to overcome a Section 102(b)(7) exculpatory charter provision on a motion to dismiss. Several decisions of the Court of Chancery make clear that, even after *Emerald Partners II*, this rule is no different in an action challenging a controlling stockholder transaction subject to entire fairness review.

The Opinion below also rests on an incorrect interpretation of *Emerald Partners II*. In that case, the defendant directors were precluded from relying on a Section 102(b)(7) charter provision because there were factual issues regarding their own conduct (which implicated their fiduciary duty of loyalty). This Court did not adopt a presumption that directors in a controlling stockholder transaction lack independence; to the contrary, it is a core principle of Delaware law that independent and disinterested directors are presumed to exercise their business judgment in the interests of shareholders. *Emerald Partners II* is correctly read

only as a decision about trial burdens and the appropriate sequence of determining entire fairness and exculpation *at trial*.

Even the Court below recognized that the *per se* rule it (mistakenly) applied was deeply problematic. (Op. at 27-31.) If upheld, such a *per se* rule would upend the presumption of the business judgment rule. The Court below noted that "doctrinally it seems insufficient to simply plead that that [sic] a director has participated in a transaction with a controller and thus an inference of disloyalty arises sufficient to sustain a complaint against her." (Op. at 28.) The *per se* rule also would undermine the purpose of Section 102(b)(7) by forcing disinterested, independent directors to incur the burden and expense of defending a stockholder action through trial, despite there being no well-pled basis to impose liability against them. As the Court below observed, such a rule would make "service on a special committee risky, and thus unattractive to qualified and disinterested directors." (Op. at 28-29.) It may also create an incentive for special committee members to "reject entering negotiations with controllers, a rejection that may cost minority stockholders value." (Op. at 29.) It would also make the disposition of controlling stockholder cases more inefficient and expensive to resolve without significant correspondent benefit to minority stockholders, to whom a controller would still be liable absent entire fairness.

For all these reasons, and those set forth below, this Court should reverse.

## STATEMENT OF FACTS[2]

On February 18, 2013, Chiesi, then the controlling stockholder of Cornerstone, announced its proposal to purchase all the outstanding shares of Cornerstone common stock at a price range of $6.40 to $6.70 per share. Chiesi made clear that it was interested only in purchasing the outstanding shares of Cornerstone and had no interest in any other strategic transaction. (Op. at 4-6.) Chiesi did not at the outset condition its proposal on both a recommendation by a committee of independent directors and a majority-of-the minority stockholder approval. (Op. at 5.)

In response to Chiesi's proposal, the Cornerstone board of directors appointed a special committee comprised of Harper, Shawver, Codeanne, Enright, and Heffernan (the "Special Committee") to evaluate Chiesi's offer.[3] The Special Committee retained legal and financial advisors, and then proceeded to conduct a vigorous arm's length negotiation with Chiesi over nearly seven months. (*See generally* Op. at 7-11.) In particular:

- The Special Committee met many times and was actively involved in reviewing the Company's forecasts (Op. at 7; A29-31, A33-34 (Compl. ¶¶ 52, 57, 63, 65));
- The Special Committee retained qualified legal and financial advisors (A28-29 (*Id.* ¶ 51));

[2] These facts were drawn from the Complaint and the Director Defendants assumed these facts to be true solely for purposes of the Motions below.

[3] Collard and Stephan did not serve on the Special Committee.

- The Special Committee "correctly" (as Plaintiffs conceded in the Complaint) determined that the Company's intrinsic value was "the appropriate basis for negotiations," and rejected Chiesi's attempts to negotiate based on premiums to previous trading prices (A29-30 (*Id.* ¶ 52));

- The Special Committee evaluated whether to include contingent value rights as part of the merger consideration in an attempt to bridge the gap in the parties' respective valuations and to address the uncertainties associated with some of the Company's products (A32 (*Id.* ¶¶ 59-60));

- In response to Chiesi's initial inadequate offers, and despite Chiesi's expressed lack of interest in alternative strategic transactions, the Special Committee requested Chiesi to help facilitate a process in which the committee would solicit alternative proposals from prospective third-party acquirors (A31 (*Id.* ¶ 57));

- The Special Committee negotiated with and persuaded Chiesi to increase its bid from $6.40 per share to $9.50 per share, including rejecting four of Chiesi's offers ($6.40, $8.25, $9.00, and $9.25) (A27-33 (*Id.* ¶¶ 50-64)).[4]

Finally, on September 11, 2013, the Special Committee and Chiesi agreed in principle to an acquisition by Chiesi at $9.50 per share (a 78% premium over the trading price on the day prior to Chiesi's initial offer). (A33, A41 (*Id.* ¶¶ 64, 88).)

[4] The Special Committee's hard bargaining continued even after a Chiesi representative reminded the Special Committee members that they could be removed from the board. Indeed, after this remark, the Special Committee nevertheless rejected three ensuing offers from Chiesi and requested its assistance with soliciting a potential alternative transaction. Op. at 8-9. Despite these facts and that the ultimate merger agreement provided for removal of the directors in any event, Plaintiffs argued below that Chiesi's communication was a "threat" that affected the independence of the directors. However, the Court below did not reach this argument given its holding regarding what it took to be the applicable pleading standard under *Emerald Partners II*. *Id.* at 32.

The parties negotiated a merger agreement, which ultimately conditioned the merger on approval of a majority of the minority stockholders. (Op. at 10.)

On September 15, 2013, the Special Committee's financial advisor opined that a price of $9.50 per share was fair from a financial point of view to the Company's stockholders other than Chiesi and its affiliates. The Special Committee then approved the Merger, as did the Cornerstone board (including Collard and Stephan, but not certain Chiesi-affiliated directors). (*Id*. at 10-11.)

On February 3, 2014, the merger was approved by Cornerstone’s stockholders, including the requisite majority-of-the-minority vote. (*Id*. at 11.)

# ARGUMENT

## QUESTION PRESENTED

In the context of a suit challenging a controlling stockholder transaction, should claims against disinterested and independent director defendants be dismissed pursuant to Rule 12(b)(6) and a Section 102(b)(7) exculpatory charter provision where the plaintiff has not alleged well-pled facts from which it reasonably could be inferred that those directors engaged in non-exculpated conduct, even where the transaction at issue is subject to entire fairness review for purposes of evaluating the liability of a controlling stockholder?

## SCOPE OF REVIEW

This Court reviews a trial court's ruling on a motion to dismiss pursuant to Rule 12(b)(6) *de novo*, *Ramirez v. Murdick*, 948 A.2d 395, 399 (Del. 2008), to "determine whether the trial judge erred as a matter of law in formulating or applying legal precepts." *Clinton v. Enter. Rent-A-Car Co.*, 977 A.2d 892, 895 (Del. 2009) (quoting *Feldman v. Cutaia*, 951 A.2d 727, 730-31 (Del. 2008)).

## MERITS OF ARGUMENT

### I. Rule 8 Requires Plaintiffs to Plead Facts to Support an Inference that Each Director Defendant Breached a Non-Exculpated Duty.

The Court of Chancery's decision rests on a *per se* rule that incorrectly permits a breach of fiduciary duty claim to go forward against company directors on a complaint that pleads no facts supporting any inference of wrongdoing by them individually. Specifically, the Court of Chancery held that — in the context of a controlling stockholder transaction — so long as a claim is pleaded against the controlling stockholder, disinterested and independent director members of a special committee (and even disinterested and independent directors who did not serve on the special committee) may also be made parties to that suit and be required to go to trial without pleading any further facts (or even adducing any evidence at the summary judgment stage) to support an inference that those individuals breached any duty whatsoever. That conclusion directly contravenes Rule 8(a) of the Court of Chancery Rules and fundamental pleading principles, and should be reversed.

Rule 8(a) of the Court of Chancery Rules requires that a pleading contain a "short and plain statement of the claim showing that the pleader is entitled to

relief…." Ct. Ch. R. 8(a).[5] Group pleading is not permitted. Rather, a complaint must identify the conduct of *each* defendant giving rise to a claim so that each defendant is given fair notice of the *particular* wrong that he is alleged to have committed.[6] Here, this means that the Complaint must set forth facts supporting claims *separately* against the controlling stockholder and the directors (and as against them, each individually). When a complaint fails to state a claim against particular defendants, it "should be dismissed without the need for the defendants to file an answer and without proceeding with discovery." *Malpiede*, 780 A.2d at 1094; *see also* Ct. Ch. R. 12(b)(6).[7]

Moreover, in the context of a controlling stockholder transaction, Delaware law provides that distinctly different standards of liability govern the conduct of (i) the controlling stockholder; and (ii) the directors serving on a special committee

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5 The Court of Chancery Rules govern procedure in that court, *see* Ct. Ch. R. 1, and have the "force and effect of a legislative enactment." *Nelson v. Frank E. Best Inc.*, 768 A.2d 473, 474 (Del. Ch. 2000) (internal quotation marks omitted).

6 *See*, *e.g.*, *Gassis v. Corkery*, 2014 WL 3565418, at *4-5 (Del. Ch.) (on motion to dismiss misappropriation claim, distinguishing between potential liability of corporation and individual directors, who could be liable based only on their own conduct); *Turner v. Bernstein*, 1999 WL 66532, at *7 (Del. Ch.) (denying directors' motion to dismiss disclosure claim, but granting motion of acquiring company which had not been a controller and therefore owed no duty).

7 Likewise, at the summary judgment stage, summary judgment "shall be rendered forthwith if the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Ct. Ch. R. 56(c) (emphasis added).

that negotiates and approves such a deal (and company directors generally). As a result, the necessary facts required to support a claim against the controlling stockholder are different from those that are necessary to support a claim against a company director.

The controlling stockholder is subject to a strict-liability rule. Absent certain procedural protections, the controlling stockholder — which is acting as a self-interested fiduciary — must demonstrate the entire fairness of the transaction. *See, e.g.*, *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994) ("A controlling or dominating shareholder standing on both sides of the transaction, as in a parent-subsidiary context, bears the burden of proving its entire fairness.").[8] If the transaction is found not to be entirely fair, the controller will be liable. Given the strict liability associated with such a claim, a plaintiff ordinarily satisfies Rule

[8] The business judgment standard of review, and not entire fairness, governs a controlling stockholder merger when "(i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority." *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635, 644 (Del. 2014). That principle is inapplicable in this case because Chiesi did not satisfy the first condition from the outset. Op. at 5.

8 vis-à-vis the controlling stockholder merely by alleging that the transaction occurred and was not entirely fair.[9]

By contrast, a claim for breach of fiduciary duty against a corporate director requires the plaintiff to overcome the business judgment rule, a presumption that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds, Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). Unlike a controlling stockholder, a director is presumed *ab initio* to have exercised his independent business judgment in good faith.[10] Thus, the plaintiff must establish that the director breached the duty of care or the duty of loyalty, or acted in bad faith. Only then would the presumption of the business judgment rule be rebutted

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[9] *See, e.g.,* Op. at 26 ("To plead a case sufficient to withstand a motion to dismiss with regard to a stockholder who has transacted with the corporation, the plaintiff must merely plead facts raising an inference that the defendant stockholder is a controller and that the transaction was not entirely fair to the [other stockholders]."); *Monroe Cnty. Employees' Ret. Sys. v. Carlson*, 2010 WL 2376890, at *2 (Del. Ch.) (same).

[10] *See Citron v. E.I. DuPont de Nemours & Co.*, 584 A.2d 490, 499 (Del. Ch. 1990) (applying business judgment rule to independent special committee directors in controlling stockholder merger).

and the director shoulder the burden of demonstrating the entire fairness of the transaction.[11]

At the pleading stage, it is well-established that "the plaintiffs have the burden to plead facts sufficient to rebut [the business judgment rule] presumption." *Gantler v. Stephens*, 965 A.2d 695, 706 (Del. 2009); *see also McMullin v. Beran*, 765 A.2d 910, 918 (Del. 2000). For a duty of care claim, this means pleading facts to support the inference that the director's conduct amounted to gross negligence. *See, e.g.*, *Trenwick Am. Litig. Trust v. Ernst & Young L.L.P.*, 906 A.2d 168, 194 (Del. Ch. 2006), *aff'd*, 931 A.2d 438 (Del. 2007). Otherwise, a complaint must contain well-pled facts from which it may be reasonably inferred that "a majority of the Director Defendants either stood on both sides of the merger or were dominated and controlled by someone who did," *In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 728 (Del. Ch. 1999), *aff'd sub nom., Walker v. Lukens, Inc.*, 757 A.2d 1278 (Del. 2000) (TABLE), or "failed to act in good faith, *i.e.*, where a fiduciary intentionally fails to act in the face of a known duty to act, demonstrating

[11] *See, e.g.*, *Emerald Partners v. Berlin ("Emerald Partners I")*, 726 A.2d 1215, 1221 (Del. 1999) ("[A] breach of any one of the board of directors' triad of fiduciary duties, loyalty, good faith or due care, sufficiently rebuts the business judgment presumption and permits a challenge to the board's action under the entire fairness standard.").

a conscious disregard for his duties." *In re NYMEX S'holder Litig.*, 2009 WL 3206051, at *6 (Del. Ch.) (internal quotation marks & citations omitted).[12]

Section 102(b)(7) adds another layer to these pleading requirements. Where, as here, "the directors on the Board are protected by the § 102(b)(7) provision exculpating them for personal liability stemming from a breach of the duty of care, the complaint must be dismissed against the directors unless the plaintiffs have successfully pled non-exculpated claims for breach of the duty of loyalty against them." *In re Synthes, Inc. S'holder Litig.*, 50 A.3d 1022, 1032 (Del. Ch. 2012); *see also Malpiede*, 780 A.2d at 1092. Allegations that implicate only the duty of care are insufficient. *Malpiede*, 780 A.2d at 1094-95.

The Court of Chancery's *per se* rule, however, directly contravenes these fundamental pleading requirements, well-established by a long line of cases decided by this Court. *See supra*. Pleading the bare facts necessary to support an inference that a controlling stockholder transaction is not entirely fair is sufficient to state a claim *against the controlling stockholder* who is subject to a strict liability standard. But lack of entire fairness alone is not sufficient to support an inference that corporate directors breached any duty, let alone a non-exculpated duty. As the Court of Chancery explained in *In re Southern Peru Copper*

[12] As explained in the Director Defendants' briefing below, the Complaint does not contain such well-pled facts and fails to state a claim for a non-exculpated breach of fiduciary duty.

*Corporation Shareholder Derivative Litigation*, 52 A.3d 761, 787 n.72 (Del. Ch. 2011), *aff'd sub nom. Am. Mining Corp. v. Theriault*, 51 A.3d 1213 (Del. 2012):

> The entire fairness standard ill suits the inquiry whether *disinterested directors* who approve a self-dealing transaction and are protected by an exculpatory charter provision authorized by 8 Del. C. § 102(b)(7) can be held liable for breach of fiduciary duties. Unless there are facts suggesting that the directors consciously approved an unfair transaction, the bad faith preference for some other interest than that of the company and the stockholders that is critical to disloyalty is absent. The fact that the transaction is found to be unfair is of course relevant, but hardly sufficient, to that separate, individualized inquiry. In this sense, the more stringent, strict liability standard applicable to interested parties . . . is critically different than that which must be used to address directors such as those on the Special Committee.

The decision below, however, explicitly rests on the mistaken proposition that pleading lack of entire fairness alone suffices to permit claims against company directors who negotiated or facilitated the transaction to go forward. Indeed, the Court of Chancery held that stating a claim against a disinterested director in the context of a controlling stockholder transaction subject to entire fairness review requires only allegations to the effect 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.

(Op. at 31-32.) Such a *per se* rule would effectively make the pleading standard for claims against the directors the same as the pleading standard for claims against

the controlling stockholder even though they are subject to different standards of liability. Because Rule 8(a) requires a plaintiff to plead claims against each defendant, the Court of Chancery's Opinion should be reversed.

## II. *Emerald Partners* Did Not Change the Pleading Requirement for a Breach of Fiduciary Duty Claim in Controlling Stockholder Transactions.

In its Opinion, the Court of Chancery explicitly recognized that the different standards of liability governing the controlling stockholder and the company directors cautioned against its *per se* rule,[13] but mistakenly felt constrained by this Court's decision in *Emerald Partners II*. Quoting from that decision, the Court below stated:

> "[W]hen 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," that is, upon a fully-developed factual record and a determination of whether the transaction was entirely fair.

(*Id*. at 31 (quoting *Emerald Partners II*, 787 A.2d at 94).) The Court of Chancery incorrectly concluded that, by virtue of this holding, this Court had eliminated the basic requirement that a plaintiff plead a cognizable claim against a company director. This conclusion was based on a *non sequitur*, *i.e.*, that because at trial

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[13] *See id*. at 26 ("It is the fundamental difference in the type of potential liability of two different groups of fiduciaries — strict in the case of interested fiduciaries, breach-based in the case of disinterested fiduciaries — that, I believe, has led to some lack of clarity in our case law." (footnote omitted)).

entire fairness must be determined before a director's liability, a pleading of entire fairness alone is sufficient to get to trial.

As discussed below, however, *Emerald Partners II* was not nearly so broad and did no such thing. Rather, *Emerald Partners II* is correctly read only as a decision about trial burdens and the appropriate sequence of determining entire fairness and exculpation *at trial*.

To begin with, the procedural context of the *Emerald Partners* decisions puts the holdings of those decisions in critical context and makes clear that *Emerald Partners II* should not be read as a decision sweeping away this Court's jurisprudence on the requirement that a valid claim be pled against a company director in order for that claim to proceed beyond the pleading stage.

The plaintiffs in *Emerald Partners* challenged the merger of their corporation with its controlling stockholder, alleging, among other things, that the merger was not entirely fair and that the director defendants[14] had committed disclosure violations in the company's proxy statement. *Emerald Partners I*, 726 A.2d at 1220 n.3; *Emerald Partners,* 1995 WL 600881, at *2-4.

[14] The controlling stockholder was initially a defendant as well, but after declaring bankruptcy, was dismissed from the case. *Emerald Partners v. Berlin*, 1995 WL 600881, at *1 (Del. Ch.).

The defendants did not move to dismiss under Rule 12(b)(6), but instead moved for summary judgment after discovery.[15] The Court of Chancery granted that motion, finding that the alleged disclosure violations at issue involved (at most) a breach of the duty of care, and therefore that the defendants were exculpated from liability pursuant to the corporation's Section 102(b)(7) provision. *Emerald Partners*, 1995 WL 600881, at *6-7.

In *Emerald Partners I*, this Court reversed, observing that the plaintiffs had "made a sufficient showing through factual allegations that entire fairness should be the standard by which the directors' actions are reviewed." 726 A.2d at 1222.[16] In so holding, this Court noted that there were several factual issues concerning the defendant directors' adherence to their duty of loyalty, including:

> i) [the controlling stockholder's and an affiliated director's]

[15] The director defendants had previously moved for judgment on the pleadings with respect to a derivative claim against them. The Court of Chancery found that the complaint did not make the particularized allegations required under Rule 23.1 to demonstrate demand futility, and dismissed that count. *Emerald Partners v. Berlin*, 1993 WL 545409, at *5 (Del. Ch.).

[16] The defendants had argued, and the Court of Chancery found, that plaintiffs' "entire fairness" claim was not contained in the complaint. 1995 WL 600881, at *3 n.2. The operative complaint alleged that "[t]he timing, structure and price of the Merger was grossly unfair to the minority stockholder of [the company] and constituted a breach of the duty of fairness [owed] by defendants to plaintiff and the class." *Emerald Partners I*, 726 A.2d at 1220 n.3. However, the Court noted that by that late stage of the proceedings, the defendants had the requisite notice of the claim based on, among other things, the facts elicited in discovery, the parties' arguments, and statements by the Court of Chancery and this Court. *Id.* at 1220-22.

> improper participation in the deliberations of the non-affiliated directors; ii) [the controlling stockholder's] improper contact with [the non-affiliated directors' financial advisor]; iii) the complete lack of negotiation of the exchange ratio; iv) the utter disregard for the committee process; and v) the failure to seek an updated fairness opinion.

*Id.* at 1220 n.5 (internal quotation marks omitted). The Court also ruled that the defendants could not invoke the Section 102(b)(7) provision at that stage of the proceedings because "the entire fairness and disclosure claims under these circumstances were intertwined and should not have been separately considered." *Id.* at 1222. Accordingly, the Court remanded for a trial at which the defendants would have the burden of demonstrating entire fairness. *See Emerald Partners II*, 787 A.2d at 89.

Notably, this Court did not rule out the pre-trial application of a Section 102(b)(7) provision in all cases, clarifying that "[w]here the factual basis for a claim *solely* implicates a violation of the duty of care, this Court has indicated that the protections of such a charter provision may properly be invoked and applied." *Emerald Partners I*, 726 A.2d at 1224.

Thus, in *Emerald Partners I*, this Court permitted the claim to go forward to trial at the summary judgment stage for the simple reason that there were issues of fact surrounding the question whether the company directors had engaged in a non-exculpated breach of the duty of loyalty. Moreover — and critical to what

followed — the Court found that those factual issues were inextricably intertwined with the factual issues concerning the entire fairness of the transaction.[17] *Id*. at 1222.

On remand from *Emerald Partners I*, the Court of Chancery held a trial and — instead of conducting an entire fairness analysis — it determined that the defendants had at most breached a duty of care and therefore were exculpated from any liability. Although the Court noted that the directors' decision-making process had not been a "model of procedural perfection," it found that the defendants had shown that they had not breached their duties of loyalty or good faith. *Emerald Partners v. Berlin*, 2001 WL 115340, at *6, *25-26 (Del. Ch.). The Court further concluded that, given its ruling on the Section 102(b)(7) issue, it was not obligated to determine whether the merger was entirely fair. *Id.* at *28 n.78.

In *Emerald Partners II*, this Court again reversed, concluding that the Court of Chancery was required first to determine whether the transaction was entirely fair. The Court reasoned 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

[17] As the Court of Chancery later put it *In re General Motors Class H Shareholders Litigation*, 734 A.2d 611, 619 n.7 (Del. Ch. 1999) in *Emerald Partners I* "the Delaware Supreme Court disagreed with the Chancery Court's decision that disclosure claims could not be 'categorized' as involving disloyalty or bad faith, but simply as involving 'due care.'"

been decided." *Emerald Partners II*, 787 A.2d at 94 (emphasis in original). The Court explained that once the entire fairness standard is implicated, "a substantive finding of entire fairness is only possible after examining and balancing the nature of the duty or duties that the board breached in a contextual comparison to how the board otherwise properly discharged its fiduciary responsibilities." *Id.* at 93. After conducting that analysis, the Court must identify the particular breach or breaches giving rise to liability, and only then can determine whether the particular breach is subject to exculpation. *Id.* at 93-94.

Thus, *Emerald Partners II* concerns how a court should determine whether there has been a non-exculpated breach of duty by a company director *at trial when entire fairness is the standard of review applicable to the director's conduct* (the company was not a party to the case at trial, *see supra* n.14). The Court reasoned that a trial court must first determine the entire fairness of the transaction because any factual issues that implicate a potential breach of duty are inextricably intertwined with the issues relating to the transaction. But this Court did not do away with the requirement that there be facts placed at issue implicating a non-exculpated breach of duty to get to trial in the first place, *i.e.*, facts to implicate the

entire fairness standard of review to the directors' conduct.[18] Rather, in *Emerald Partners I*, this Court had already found that this requirement had been satisfied.

As the Court of Chancery later explained in *DiRienzo v. Lichtenstein*, 2013 WL 5503034 (Del. Ch.) — in granting a motion to dismiss filed by director defendants in circumstances similar to this case — this Court's statements in *Emerald Partners II* regarding the timing of consideration of a Section 102(b)(7) provision should be read in light of the fact that the Court had made that statement:

> after it had been decided that that [sic] the directors' actions were subject to entire fairness review. Thus, the directors in *Emerald Partners* were precluded from relying on a 102(b)(7) charter provision by virtue of their conduct, not because the transaction was subject to entire fairness review for other reasons.

*Id*. at *11.

Nor did this Court sweep away the basic requirement that a plaintiff plead a breach of duty against a company director. In fact, in *Emerald Partners II*, this Court expressly noted that "in actions against the directors of Delaware

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[18] On remand of *Emerald Partners II*, the Court of Chancery found the transaction to be entirely fair and that, even if it was not entirely fair, the defendants would be exculpated because any unfairness was the result of a breach of the duty of care. *Emerald Partners v. Berlin*, 2003 WL 21003437, at *38 (Del. Ch.). This Court affirmed the trial court's finding of fairness, but explicitly did not address the trial court's alternative ruling regarding the Section 102(b)(7) provision. Underscoring the factual issues concerning the directors' potential breaches of duty in that case, the Court specifically noted that "the many process flaws in this case raise serious questions as to the independent directors' good faith…." *Emerald Partners v. Berlin*, 2003 WL 23019210, at *1 (Del.).

corporations with a Section 102(b)(7) charter provision, a shareholder's complaint must allege *well-pled* facts that, if true, implicate breaches of loyalty or good faith." 787 A.2d at 92 (emphasis added) (citing *Malpiede*, 780 A.2d at 1094). The Court also quoted its prior decision in *Malpiede* with approval for the proposition that, when a complaint "unambiguously asserts *only* a due care claim":

> The Section 102(b)(7) bar may be raised on a Rule 12(b)(6) motion to dismiss (with or without the filing of an answer), a motion for judgment on the pleadings (after filing an answer), or a motion for summary judgment (or partial summary judgment) under Rule 56 after an answer, with or without supporting affidavits.

*Id.* at 91 n.35 (internal quotation marks omitted).

Indeed, in *Malpiede* itself — decided between *Emerald Partners I* and *Emerald Partners II* — this Court emphasized that the procedural posture of *Emerald Partners I* was important to understanding it holding. In *Malpiede*, this Court affirmed the dismissal of breach of duty of loyalty and bad faith claims against the director defendants on the grounds that they were not pled adequately and that any due care claims were barred pursuant to the Section 102(b)(7) exculpatory provision in the company's charter. 780 A.2d at 1083-85, 1092-96. Although *Malpiede* did not involve a controlling stockholder transaction, the Court carefully distinguished *Emerald Partners I* based on the procedural posture of that case, stating in pertinent part:

> The procedural posture here is quite different from that in

> *Emerald Partners.* There the Court stated that it was incorrect for the trial court to grant summary judgment on the record in that case because the defendants had the burden *at trial* of demonstrating good faith if they were invoking the statutory exculpation provision. In this case, we focus not on trial burdens, but only on pleading issues. A plaintiff must allege well-pleaded facts stating a claim on which relief may be granted. Had plaintiff alleged such well-pleaded facts supporting a breach of loyalty or bad faith claim, the Section 102(b)(7) charter provision would have been unavailing as to such claims, and this case would have gone forward.

*Id.* at 1094 (footnote omitted) (emphasis in original).

Since *Emerald Partners II*, several decisions in the Court of Chancery have concluded that *Emerald Partners* does not permit a plaintiff to bootstrap an entire fairness claim against a controlling stockholder into an entire fairness claim against company directors, and further that a Section 102(b)(7) exculpation clause may be invoked by a defendant director on a pre-trial motion (*e.g.*, a motion to dismiss or motion for summary judgment) in a controlling stockholder transaction case just as in any other case.

In *In re Southern Peru Copper Corporation Shareholder Derivative Litigation*, Del. Ch., C.A. No. 961-VCS, Strine, V.C. (Dec. 21, 2010) (TRANSCRIPT) the Court of Chancery granted a summary judgment motion by disinterested director defendants based on a Section 102(b)(7) exculpatory charter provision. The Court expressly rejected the argument that *Emerald Partners* precluded pre-trial dismissal on Section 102(b)(7) grounds in an entire fairness

case involving a controlling stockholder transaction, noting that numerous cases had been decided after *Emerald Partners* "to suggest that maybe, for about seven to ten good and sufficient reasons, that really couldn't be the law." *Id*. at 40:6-41:2 (emphasis added).

Similarly, in *DiRienzo v. Lichtenstein*, the Court of Chancery dismissed breach of fiduciary duty claims against members of a special committee that negotiated and approved a controlling stockholder transaction alleged to be not entirely fair. The Court specifically rejected the interpretation of *Emerald Partners* adopted by the Court below here (*see supra*) and explained:

> It is a now well-established principle of Delaware corporate law that in an interested merger, *the controlling or dominating shareholder proponent of the transaction* bears the burden of proving its entire fairness. Defendants in this case concede that . . . the controlling shareholder proponent of the Merger, will have the burden of establishing the entire fairness of the Merger. But, it does not follow from the fact that [the controlling shareholder] must prove the Merger was entirely fair that the Special Committee shares that same obligation. A special committee must prove the entire fairness of its actions when a plaintiff alleges that the committee engaged in non-exculpated behavior such as by acting disloyally or in bad faith. In such cases, the burden of entire fairness flows from the actions, or lack thereof, of the special committee itself, and not from the separate obligations of a controlling or dominant shareholder. . . .
>
> To burden the Special Committee with proving entire fairness, [plaintiff] must allege sufficiently that the committee members breached a non-exculpated fiduciary duty. This inquiry necessarily requires consideration of the Company's 102(b)(7) provision.

*DiRienzo,* 2013 WL 5503034, at *10-11 (footnotes & internal quotation marks omitted).

In *Shandler v. DLJ Merchant Banking, Inc.*, the Court of Chancery reached the same conclusion, dismissing claims as against one company director in a case that involved a controlling stockholder transaction subject to entire fairness review. 2010 WL 2929654, at *12 (Del. Ch.). The Court explained that in "the absence of any pled facts otherwise supporting an inference that [the director] breached his duty of loyalty by acting in bad faith to injure [plaintiff], the complaint at best states a due care claim against [the director]. That claim is barred by the exculpatory charter provision and therefore the complaint is dismissed against [the director]." *Id*.

Several other decisions in the Court of Chancery have reached similar results.[19]

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[19] *In re Gen. Motors*, 734 A.2d at 619 n.7 ("I do not read [*Emerald Partners I*] as precluding a Rule 12(b)(6) dismissal of claims that the directors breached their fiduciary duty of care on the *basis* of an exculpatory charter provision so long as dismissal on that *basis* does not *thereby* preclude plaintiffs from pressing well-pleaded allegations that the directors breached their fiduciary duties of loyalty and good faith."); *In re BHC Commc'ns S'holder Litig.*, 789 A.2d 1, 5-7, 9-11 (Del. Ch. 2001) (dismissing claims against company directors in entire fairness case based on exculpatory charter provisions after finding that the claims alleged those defendants were based on allegations of breach of the duty of care); *Lukens*, 757 A.2d at 733 ("According to plaintiffs, the § 102(b)(7) Provision can only be raised as an affirmative defense and the Court can only determine its applicability on the basis of a well-developed factual record. Nothing in the *Emerald Partners* opinion requires such a narrow or crabbed

There have been some decisions — like the one below — that have come out the other way based on the mistaken view that *Emerald Partners* does not permit pre-trial dismissal of claims against director defendants in a controlling stockholder case governed by the entire fairness standard.[20] But for the reasons set forth herein, we respectfully submit that those cases are wrongly decided.

## III. Fundamental Principles of Delaware Corporate Law and Policy Considerations Require that Plaintiffs Plead a Non-Exculpated Breach Against Each Director Defendant.

As the Court of Chancery below itself recognized — in line with several other decisions in the Court of Chancery — fundamental principles of Delaware corporate law and several policy considerations strongly weigh against adopting a *per se* rule that would wipe away basic pleading requirements and force a company director to face the burdens of trial without any allegation of wrongdoing against him or her.

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reading of section 102(b)(7) charter provisions."); *In re Frederick's of Hollywood, Inc.*, 2000 WL 130630, at *6 (Del. Ch.) ("[T]he plaintiffs argue that the Frederick's exculpatory provision cannot provide a basis to dismiss the complaint at the pleading stage, because the applicability of the charter provision can be determined only on a developed factual record. The plaintiffs misread *Emerald Partners*."), *aff'd sub nom. Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001); *O'Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 914 (Del. Ch. 1999) (denying motion to dismiss but expressly only because of the specific allegations against the directors; acknowledging applicability of Section 102(b)(7) at pleading stage).

[20] *See, e.g.*, *In re Orchard Enters., Inc. S'holder Litig.*, 88 A.3d 1, 37-38 (Del. Ch. 2014); *Frank v. Elgamal*, 2014 WL 957550, at *32-33 (Del. Ch.).

***First***, Delaware corporate law has long recognized as a core principle that "directors are entitled to a *presumption* that they were faithful to their fiduciary duties." *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004) (citing *Aronson*, 473 A.2d at 812). This presumption rests on the understanding that directors are motivated to exercise their independent judgment by a variety of factors, including "personal integrity, honesty, concern about their business reputations, and the threat of liability to shareholders…." *Id.* at 1052 n.32 (citing Bryan Ford, *In Whose Interest: An Examination of the Duties of Directors and Officers in Control Contests*, 26 ARIZ. ST. L.J. 91, 127 (1994)).

As the Court of Chancery explained in *In re MFW Shareholder Litigation*, 67 A.3d 496 (Del. Ch. 2013), even in a controlling stockholder transaction:

> most directors will want to procure a deal that their minority stockholders think is a favorable one, and virtually all will not want to suffer the reputational embarrassment of repudiation at the ballot box. That is especially so in a market where many independent directors serve on several boards, and where institutional investors and their voting advisors, such as ISS and Glass Lewis, have computer-aided memory banks available to remind them of the past record of directors when considering whether to vote for them or withhold votes at annual meetings of companies on whose boards they serve.

*Id.* at 529 (footnotes omitted), *aff'd sub nom. Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014). To infer automatically that a disinterested director would risk his or her reputation, future income from service on other corporate boards,

and potential liability to stockholders by disregarding his fiduciary obligations and rubber-stamping a controlling stockholder transaction would create a "dubious presumption" that a disinterested director would "sell his or her soul" for a controlling stockholder. E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 406 (1997).

Indeed, this understanding underlies this Court's recent holding in *M & F Worldwide* that a transaction with the controller is entitled to business judgment rule deference if certain criteria are met, including the existence of an independent special committee. As the Court below itself recognized:

> The automatic inference [implicit in the *per se* rule] seems inconsistent with our Supreme Court's recent opinion in *M & F Worldwide,* which suggests that a motion to dismiss may be granted where the transaction is conditioned *ab initio* on a majority-of-the-minority vote and is negotiated by a facially disinterested and independent special committee, a proposition recently found persuasive in this Court[.]

(Op. at 29 (footnote omitted).) Indeed, the Court below agreed that "doctrinally it seems insufficient to simply plead that that [sic] a director has participated in a transaction with a controller and thus an inference of disloyalty arises sufficient to sustain a complaint against her." (*Id*. at 28.)

***Second***, as the Court below further explained, requiring that a plaintiff plead a non-exculpated breach of fiduciary duty in a controlling stockholder transaction case "is consistent with our treatment of directors alleged to have breached duties

in non-controller-dominated transactions, where the requirement of specific pleading of non-exculpated breaches of duty allows management of the corporation to proceed unaffected by frivolous litigation and protects the directors' ability to pursue appropriate levels of risk without fear of liability, so long as their actions are consistent with the duty of loyalty." (*Id*. at 27-28.)[21]

Proceeding along these same lines, the Court went on to explain that a *per se* rule creates undesirable incentives for those considering service on a board and those already on a board considering a potential transaction with a controlling stockholder:

> The automatic inference that a director negotiating or facilitating a transaction with a controller, without more, is a conflicted or disloyal director makes service on a special committee risky, and thus unattractive to qualified and disinterested directors. Since directors who *refuse* to negotiate with a controller may also be breaching a fiduciary duty, but will receive the deferential business judgment review for such an alleged breach, the automatic inference creates an incentive to reject entering negotiations with controllers, a rejection that may cost minority stockholders value.

(Op. at 28-29.)

***Third***, adoption of a *per se* rule would make the disposition of controlling stockholder cases more inefficient and expensive to resolve. Company directors

[21] *See also, e.g., Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins*, 2004 WL 1949290, at *10 (Del. Ch.) ("General allegations of domination over a Board are simply not sufficient under Delaware law to state a traditional duty of loyalty claim.")

will be dragged along in virtually every controlling stockholder suit, with the attendant costs of separate counsel and the burdens associated with having multiple additional parties participate in every aspect of the proceedings. Moreover, such a rule provides little benefit to minority shareholders. As the Court below explained:

> the pleading rule the Defendants advocate would have little adverse effect on the minority stockholders, to whom the controller would still be liable absent entire fairness. Such a pleading rule would not negate judicial scrutiny of the directors' actions in the context of the fairness of the transaction, which would occur whether or not they remained defendants.

(*Id*. at 29-30.)

***Fourth***, the Court of Chancery's *per se* rule — which precludes pre-trial application of a Section 102(b)(7) exculpation clause — undermines the intended policy goals of Section 102(b)(7). As this Court has recognized, "Section 102(b)(7) was adopted by the Delaware General Assembly in 1986 following a directors and officers insurance liability crisis and the 1985 Delaware Supreme Court decision in *Smith v. Van Gorkom.*" *Malpiede*, 780 A.2d at 1095 (footnotes omitted). Among other things, the General Assembly was concerned that then-widespread unavailability of traditional directors' liability insurance "threatened the quality and stability of the governance of Delaware corporations because directors have become unwilling, in many instances, to serve without the protection which such insurance provides and, in other instances, may be deterred by the

unavailability of insurance from making entrepreneurial decisions." S.B. 533, 133rd Gen. Assembly (DE 1986).

Similarly, the *per se* rule adopted by the Court below forces disinterested and independent directors to endure the burdens of litigation — including the reputational harms that may come along with being a named defendant — without any well-pled (or other) basis for a claim against them, and does not permit them to interpose the intended protections of a Section 102(b)(7) exculpation clause until after going through an entire trial. As a result, outside directors could become less willing to serve on special committees formed to evaluate an offer from, and negotiate a potential strategic transaction with, a controlling stockholder. In addition, special committee members, for fear of lengthy litigation and trial, may be deterred from recommending and approving a controller transaction that is worthwhile for the company and beneficial to its minority stockholders.

As the Court of Chancery explained in *In re BHC Communications Shareholder Litigation*, "[t]he function of Section 102(b)(7) provisions is to render duty of care claims not cognizable and to preclude plaintiffs from pressing claims of breach of fiduciary duty, absent the most basic factual showing (or reasonable basis to infer) that the directors' conduct was the product of bad faith, disloyalty or one of the other exceptions listed in the statute." 789 A.2d at 9-10 (internal quotation marks & citation omitted).

## CONCLUSION

For the foregoing reasons, the Court should reverse.

Respectfully submitted,

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1173385

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