September 16, 2014

In re Cornerstone Therapeutics Inc. Stockholder Litigation

Delaware Chancery Court Declines to Dismiss Claims Against Disinterested Directors Not Pled with Particularity in Transaction in Which Entire Fairness Review Applies

SUMMARY

In an opinion[1] issued on September 9, 2014, the Delaware Court of Chancery (VC Glasscock) held that in a controlling stockholder freeze-out merger subject to entire fairness review at the outset, disinterested directors entitled under a company's charter to exculpation for duty of care violations cannot prevail in a motion to dismiss even though the claims against them for breach of fiduciary duty are not pled with particularity; instead, the issue of whether they will be entitled to exculpation must await a developed record, post-trial. The decision once again highlights the litigation cost that will be imposed on companies engaged in controlling stockholder freeze-out mergers for failing to employ both of the safeguards that Delaware has endorsed to ensure business judgment, instead of entire fairness, review— (1) an up-front non-waivable commitment by the controller to condition the transaction on an informed vote of a majority of the minority stockholders and (2) approval of the transaction by a well-functioning and broadly empowered special committee of disinterested directors. At the motion to dismiss stage, disinterested directors effectively will be treated in the same manner as controllers and their affiliated directors.

BACKGROUND

In February 2013, Chiesi Farmaceutici S.p.A. ("Chiesi") sought to acquire the approximately 35% of the shares of Cornerstone Therapeutics, Inc., a Delaware publicly traded company ("Cornerstone"), it did not already own at a price range of $6.40 to $6.70 per share. Chiesi did not condition its offer on receipt of the approval of a majority of the minority of Cornerstone stockholders. Because some members of

Cornerstone's board had current or prior employment relationships with Chiesi, the Cornerstone board formed a special committee comprised of five independent directors to consider the offer.

The special committee hired counsel and financial advisors. Over a period of seven months, the special committee met 37 times and received six separate detailed financial presentations from its financial advisor. During that time, the special committee counteroffered first at $12/share, then, after Chiesi rejected the proposal, at $11/share and, after disappointing Cornerstone earnings were released and the special committee instructed its financial advisors to revise management's updated projections, at $10.25/share. Chiesi's financial advisor reminded the special committee after its first counteroffer that Chiesi had the right to remove and replace all of Cornerstone's directors and senior management. The special committee ultimately approved a freeze-out merger at $9.50/share, supported by its financial advisor's fairness opinion. The full board, with the two current Chiesi employees recusing themselves, thereafter voted to approve the merger. The merger was conditioned on the approval of a majority of the minority of Cornerstone's stockholders; it was approved by more than 80% of the minority stockholders. The plaintiffs brought suit, asserting that the special committee directors, the founder and former CEO of Cornerstone who served as a director and the three Chiesi-affiliated Cornerstone directors, as well as Chiesi, had breached their fiduciary duties and that Cornerstone had aided and abetted the breaches. Cornerstone and the non-Chiesi-affiliated Cornerstone directors filed motions to dismiss with respect to the claims against them.

THE COURT'S DECISION

Having determined that entire fairness review applied *ab initio* because the complaint alleged that the merger was not entirely fair to the minority stockholders and was not contingent up front on a non-waivable condition requiring the approval of a majority of the minority stockholders, the Court found that controlling precedent required the Cornerstone directors to await a developed record, post-trial, before their liability is determined, even though no specific allegations of wrongdoing were made regarding the disinterested directors.

The Court rejected the defendant directors' contention that because the burden of proving entire fairness is upon them, there must be specifically pleaded breach of duty of loyalty claims, and *in dicta*, suggested there may be a need for a legislative correction or Supreme Court review of the issue. The Court acknowledged that the approach the defendants advocated would be consistent with Delaware law's treatment of directors alleged to have breached duties in non-controller transactions, it would allow management of the corporation to be unaffected by frivolous litigation and it would protect directors' ability to pursue appropriate levels of risk without fear of liability. The Court stated that "doctrinally it seems insufficient to simply plead that…a director has participated in a transaction with a controller" to automatically obtain a sufficient inference of disloyalty to survive a motion to dismiss by a disinterested negotiating or facilitating director.[2] Such an automatic inference approach, the Court stated, makes service on a special committee unattractive to qualified directors and creates a perverse incentive for directors to reject controller transactions that may be beneficial to minority stockholders. As the Court noted, it also appears inconsistent with *Kahn v. M&F Worldwide Corp.*,[3] in which the Delaware Supreme Court held that a transaction conditioned up front on approval of a majority of the minority stockholders and a well-functioning special committee of disinterested and independent directors was entitled to business judgment review, and thus by implication specific pleadings of special committee interest or ineffectiveness logically would be required to defeat a motion to dismiss.

At the same time, the Court stated, the automatic inference rule advocated by the plaintiffs, and already applicable to controllers and their affiliated directors, had its advantages. Director loyalties, which are of highest concern in controller transactions, the Court stated, are "often cryptic and unknowable" at the pleading stage, and waiting until a post-trial determination of entire fairness may help ensure that "faithless" directors are called to account.

Ultimately, the Court determined that it could not make a policy decision about the relative merits of the competing arguments because it was bound by *Emerald Partners v. Berlin*[4] to deny the defendants' motion to dismiss; *Emerald* required a fully developed factual record and a determination of whether the transaction was entirely fair before a determination of a director defendant's exculpation from monetary damages can be made. Applying *Emerald*, the Court found that the plaintiffs had sufficiently pled that Chiesi controlled the corporate machinery, that it used that machinery to facilitate an interested transaction, that the transaction was not entirely fair to the minority and that the disinterested directors negotiated or facilitated the transaction. In so finding, the Court distinguished *In re Southern Peru*,[5] in which the Court dismissed the case against defendant directors on the grounds that there were no facts "suggesting that the directors consciously approved an unfair transaction," because that case was decided in the context of a motion for summary judgment that involved a developed factual record, and not in the context of a motion to dismiss.[6] The Court noted in *dicta* that even had it accepted the pleading standard advanced by the defendants, the plaintiffs' allegation that an agent of the controller had threatened the special committee members with removal raised questions as to the special committee's effectiveness that may have led to a denial of the motion to dismiss in any event. The Court also granted Cornerstone's motion to dismiss the claim that Cornerstone had aided and abetted the directors' fiduciary duty breaches since the Court stated a corporation cannot aid and abet violations by the fiduciaries that serve it.

IMPLICATIONS

The *Cornerstone* decision once again makes clear that absent the twin procedural protections that shift review of a controller transaction from entire fairness to business judgment, directors, even ones who are protected by exculpation provisions in the company's charter, will continue to be subject, at minimum through the summary judgment phase, to the cost and time attendant acquisition litigation.

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ENDNOTES

1 *In re Cornerstone Therapeutics Inc. Stockholder Litigation*, C.A. No. 8922-VCG slip op. (Del. Ch. Sept. 9, 2014).

2 *Id*. at 28.

3 No. 334, 2013, slip op. (Del. Mar. 14, 2014). For a full discussion of the Kahn v. M*&F Worldwide* decision, see our publication, dated March 17, 2014, entitled "*Kahn v. M&F Worldwide Corp.*"

4 787 A.2d 85 (Del. 2001).

5 52 A.3d 761 (Del. Ch. 2011).

6 While the Court stated that directors could not escape litigation until a trial was held, the Court's distinguishing of *Cornerstone* from other entire fairness precedents on the basis of the instant case being in the context of a motion to dismiss, while the others were in the context of a motion for summary judgment, suggests that non-exculpated claims against disinterested directors in entire fairness cases could be dismissed at the summary judgment stage (and not necessarily at trial) if there was no evidence of procedural or substantive unfairness at that time.

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