April 15, 2020

Delaware Court of Chancery Affirms CEO Termination Decision Protected by Business Judgment Rule

Court Dismisses Action Against lululemon Directors Based on Paying Severance to Former CEO Notwithstanding Ability to Terminate for "Cause"

SUMMARY

On April 2, 2020, in *Shabbouei* v. *Potdevin*,[1] the Delaware Court of Chancery granted a motion to dismiss a stockholder derivative action against the board of directors of lululemon athletica inc. alleging that the directors "breached their fiduciary duties by rushing to pay an excessive severance fee" in connection with the former CEO's separation "as a means to cover up their slow response to his well-documented malfeasance."[2]

In reaching its decision, the Court found that Plaintiff did not support a reasonable inference that the Board failed to exercise proper business judgment in settling with the CEO rather than terminating his employment for cause, which "could have embroiled the Company in an embarrassing legal battle with its former CEO."[3] Although Plaintiff did not affirmatively assert a *Caremark* claim,[4] the Court nevertheless analyzed implied allegations that the Board failed to exercise appropriate oversight and determined that the Board's actions in investigating and settling the claim did not implicate a "conscious indifference" to "red flags" underlying such a claim.[5] Furthermore, the Court held that the Plaintiff had not "come close to reaching [the outer] limit," whereby the Board's decision was "so disproportionately [irrational] as to be unconscionable and constitute waste,"[6] and that the complaint did not plead sufficient facts to constitute a claim of unjust enrichment against the CEO.

BACKGROUND

The complaint alleged that in response to two reported incidents of CEO misconduct (neither of which was described with any particularity in the complaint), the lululemon Board commenced an investigation into the behavior of then-CEO Laurent Potdevin, meeting first informally and then again five times over a three-month period. In particular, it was alleged that the former CEO "created a toxic culture" at the Company, involving a "practice of harassment and sexual favoritism[,]" and fostering a "boys club" during his tenure.[7] After allegedly "verifying reports that its CEO had engaged in pervasive misconduct" and "consulting extensively with outside counsel," the Board authorized one director, Glenn Murphy (who served in various Chairman roles on the Board during the relevant time frame) to negotiate the terms of a potential separation agreement on behalf of the Company.[8] Pursuant to the CEO's employment agreement, a termination for cause would have required a demonstration by the Company that the CEO had engaged in conduct constituting "gross negligence, recklessness or willful misconduct with respect to his obligations under the [employment] [a]greement or otherwise relating to the business of the Company."[9] Upon a termination for cause, the CEO would not have been entitled to severance payments under the employment agreement.

Based on negotiations with the CEO, the Board agreed to a separation agreement in February 2018, which provided for a $5 million payment, with $3.35 million payable upfront and the remainder to be paid over an 18-month period, in exchange for a release of claims against the Company and the Board, an extension of the non-solicitation covenant set forth in the employment agreement and, according to the Plaintiff, the CEO's "quiet departure" from the Company.[10]

Plaintiff served the Company with an inspection demand under Section 220 of the Delaware General Corporation Law in April 2018 to investigate wrongdoing surrounding the CEO's departure from the Company, and filed a derivative complaint in November 2018 without first making a litigation demand on the Board. The Plaintiff's complaint consisted of three derivative counts, alleging that: (i) defendants breached their fiduciary duties in approving the separation agreement; (ii) the separation agreement constituted corporate waste; and (iii) the CEO was unjustly enriched by the separation agreement.

Defendants moved to dismiss Plaintiff's complaint under Court of Chancery Rule 23.1, arguing that Plaintiff failed to plead demand futility with the particularity required by law.

THE DELAWARE COURT OF CHANCERY'S DECISION

In dismissing Plaintiff's complaint for failure to adequately plead demand futility, Vice Chancellor Joseph R. Slights applied the standard set forth in the well-known *Aronson*[11] decision, which protects a board's affirmative decision "*unless* a plaintiff can plead particularized facts in support of a reasonable inference that either (i) a majority of the board is interested in the challenged decision, or (ii) the challenged decision was not a product of valid business judgment."[12]

To plead demand futility under the second *Aronson* prong, Plaintiff was required to plead particularized facts in support of a reasonable inference that entering into the separation agreement did not constitute valid business judgment on the part of the Board. Because lululemon has an exculpatory clause in its certificate of incorporation (meaning the directors were exculpated from monetary liability for a breach of the duty of care), Plaintiff was required to plead that the Board breached its duty of loyalty by demonstrating that the Board's decision was "so egregious on its face that" it could not have "[met] the test of business judgment."[13] The Court emphasized that, under the business judgment rule, Delaware courts "focus on the 'process' employed [by boards] to make a decision" and boards are otherwise entitled to "deference . . . regarding (i) how much information [is] needed before" taking action and (ii) "how to structure . . . meetings."[14]

The Court found that the Board did not have a duty to terminate the CEO's employment for cause prior to any attempt to negotiate his separation, and that the Board's decision to negotiate was reasonable. Plaintiff had also argued that the Board was both *too slow* in responding to the first incident involving the CEO and *too fast* in responding to the second incident, but the Court found that it is the "Board's prerogative to decide when it had enough information to decide how to separate [the CEO] from the Company[.]"[15] Additionally, with respect to the Board's informal meeting, the Court found that using "'off the record conversations' to encourage 'an open dialogue on the facts'" surrounding the CEO's investigation was also entitled to deference.[16] Finally, the Court rejected an argument that the Board "made a 'conscious decision to allow [the CEO] to decide his own fate'" since the Board had only "authorized Mr. Murphy to *negotiate*" the CEO's separation, hardly leaving the decision in the CEO's hands.[17] Ultimately, the Court held that the Plaintiff did not support a reasonable inference that the Board failed to exercise proper business judgment.

Under the first *Aronson* prong, the Plaintiff was required to plead particularized facts in support of a reasonable inference that a majority of the Company's directors (i) "'appeared on both sides' of the [s]eparation [a]greement[,] (ii) derived a 'personal financial benefit from it in the sense of self-dealing' or (iii) were beholden to an interested person."[18] The Court determined that, to plead that the Board was interested in the separation agreement, the Plaintiff would need to plead particularized facts "supporting an inference that the [s]eparation [a]greement extinguished a *substantial likelihood* of Board liability."[19]

Although Plaintiff did not affirmatively assert a *Caremark* claim (or that the Board faced a substantial likelihood of liability from such a claim), the Court nevertheless analyzed implied allegations that the Board failed to exercise appropriate oversight and therefore faced *Caremark* liability. The Court determined that it was "not conceivable" that the Board failed to establish a reporting system since the Company's ethics code and whistleblower hotline were utilized to report the allegations of misconduct against the CEO.[20] Similarly, it could not be inferred from the complaint that the Board acted in bad faith to ignore the CEO's misconduct. Even if the Board could have been more rapid in responding to the allegations (and the Court found no well-pled facts supporting any inference of that), the Court found that this would not have exposed the directors to a substantial risk of liability. Further, in connection with the *Caremark* analysis, the Court found that the complaint did not support a reasonable inference that the Board consciously disregarded a duty to act between when the first alleged incident occurred and when a response was initiated by the Board to the second incident. Among other things, the Board responded to the second incident by engaging outside counsel to investigate, reviewing the report prepared by counsel, and authorizing negotiations to secure the former CEO's departure. Accordingly, the Court found that an unpled *Caremark* claim could not be used to show Board interestedness in the separation agreement. Among other "interestedness" theories, the Court similarly rejected an argument that directors were self-interested in the separation agreement based on the CEO's release of claims against the Board.

In connection with Plaintiff's efforts to plead demand futility, Plaintiff also argued that the Board's decision to enter into the separation agreement constituted waste since the CEO would not have been in a position to challenge a termination of employment for cause, making the $5 million severance payment unwarranted. For a successful waste argument, Plaintiff was required to plead that the separation agreement was not attributable to a rational business purpose. The Court found that no such inference could be drawn with respect to the separation agreement since the CEO was required to release the Company and the Board from all claims and, further, that the separation agreement extended the non-solicitation covenant for the CEO. Additionally, the separation agreement allowed the Company to end the CEO's "troublesome tenure", "swiftly . . . remediate an environment the [c]omplaint describe[d] as 'toxic'" and "avoid potentially costly and embarrassing litigation," all of which were deemed corporate benefits by the Court.[21]

Finally, the Court dismissed Plaintiff's claim against the CEO for unjust enrichment based on similar reasoning that the Board was disinterested with respect to the separation agreement, and the complaint's failure to plead facts allowing a reasonable inference that a majority of the Board was beholden to the CEO.

IMPLICATIONS

As cited in the Court's decision, "the '#MeToo movement' created 'heightened awareness' with respect to allegations of harassment"[22] that many boards are now facing. This decision provides guidance to boards of Delaware companies regarding the application of the business judgment rule in connection with investigations into allegations of misconduct, as well as settlement negotiations with executives, particularly where plaintiffs are required to plead demand futility. A few items are worth noting:

- ***The company's procedures for detecting incidents of misconduct and harassment.*** In discussing the Board's oversight efforts, the Court credited lululemon with having established an ethics code and a whistleblower hotline, integral to identifying the CEO's alleged misbehavior. The Board's committee charters also included extensive guidelines for how each committee would oversee compliance with the Company's ethics policies.
- ***Steps to be taken in investigations and response.*** Acknowledging that there is "no 'single blueprint' a Board must follow to satisfy its fiduciary duties[,]" the Court cited the Board's actions

to, among other things: (i) launch an investigation internally, (ii) hire a law firm to conduct an outside investigation, (iii) form a subcommittee with respect to the investigation, and (iv) consider the impact on the Company's brand.[23] The Board's informal meetings and off-the-record discussions were also credited toward this process. The Court also acknowledged the Board's quick response within two days of reviewing the investigative report.

- ***Application of* Caremark.** Although the Plaintiff did not affirmatively assert a *Caremark* claim, the complaint contained implicit allegations of oversight failures on the part of the Board, which the Court nevertheless analyzed in light of the *Caremark* standard. However, the Court's discussion may indicate its reluctance to find *Caremark* breaches in this type of situation.
- ***Circumstances in which departing executives accused of misconduct may be entitled to severance under existing agreements and company policies.*** The Court found that the Board's decision to negotiate in this case was reasonable, despite the possibility of terminating the CEO's employment for cause. Notably, the "cause" definition from the CEO's employment agreement did not specifically refer to lululemon's anti-harassment policies, but many companies have moved toward incorporating references to anti-harassment policies with specificity, and we expect that scrutiny surrounding a board's decision to negotiate a settlement in lieu of a termination for cause will be context-driven in light of a company's particular policies and practices and the terms of any relevant employment agreement.

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ENDNOTES

1 2020 WL 1609177 (Del. Ch. Apr. 2, 2020).

2 *Id.* at *1.

3 *Id.* at *12.

4 *In re Caremark Int'l, Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).

5 *Shabbouei*, 2020 WL 1609177, at *8 (citing *White* v. *Panic*, 793 A.2d 356, 371 (Del. Ch. 2000); *South* v. *Baker*, 62 A.3d 1, 18 (Del. Ch. 2012); *Horman* v. *Abney*, 2017 WL 242571, at *14 (Del. Ch. Jan. 19, 2017) (stating that a *Caremark* claim is incongruous with allegations that when "red flags were waived," the "Board responded")).

6 *Shabbouei*, 2020 WL 1609177, at *13.

7 *Id.* at *3.

8 *Id.* at *1.

9 *Id.* at *2 (quoting Verified S'holder Deriv. Am. Compl. for Breach of Fiduciary Duty, Waste of Corp. Assets, and Unjust Enrichment ("Compl.") (D.I. 17) at ¶ 74).

10 *Id.* at *4.

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

12 *Shabbouei*, 2020 WL 1609177, at *6.

13 *Id.* at *9 (quoting *Aronson*, 473 A.2d at 815; *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 64–66 (Del. 2006)).

14 *Id.* at *10.

15 *Id.* at *11.

16 *Id.* at *12. The Court noted that, although it has been "suspicious of a board's choice to conduct un-minuted meetings in other circumstances, those instances involved other compelling facts weighing in favor of demand futility," which were lacking in this case.

17 *Id.* at *10-11.

18 *Id.* at *6.

19 *Id.* at *7.

20 *Id.*

21 *Id.* at *13.

22 *Id.* at *8 (quoting Compl. ¶ 87; Pl. David Shabbouei's Answering Br. in Opp'n to the Defs.' Mot. to Dismiss Pl.'s Verified S'holder Deriv. Am. Compl. (D.I. 28) at 47).

23 *Id.* at *12.

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