Fiduciary Duties of the Board of Directors

by Practical Law Corporate & Securities

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A Practice Note describing the fiduciary duties of the board of directors, including the core duties of care and loyalty. This Note also discusses the standards of review that courts apply when judging directors' conduct, including the business judgment rule, enhanced scrutiny, and entire fairness.

Directors bear **fiduciary duties** to protect the interests of the corporation and to act in the stockholders' best interests. When stockholders invest in a corporation, they entrust their capital to the corporation's directors. But while it is the stockholders' investment that is at risk, it is a cardinal precept of Delaware corporate law (and of many other jurisdictions) that the business and affairs of the corporation are managed by its directors, not its stockholders (*Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000)). Through this arrangement, the directors act as agents for the stockholders, guided by their fiduciary duties.

This Practice Note describes the fiduciary duties of the **board of directors** under Delaware law. This Note focuses on Delaware law because:

- Delaware is a leading jurisdiction of incorporation, with a majority of all US Fortune 500 companies incorporated in Delaware.
- Delaware's law on fiduciary duties is well established and widely followed in other jurisdictions.

Fiduciary duties are codified in some states' statutes, but remain a product of common law in Delaware. For information on how fiduciary duties are applied in other states, see Corporation Law: State Q&A Tool: Question 5.

This Note is a general overview of the fiduciary duties of directors of Delaware corporations. For overviews of fiduciary duties in other contexts, see Practice Notes:

- Fiduciary Duties in M&A Transactions, addressing fiduciary duties of directors of solvent, public corporations in negotiated M&A transactions under Delaware law.

- Fiduciary Duties of Directors of Financially Troubled Corporations, covering fiduciary duties of directors of corporations that are insolvent or nearing insolvency.

- Defending Against Hostile Takeovers, discussing fiduciary duties of directors and takeover defenses in the context of hostile bids.

- Fiduciary Duties of Officers of Corporations, explaining the fiduciary duties of officers under Delaware law.

- Fiduciary Duties in LLCs and LPs, describing the fiduciary duties owed by members and managers of limited liability companies and by general partners of limited partnerships under Delaware law.

This Note does not address the corporate governance requirements for public companies under the rules of the **Securities and Exchange Commission** (SEC) and various stock exchanges. For more information on the obligations of directors under those regimes, see Practice Notes, Corporate Governance Standards: Board of Directors and Periodic Reporting and Disclosure Obligations: Overview.

For a more detailed discussion of fiduciary duties of directors in M&A transactions, see Practice Note, Fiduciary Duties in M&A Transactions. For a description of fiduciary duties of directors of insolvent corporations, see Practice Note, Fiduciary Duties of Directors of Financially Troubled Corporations.

Legal Framework

Under Delaware law, corporate acts are reviewed for their compliance with two sets of rules:

- The technical rules of the corporate contract between the directors and stockholders that address the legality of the act taken by the corporation.

- An overlay of equitable rules to ensure that otherwise legal acts are taken in compliance with the board's fiduciary duties to the corporation and its stockholders.

Delaware courts call this review the twice-testing principle (*Sample v. Morgan*, 914 A.2d 647, 672 (Del. Ch. 2007); *Carsanaro v. Bloodhound Techs., Inc.*, 65 A.3d 618, 641-42 (Del. Ch. 2013), *abrogated on other grounds by El Paso Pipeline GP Co. v. Brinckerhoff*, 152 A.3d 1248, 1264 (Del. 2016)).

A corporation may not eliminate or modify the fiduciary duties of directors unless authorized by Delaware statute. The Delaware statutes only grant limited authority to corporations relating to the fiduciary duties of directors, primarily in Section 102(b)(7) of the DGCL and Section 122(17) of the DGCL (see Exculpation from Liability and Corporate Opportunity Doctrine).

A provision in a corporation's organizational documents that attempts to otherwise eliminate or modify a director's fiduciary duties will be ineffective. For example, the Delaware Chancery Court held that a provision in a corporation's certificate of incorporation stating that the board's good faith decisions on certain matters are conclusive and binding does not prevent the court from reviewing a director's actions in equity for a breach of fiduciary duty or change the court's standard of review. (*Totta v. CCSB Fin. Corp.*, 2022 WL 1751741, at *14-18 (Del. Ch. May 31, 2022).) This is in contrast to the broad authority the Delaware legislature has granted to limited liability companies and limited partnerships to modify and eliminate fiduciary duties (see Practice Note, Fiduciary Duties in LLCs and LPs).

Corporate Contract

There are three primary components of the corporate contract:

- The corporate statute of the corporation's state of incorporation. In Delaware, this is the **Delaware General Corporation Law** (DGCL). The majority of other states base their legislation on Delaware law or on the Model Business Corporation Act (MBCA).
- The corporation's **certificate of incorporation** (often referred to as the charter).
- The corporation's **by-laws**.

These three sources form a hierarchy. A by-law that conflicts with the charter is void and a charter provision that conflicts with the statute is void (*Sinchareonkul v. Fahnemann*, 2015 WL 292314, at *6 (Del. Ch. Jan. 22, 2015)).

Corporate charters and by-laws, within the framework of the DCGL, operate in some respects as a contractual arrangement among the corporation, the stockholders, and the directors, but directors are not contractually bound to the corporation by the charter. Although stockholders can bring breach of contract claims against a corporation for violating its charter, a corporation cannot (either directly or derivatively) bring a breach of contract claim against its directors for allowing the corporation to violate its charter. The directors' failure to follow the charter may, however, be a breach of fiduciary duty (see Breach Committed in Bad Faith). (*Lacey v. Mota-Velasco,* 2021 WL 508982, at *7-9 (Del. Ch. February 11, 2021).)

Common Law

The rules governing directors' fiduciary duties stem from decades-old, yet continuously evolving, common law. Combining the two bodies of law, the Delaware courts interpret the statute and language in the subject corporations' **organizational documents**, evaluate the context of any alleged misconduct, and apply a standard of review based on precedent.

Role of Directors in Management of the Corporation

The board of directors holds ultimate responsibility for the business and affairs of the corporation. This power is codified in Section 141(a) of the DGCL and by similar statutes in other states. The board discharges this responsibility by:

- Appointing officers who run the day-to-day operations of the corporation, propose strategies and objectives, and implement corporate plans.
- Supervising those officers.
- Making major decisions for the corporation (for example, selling the company or entering into a significant joint venture).

For a discussion about the directors' ability to delegate duties to officers, see Delegation to Officers.

Stockholders Do Not Manage the Corporation

The stockholders of the corporation, by contrast, have two fundamental rights:

- To elect directors to the board.
- To exit the corporation by selling their shares.

The stockholders do not manage the corporation themselves. Even a majority stockholder who has the voting power to replace the directors does not manage the corporation, even though it owes fiduciary duties to the other stockholders (see Who Owes Duties to Whom). The Delaware Court of Chancery ruled that stockholders cannot amend the corporation's by-laws to give them the right to remove and appoint officers, even if they have the votes to do so, since that right is a substantive business decision reserved to the board (*Gorman v. Salamone*, 2015 WL 4719681, at *5 (Del. Ch. July 31, 2015)).

Stockholders have limited statutory consent rights to approve certain fundamental transactions. For a summary of some of these consent rights, see Corporate and LLC Consents Required for Mergers and Acquisitions Checklist.

Stockholders may also have other special rights such as **dividend** payments, veto rights, and consent rights, if provided for contractually in the certificate of incorporation or in a stockholders agreement (see Practice Note, Stockholders Agreement Commentary). But these rights must be specifically negotiated, and are not automatically available as a matter of law.

Delegation

Delegation to Board Committees

Directors are often selected for their expertise in a particular area or for their industry connections, and are added to the board to fill an advisory or supervisory role within their area of focus. To facilitate this, state law permits, and corporate charters typically authorize, the board to delegate any of its powers to a committee of directors. However, many states restrict the activities that a committee of less than an entire board can conduct.

Board committees have significant power under Delaware law. A duly appointed committee (such as a compensation or **nominating committee**) holds all powers delegated to it by the full board (or as otherwise provided for in the certificate of incorporation or by-laws), other than the power to:

- Approve, adopt, or recommend to the stockholders any action or matter (other than the election or removal of directors) expressly required by Delaware law to be approved by the stockholders.
- Adopt, amend, or repeal any of the corporation's by-laws.

(DGCL § 141(c)(2).)

Delegating powers to committees also benefits the other members of the board. Directors are explicitly protected from liability when they reasonably rely in good faith on reports from committees, officers, and other experts when making decisions for the corporation (DGCL § 141(e)). For a discussion of the advantages of forming a special committee, see Practice Note, Making Good Use of Special Committees: The Advantages of Using a Special Committee.

Delegation to Officers

Directors are ultimately responsible for managing the corporation, but they are not expected to manage its day-to-day activities. Directors are therefore permitted to delegate managerial duties to officers, except to the extent delegation is prohibited by the corporation's charter or by-laws (DGCL §141(a)).

The board has the authority to delegate powers to the officers "as in the board's good faith, informed judgment are appropriate," but the power to delegate "is not without limit." The board may not formally or effectively abdicate its power and fiduciary duties to manage or direct the management of the corporation. A board may delegate powers subject to possible review, but it cannot abdicate them. (*In re Pattern Energy S'holders Litig.*, 2021 WL 1812674, at *59 (Del. Ch. May 6, 2021) (quoting *Grimes v. Donald*, 1995 WL 54441, at *8-9 (Del. Ch. Jan. 11, 1995)).) Abdication of directorial duty is evidence of a breach of the duty of loyalty and lack of good faith (for example, see Abdication of Duty of Disclosure).

The determination of whether a director has abdicated a particular duty is a fact specific inquiry. Delaware courts consider:

- Why the delegation was made.
- What task was delegated.
- Whether the board acted independently in delegating the task.

In determining whether the delegation was made in bad faith, Delaware courts consider:

- The agent to whom the directors delegated the task (for example, whether the agent had a known conflict of interest related to the delegated matter).
- The scope of the delegation (for example, whether the delegation was complete and whether the directors retained the ability to review, discuss, or approve the delegated matters).

(*In re Pattern Energy*, 2021 WL 1812674, at *59-61.)

Delegation to Others

The board may delegate to a person or body other than a board committee or officers the authority to:

- Issue stock (DGCL § 152(b)).

- Sell treasury shares (DGCL § 153(c)).
- Issue rights or options to acquire stock (DGCL § 157(c)).

To delegate, the board must adopt a resolution that fixes the following:

- The maximum number of shares of stock, rights, or options that the delegate may issue or sell.
- A time period during which the issuances or sales may occur.
- The minimum amount of consideration to be received for the issuances or sales

The delegated person or body is prohibited from issuing or selling to themselves the stock, rights, or options they have been delegated authority over. (DGCL §§ 152(b), 251(c), and 157(c).).

Core Fiduciary Duties

Directors owe two core fiduciary duties:

- The duty of care, which requires that directors be fully and adequately informed and act with care when making decisions and acting for the corporation (see Duty of Care).
- The duty of loyalty, which requires that directors act and make decisions in the best interest of the corporation, not in their own personal interest (see Duty of Loyalty).

Courts and practitioners frequently refer to other duties, such as the duty of good faith (see Duty of Good Faith), the duty of disclosure (see Duty of Disclosure), and the duty of oversight (see Failure of Oversight). This nomenclature implies that these are standalone fiduciary duties, and in some states the duty of good faith is analyzed as a separate duty. Under Delaware law, however, they are treated as obligations that stem from the core fiduciary duties of care and loyalty.

Who Owes Duties to Whom

Identifying which persons owe fiduciary duties, and to whom they are owed, is complex:

- **Directors owe fiduciary duties to the corporation and its stockholders.** Directors owe their fiduciary duties to the corporation and its stockholders (*Arnold v. Soc'y for Sav. Bancorp, Inc.*, 678 A.2d 533, 539 (Del. 1996)). Certain states (for example, Pennsylvania) have constituency statutes that explicitly allow the board of directors to consider the interests of constituencies other than the stockholders, including employees, customers, suppliers, and creditors (15 Pa C.S.A. §515(a)). The DGCL contains no such provision.

- **Directors owe fiduciary duties to common stockholders in preference to preferred stockholders.** Under ordinary circumstances, the board owes fiduciary duties to preferred and common stockholders equally. However, if the interests of preferred and common stockholders diverge, the board owes its fiduciary duties to its common stockholders in preference to the preferred stockholders (*In re Trados Inc. S'holder Litig.*, 2009 WL 2225958, at *7 (Del. Ch. July 24, 2009)). Directors only owe fiduciary duties to the preferred stockholders to the extent the preferred stockholders' and common stockholders' rights are the same. Directors do not owe preferred stockholders fiduciary duties when the preferred stockholders rely on their preferred rights and preferences which are contractual in nature and are governed by the terms of the **certificate of designation** under which the **preferred stock** was issued (*Frederick Hsu Living Trust v. ODN Holding Corp.*, 2017 WL 1437308, at *21 (April 24, 2017)).

- **An insolvent corporation owes fiduciary duties to its creditors**. If the corporation is **insolvent**, directors continue to owe fiduciary duties to the corporation, but the corporation's creditors replace the stockholders as the primary beneficiaries of those duties. Creditors of solvent corporations are generally protected by contract and by debtor-creditor law, not by corporate law binding the directors. For a discussion of the fiduciary duties of an insolvent corporation, see Insolvency.

- **A controlling stockholder owes fiduciary duties to the corporation and the minority stockholders**. A controlling stockholder owes fiduciary duties to the corporation and minority stockholders if it owns 50% or more of the voting power of or exercises control over the affairs of the corporation (*Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1114 (Del. 1994)). For a discussion of the test for control, see Defining Control for Entire Fairness. For a discussion of when non-stockholders may owe fiduciary duties if they exercise control, see Control By Non-Stockholders.

- **Officers owe fiduciary duties to the corporation and its stockholders**. Officers of Delaware corporations owe the same fiduciary duties of care and loyalty as directors owe (*Gantler v. Stephens*, 965 A.2d 695, 709 (Del. 2009)). For a detailed discussion of officers' duties and the standard of review of their conduct under Delaware law, see Practice Note, Fiduciary Duties of Officers of Corporations.

- **The corporation itself does not owe fiduciary duties to its stockholders.** The corporation itself does not owe fiduciary duties to the stockholders and cannot be held to have aided or abetted any breaches by the directors of their duties (see *Arnold*, 678 A.2d at 539; *Buttonwood True Value P'rs, L.P. v. R.L. Polk & Co., Inc.*, 2014 WL 3954987, at *4 (Del. Ch. Aug. 7, 2014)).

Insolvency

Under Delaware law, the fiduciary duties of the board do not typically extend to other constituencies such as bond holders and other creditors because they are protected by contract or other statutory schemes (such as state commercial laws). However, as a corporation approaches insolvency, the creditors start to resemble equity holders in that they may ultimately have the final claim on the corporation's assets. At that point, creditors arguably hold the interest in maximizing the value of the corporation that is ordinarily held by the common stockholders. Some courts have indicated that a director's fiduciary duties might shift at this point to the creditors.

The Delaware Supreme Court addressed this question in the *Gheewalla* case. The Court held that creditors of a corporation have no right to assert **direct claims** against directors for breach of fiduciary duty. This remains the case whether the corporation is merely approaching insolvency (referred to as the zone of insolvency) or is already insolvent. The court rationalized that creditors should continue to be protected by contracts, commercial laws (such as the covenant of good faith and fair dealing), and bankruptcy laws. When a corporation falls into the zone of insolvency, directors should not be hindered by the threat of fiduciary duty lawsuits when negotiating with creditors. (*N. Am. Catholic Educ. Programming Found. Inc. v. Gheewalla*, 930 A.2d 92, at *99-103 (Del. 2007).) However, creditors hold **standing** to bring a **derivative claim** for any breaches of fiduciary duty on behalf of the corporation once a corporation becomes insolvent (*Quadrant Structured Prod. Co., Ltd. v. Vertin*, 102 A.3d 155, 172-176 (Del. Ch. 2014)).

For more information on the fiduciary duties of directors of distressed or insolvent companies, see Practice Note, Fiduciary Duties of Directors of Financially Troubled Corporations.

Duty of Care

A director must follow the duty of care when acting on behalf of the corporation. Many states have codified the duty of care, generally following the standards of the MBCA. Both California and New York have codified the duty of care and closely follow the MBCA with minor modifications:

- The California statute requires a director to act in good faith, in a manner the director believes to be in the best interests of the corporation and its stockholders, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances (Cal. Corp. Code § 309(a)).

- The New York statute requires a director to act in good faith and with the degree of care which an ordinarily prudent person in a like position would use under similar circumstances (NYBCL § 717(a)).

While not codified in Delaware, the duty of care has been developed in case law along similar lines. Delaware courts generally describe the duty of care as the obligation to use the amount of care that an ordinarily careful and prudent person would use in similar circumstances. A director breaches the duty of care by failing to take action in a situation where a careful person would have taken action. This formulation implies that directors' decisions are always scrutinized for reasonableness. However, Delaware courts recognize that directors sometimes must take business risks to promote the best interests of the corporation and its stockholders, and that judges and stockholders are not in the best position to second-guess business decisions made by the board of directors. Judges have been particularly careful not to impose liability for a decision that seems wrong only in hindsight.

No Duty to Maximize Profits or Minimize Taxes

The duty of care does not require the board to take any particular actions. Of particular note, directors have no *per se* duty to maximize the profits of the corporation. Directors can take actions that do not directly increase the corporation's profits (for example, cause the corporation to make charitable donations) if there is a connection to a rational business purpose. The board cannot be held liable for making a business decision simply because another decision would have been more profitable.

For example, the Delaware judiciary has repeatedly ruled that a board has no fiduciary duty to minimize corporate taxes (see *Freedman v. Adams*, 58 A.3d 414, 417 (Del. 2013) ("The decision to sacrifice some tax savings in order to retain flexibility in compensation decisions is a classic exercise of business judgment"); *Seinfeld v. Slager*, 2012 WL 2501105, at *3 (Del. Ch. June 29, 2012) ("Delaware law is clear that there is no separate duty to minimize taxes, and a failure to do so is not automatically a waste of corporate assets")).

Duty of Loyalty

The duty of loyalty requires directors to act in good faith for the benefit of the corporation and its stockholders, not for their own personal interests. The duty of loyalty embodies not only an affirmative duty to protect the interests of the corporation, which is the purpose of the duty of care, but also an obligation to refrain from conduct that would harm the corporation and its stockholders.

A breach of the duty of loyalty is implicated if there is:

- A conflict of interest (see Conflict Transactions and Entire Fairness).
- Bad faith (see Breach Committed in Bad Faith).

Breaches of the duty of loyalty are treated more seriously than breaches of the duty of care in terms of both the initial standard of review and the consequences of a breach.

Decisions or transactions involving a breach of the duty of loyalty, including a conflict of interest or bad faith, are not protected by either:

- The business judgment rule (see Business Judgment Rule).
- The statutory limitation of liability under Section 102(b)(7) (see Exculpation from Liability).

For a discussion on how the board's failure to oversee a corporation's operations may be a breach of the duty of loyalty, see Failure of Oversight.

Corporate Opportunity Doctrine

One way the duty of loyalty may be breached is if a director or officer usurps a corporate opportunity. Courts analyze several factors to determine whether a corporate opportunity rightfully belongs to the corporation. In Delaware, these factors include:

- If the opportunity is in the same line of business as the corporation's. Delaware courts have broadly interpreted the nature of a corporation's line of business and recognized that it should have a "flexible meaning, which is to be applied reasonably and sensibly" (see *Personal Touch Hldg. Corp. v. Glaubach*, 2019 WL 937180, at *16-17 (Del. Ch. February 25, 2019)).
- Whether the corporation has an interest or expectancy in the opportunity.
- Whether the corporation would be financially able to take the opportunity if presented. This factor is met if the usurper had a parallel contractual obligation to present corporate opportunities to the corporation.

- Whether taking the opportunity would create a conflict of interest or be a breach of fiduciary duties for the director or officer.

(*Yiannatsis v. Stephanis by Sterianou*, 653 A.2d 275, 278-79 (Del. 1995), quoting *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939).)

Section 122(17) of the DGCL allows corporations to renounce expectations to any specified business opportunities or specified classes or categories of business opportunities. The waivers must be specific and narrow because broad non-specific waivers would impermissibly limit the duty of loyalty (*Totta*, 2022 WL 1751741, at *16).

Insider Trading

Another way the duty of loyalty may be breached is if a director engages in insider trading under *Brophy v. Cities Services Co.* (70 A.2d 5 (Del. Ch. 1949)). A director breaches their duty of loyalty under a *Brophy* claim if the director both:

- Possessed material, nonpublic company information. For the nonpublic information to be material, the court must determine that it would been of significance to a rational investor, in light of the total mix of public information. This analysis is similar to, but distinct from, a director's obligation to disclose information to stockholders (see Duty of Disclosure).

- Used that information improperly by making trades because the director was motivated, in whole or part, by that information.

(*Goldstein v. Denner,* 2022 WL 1797224, at *5 (Del. Ch. June 2, 2022) (*Goldstein II*).)

Protections for Directors

To allow boards to take necessary business risks and to attract qualified people to serve as directors, Delaware has adopted the following protections for directors:

- **The business judgment rule.** The business judgment rule presumes that directors comply with the duty of care and imposes liability only for breaches committed with gross negligence (see Business Judgment Rule).

- **A statutory limitation of liability.** Most states allow the corporation's certificate of incorporation to eliminate or limit directors' personal liability for money damages to the corporation or its stockholders for breach of their duty of care. Delaware provides for this exculpation in Section 102(b)(7) of the DGCL. The statute allows corporations to exculpate its directors for breaches of their fiduciary duties, barring breaches committed in bad faith or breaches of the duty of loyalty. For a more detailed discussion, see Exculpation from Liability.

- **Indemnification and advancement of expenses. Indemnification** statutes protect directors from liability stemming from their service to the corporation. Section 145 of the DGCL requires a corporation to indemnify current or former directors who were made a party to a proceeding by reason of their service to the corporation and who have achieved success, on the merits or otherwise, in that proceeding. It also permits a corporation to indemnify and advance expenses to directors in certain circumstances (DGCL §145; see Indemnification and Advancement). For more information, see Practice Note, Director and Officer Indemnification for Delaware Corporations.

- **Insurance.** Delaware law permits corporations to purchase director and officer insurance (**D&O Insurance**) to insure directors by covering losses (such as settlement costs, fines, and legal fees) resulting from a breach of fiduciary duty (DGCL § 145(g)). For more information, see Practice Notes, Directors and Officers Insurance Policies and Director and Officer Indemnification for Delaware Corporations: Directors and Officers Insurance.

Exculpation from Liability

If a board of disinterested and independent directors is found to have acted with gross negligence, it may be held to have breached its duty of care. Section 102(b)(7) of the DGCL allows corporations to include an exculpatory provision in their certificate of incorporation eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for a breach of fiduciary duty. This exculpatory provision has limits, however, because it:

- **Only applies to breaches of duty of care**. The limitation of liability is only applicable to breaches of the duty of care. It is unavailable for breaches of the duty of loyalty (including breaches resulting from a conflict of interest), acts or omissions committed in bad faith, acts or omissions involving intentional misconduct or a knowing violation of law, for any transactions in which the director received an improper personal benefit, or for liabilities for the payment of unlawful dividends or unlawful stock purchase or redemption. A conflict of interest can arise when a director acts to advance:
    - their self-interest adverse to the stockholders' interest; or
    - the self-interest of an interested party from whom the director is not independent.
- **Only eliminates monetary liability of directors.** A Section 102(b)(7) provision only eliminates the directors' monetary liability, and does not eliminate the underlying breach. Therefore, it does not preclude the court from issuing an injunction to provide relief for the breach (*Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001)). Additionally, because the underlying breach is not eliminated, a third party (such as a financial advisor) can be held liable for aiding and abetting a director's breach, even if the director who committed the breach is personally exculpated (*In re Rural Metro Corp*., 88 A.3d 54, 86 (Del. Ch. 2014)), *aff'd sub nom*, *RBC Cap. Mkts., LLC v. Jervis*, 129 A.3d 816, 873 (Del. 2015)). For more information on the elements for establishing a claim of aiding and abetting a breach of fiduciary duty, see Practice Note, Fiduciary Duties in M&A Transactions: Exculpated Breach Forms Basis for Aiding and Abetting Liability.
- **Is not retroactive.** A Section 102(b)(7) provision is not retroactive. It cannot exculpate the directors for any act or omission occurring before the effective date of the provision.
- **Is unavailable to officers prior to August 1, 2022.** Exculpation under Section 102(b)(7) was only available for directors, not officers, prior to August 1, 2022 (*Gantler*, 965 A.2d at 709 n.37). However, from and after August 1, 2022, a corporation's certificate of incorporation may include a provision exculpating certain officers for the same types of claims that directors are permitted exculpation for, except that these officers may not be exculpated for

claims brought by or in the right of the corporation. For further discussion, see Practice Note, Fiduciary Duties of Officers of Corporations: Statutory Exculpation.

If the director is protected by a exculpatory provision and a plaintiff only seeks monetary damages, a director cannot be found liable and the court must dismiss the claim, unless the plaintiff pleads non-exculpated claims against the director, regardless of the standard of review (*In re Cornerstone Therapeutics Inc.*, 115 A.3d 1173, 1175 (Del. 2015)). For example, for a discussion of how an exculpatory provision affects a finding of liability under the entire fairness review, see Liability for Failing to Satisfy Entire Fairness Review. For an example of an exculpation provision, see Standard Document, Certificate of Incorporation (Short-Form DE): Paragraph 7.

Indemnification and Advancement

In addition to allowing exculpation, the DGCL requires a corporation to indemnify a current or former director who was made a party to a proceeding by reason of their service to the corporation and who has achieved success, on the merits or otherwise, in that proceeding (DGCL §145(c)(1)). The corporation is also permitted to indemnify a director who was made a party to a proceeding by reason of their service to the corporation if the director acts in good faith and in a manner the director reasonably believes is in the best interests of the corporation and for criminal proceedings has no reasonable cause to believe that their behavior was unlawful. For actions brought by or in right of the corporation (such as derivative claims) a corporation cannot indemnify a director if the director is adjudged to be liable to the corporation, unless the court determines the director is entitled to indemnity. (DGCL §145(a), (b).) The statute prohibits a corporation from indemnifying a corporate official who was unsuccessful in the underlying proceeding and who acted in bad faith (*Hermelin v. K-V Pharm. Co.*, 54 A.3d 1093, 1094 (Del. Ch. 2012)).

A corporation may also advance a director's expenses as they are incurred, subject to the director's agreement to repay the advanced expenses if it is determined the director is not entitled to indemnification (DGCL § 145(e)).

Directors usually expect to receive full indemnification and advancement of expenses to the maximum extent allowed by law.

For a more detailed discussion of Section 145 of the DGCL and the indemnification of and advancement of expenses to directors and officers, see Practice Note, Director and Officer Indemnification for Delaware Corporations. For an example of an indemnification provision for a certificate of incorporation, see Standard Document, Certificate of Incorporation (Short-Form DE): Paragraph 8.

Abstention Defense

Under Delaware law, a director who "plays no role in the process of deciding whether to approve a challenged transaction cannot be held liable on a claim that the board's decision to approve that transaction was wrongful" (*In re Tri-Star Pictures, Inc.*, 1995 WL 106520, at *2 (Del. Ch. Mar. 9, 1995)). But there are exceptions, such as if:

- Certain directors conspire with others to formulate a wrongful transaction, then deliberately absent themselves from the directors' meeting at which the proposal is to be voted onto shield themselves from any exposure to liability (*Tri-Star*, 1995 WL 106520, at *3).

- The director played a role in the negotiation, structuring, or approval of the proposal (*In re Carvana Co. S'holder Litig.*, 2022 WL 2352457, at *17 (Del. Ch. June 30, 2022)).
- An absent director knowingly accepts a personal benefit flowing from a self-interested transaction and refuses to return it on demand. That absent director can be thought to have ratified the action taken by the board and, therefore, share in the full liability of the directors (*Valeant Pharm. Int'l v. Jerney*, 921 A.2d 732, 753-54 (Del. Ch. 2007)).
- The director abstained from the formal vote to approve the transaction, yet was closely involved with the challenged transaction from the beginning and the transaction was rendered unfair based, in large part, on the director's involvement (*Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1166 n.202 (Del. Ch. 2006)).
- The directors abstained from the formal vote to approve the transaction, but "participated in the key board meeting before the vote" where they explained the rationale for the transaction and expressed their opinions about the transaction (*In re Coty Inc. S'holder Litig.*, 2020 WL 4743515, at *10 (Del. Ch. Aug. 17, 2020)).
- The directors abstained from the transaction vote but approved a compensation package that was integral to the challenged transaction being successful (an arrangement which the court termed as a "quid pro quo arrangement" (*In re CBS Corp. Stockholder Class Action and Derivative Lit.*, 2021 WL 268779, at *53 (Del. Ch. Jan. 27, 2021), as corrected (Feb. 4, 2021)).

Although the abstention defense typically involves playing no role in the transaction, including its approval, in *In re Dell Tech. Inc. Class V Stockholder Class Action and Deriv. Lit.*, the Delaware Chancery Court dismissed a fiduciary duty claim based on abstention even though the director approved the transaction where director did not participate in the negotiations and the director's other involvement was limited to "attending the meetings of the Board [and] approving the issuance of the proxy materials" (2020 WL 3096748 (Del. Ch. June 11, 2020)).

Standards of Review: Overview

The decisions and actions taken by the board of directors, together with the possibility that the directors might have breached a fiduciary duty, are evaluated under one of three standards of review:

- **Business judgment rule.** The business judgment rule is the default standard of review. It applies to decisions made by directors who are disinterested and independent. See Business Judgment Rule.
- **Entire fairness.** The entire fairness standard, which applies in situations of an actual conflict of interest, is the most onerous standard of review under Delaware law. See Conflict Transactions and Entire Fairness.
- **Enhanced scrutiny.** Enhanced scrutiny is an intermediate standard of review, which applies in recognized situations of potential conflict of interest (*Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 457-59 (Del. Ch. 2011)). See Intermediate Standard of Review: Enhanced Scrutiny.

The standard of review is different than the standard of conduct. The standard of conduct defines what directors are supposed to do to comply with their duties of care and loyalty. The standard of review is the test that courts apply to determine if the directors meet the standard of conduct. (*Chen v. Howard-Anderson,* 87 A.3d 648, 666 (Del. Ch. 2014).)

A court's decision on breach and liability often resolves itself based on the initial decision of which standard of review to apply. If the directors demonstrate that they are entitled to the presumptions of the business judgment rule, it is a virtual certainty that the court will rule in the directors' favor on any question of breach. By contrast, transactions that must be reviewed for their entire fairness are the most common source for findings of breach of fiduciary duties.

Business Judgment Rule

Courts hesitate to substitute their business judgment for the directors' or to question business decisions with the benefit of hindsight, unless the decision of the board cannot be attributed to any rational business purpose (*Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971); see also, Corporate Waste). For this reason, directors' actions are protected by the presumptions of the business judgment rule. The rule presumes that the board of directors acted on an informed basis and in the honest belief that the action was in the best interest of the corporation. In a lawsuit alleging a breach of the duty of care, the court makes this presumption unless the plaintiff shows that a majority of the directors did not meet the following three elements:

- **Stay informed.** Directors have a duty to inform themselves before making a business decision of all material information reasonably available to them (*Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985), *overruled on other grounds by Gantler*, 965 A.2d at 713). For directors to establish that they kept themselves informed of the corporation's business and the issues brought to the board, they should attend meetings (in person, by phone, or virtually), carefully read reports or other materials prepared for the board, and ask questions at meetings. Directors can rely on information and opinions from consultants, management, and employees, but they must make a good-faith determination that those persons can competently produce the reports and make the analyses on which the board relies (DGCL § 141(e)).

- **Act in good faith.** The directors must act in good faith. The decision-making process must be substantive and cannot just rubber-stamp management's actions. Delaware courts frequently define good faith as the absence of bad faith. For a discussion of bad faith, see Breach Committed in Bad Faith.

- **Take action in the best interest of the corporation.** The directors must reasonably believe the action or transaction was made in the best interest of the corporation. If the directors hold a personal interest in an action, because the directors either appear on both sides of the transaction, or expect to receive a personal financial benefit due to self-dealing, as opposed to a benefit for the corporation or all stockholders generally, the court will not presume they acted in the best interest of the corporation. If a majority of the board has a conflict of interest in the underlying action, the conflicted directors are not entitled to the presumptions of the business judgment rule.

(*Aronson*, 473 A.2d at 812.)

If a majority of the board qualifies for the presumptions of the business judgment rule, the standard for a finding of a breach of the duty of care is gross negligence (*In re Citigroup Inc.*, 964 A.2d 106, 124 (Del. Ch. 2009), citing *Aronson*, 473 A.2d at 812).

Rebutting the Business Judgment Rule

If the business judgment rule is rebutted by showing that the directors did not satisfy any of the three presumptions of the business judgment rule, Delaware courts examine directors' actions under one of the other standards of review (see Conflict Transactions and Entire Fairness and Intermediate Standard of Review: Enhanced Scrutiny).

Corporate Waste

If the plaintiff fails to rebut the presumption of the business judgment rule (because a majority of the directors were disinterested and independent) and cannot demonstrate a breach of a duty (because the directors did not act with gross negligence or bad faith), the plaintiff will not be entitled to any remedy unless the challenged transaction constitutes waste.

To recover on a claim of waste, a plaintiff must prove that the relevant exchange was "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." This is considered a stringent standard that is only met in the "rare, unconscionable case where directors irrationally squander or give away corporate assets." (*In re the Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 74 (Del. 2006).) To constitute waste, there must be no business purpose for the action. For example, the Delaware Chancery Court has found that awards of allegedly excessive compensation do not constitute waste because even excessive compensation has a business purpose. (*Knight v. Miller,* 2022 WL 1233370, at *6 (Del. Ch. Apr. 27, 2022).) Similarly, spending on items such as employee vehicles, outings, social club dues, and holiday gifts is usually attributable to a rational business purpose and typically does not support a finding of waste (see *Zutrau v. Jansing*, 2014 WL 3772859, at *20 (Del. Ch. July 31, 2014)).

Breach Committed in Bad Faith

In Delaware common law, the duty of good faith is analyzed as a component of the duty of loyalty, not as a standalone fiduciary duty (*Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006)). Exculpation under Section 102(b)(7) is unavailable for breaches of the duty of loyalty and acts made in bad faith (see Exculpation from Liability). Hence, if the board's wrongful conduct is committed in bad faith, the directors at fault cannot rely on the charter's exculpation provision.

To act in good faith, a director must act with honesty of purpose and in the best interest of the corporation. No single definition or set of factors exists that defines good faith or bad faith, but the courts have identified several situations that usually involve bad faith. These include:

- An intentional failure to act in the face of a known duty to act, demonstrating a conscious disregard for one's duties. For example, a director knows management is violating corporate policy, but makes no attempt to change the situation. (See also Failure of Oversight.)
- A knowing violation of law. For example, a director approves a waste-removal plan knowing it violates environmental laws.
- If a director acts for any purpose other than advancing the best interests of the corporation or its stockholders. For example, a director approves a sale transaction because the director wants to sell its stock.

  (*Disney*, 906 A.2d at 67.)

- A knowing violation of the corporation's charter. For example, a director approves related-party transactions that have not been reviewed by an independent committee, even though the director knows that the corporation's charter requires related-party transactions be reviewed by an independent committee before approval (*Lacey,* 2021 WL 508982, at *9).

- A complete abdication of a directorial duty, especially if the duty is delegated to someone with a known conflict of interest. For example, see Abdication of Duty of Disclosure.

Because a finding of gross negligence is necessary to establish a breach of the duty of care (which can be exculpated by a Section 102(b)(7) provision), a bad-faith act (not exculpated) must be "qualitatively more culpable than gross negligence" (*Disney*, 906 A.2d at 66). An element of **scienter**, or actual or constructive knowledge of the improper action, is necessary. The Delaware Supreme Court recently reaffirmed this high threshold for bad faith, explaining that bad faith means either:

- The conduct was "motivated 'by an actual intent to do harm.'"

- There was an "intentional dereliction of duty, a conscious disregard for one's responsibilities."

(*McElrath v. Kalanick,* 224 A.3d 982, 991-92 (Del. 2020).)

For example, the board is not entitled to the presumptions of the business judgment rule if the plaintiff demonstrates with particularized allegations that the board knowingly or deliberately failed to adhere to the terms of a stock incentive plan (*Pfeiffer v. Leedle*, 2013 WL 5988416, at *5 (Del. Ch. Nov. 8, 2013)). A knowing or intentional violation is inferred if the board violates an unambiguous term in such a plan (*Sanders v. Wang*, 1999 WL 1044880, at *7-9 (Del. Ch. Nov. 10, 1999)).

The Chancery Court has also accepted at the pleading stage, a novel theory of liability that directors (even those that were not on the committee that approved the award) may have breached their fiduciary duties by not fixing an award that was made to the CEO in violation of a plain and unambiguous limitation in an equity compensation plan, after the board received a litigation demand letter from the plaintiff describing the problem. The court inferred bad faith from the board's inaction of not fixing an award it knew to be erroneous. The court cautioned that courts should apply this theory of liability cautiously, but that it may fit these limited facts because the CEO to whom the incorrect awards were issued also owed fiduciary duties to the company to fix award. (*Garfield v. Allen,* 277 A.3d 296, at 336-48 (Del. Ch. 2022); Legal Update, Delaware Chancery Court Refuses to Dismiss Claims Alleging Breach of Contract, Breach of Fiduciary Duty, and Unjust Enrichment Related to Equity Grants.)

By contrast, a board's failure to have a CEO succession plan in place is not considered a conscious disregard of a known duty to act, unless there is a recognized duty to implement such a plan (see *Zucker v. Andreessen*, 2012 WL 2366448, at *11 (Del. Ch. June 21, 2012)).

Notably, a board's knowing breach of a corporation's contractual obligations may not implicate bad faith by the board if the board determines the benefits of the breach outweigh the costs of the breach. Due to the doctrine of efficient breach, directors have some fiduciary discretion in determining whether to breach a corporation's contractual obligations. Under that doctrine, a contract party may decide it is better off breaching the contract and paying damages than completing performance. (*Frederick Hsu Living Trust*, 2017 WL 1437308, at *24.)

Failure of Oversight

When the business judgment rule applies (no conflict of interest and no other set of facts that calls for a heightened standard of review), and assuming the directors are exculpated by a Section 102(b)(7) provision (see Exculpation from Liability), a claim of breach of fiduciary duty usually must establish bad faith on the part of the board. This claim frequently takes the form of a *Caremark* claim, in which the plaintiff argues that the board did so little to oversee the corporation's operations and exposure to risk that its failures amount to a conscious disregard of its duty to stay informed and oversee the company's exposure to risk. As discussed in Breach Committed in Bad Faith, conscious disregard of a known duty to act is a recognized element for establishing bad faith.

Two-Prong Test for a *Caremark* Claim

To satisfy its duty to stay informed and oversee the company's exposure to risk, the board must make good faith efforts to implement an information and reporting system (*In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996)).

The Delaware courts established the boundaries of the duty of oversight in the *Caremark* and *Stone v. Ritter* decisions (see *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 653 (Del. Ch. 2008)). In both of those cases, the court held that directors need to assure themselves in good faith that the corporation has reporting systems in place that are reasonably designed to provide timely and accurate information to the board.

As demonstrated in subsequent cases, directors expose themselves to director oversight liability under *Caremark* if either:

- They utterly failed to implement any reporting or information system or controls. To avoid *Caremark* liability, the board must make a good faith effort to put a reasonable board-level oversight system in place that:
  - is designed to provide the board with timely and accurate information; and
  - at a minimum addresses mission-critical compliance risks.

  (*City of Detroit Police and Fire Retirement Sys. v. Hamrock*, 2022 WL 2387653, at *12-14 (Del. Ch. June 30, 2022).)
- Having implemented such a system or controls, the directors consciously failed to monitor or oversee its operations, therefore disabling themselves from being informed of risks or problems requiring their attention (*Ritter,* 911 A.2d at 370). This basis for liability requires the plaintiff to demonstrate that:
  - there was evidence of corporate misconduct (red flags) that put the directors on notice of problems, but which were consciously disregarded (*Teamsters Local 443 Health Servs. & Ins. Plan v. Chou*, 2020 WL 5028065, at *17 (Del. Ch. Aug. 24, 2020)); and
  - the red flags were sufficiently connected to the corporate trauma, such that a reasonable observer would be put on notice of the risk of the trauma that occurred (*Hamrock,* 2022 WL 2387653, at *20-21).

In both cases, where directors fail to act when there is a known duty to act, they breach their duty of loyalty by failing to discharge it in good faith (*Ritter,* 911 A.2d at 370.) This requires a showing of scienter, that the directors knowingly acted for reasons other than the best interests of the corporation. Therefore, a sufficiently plead *Caremark* claim implicates bad faith and a breach of the duty of loyalty and is not exculpated by a Section 102(b)(7) provision (see Exculpation from Liability).

Facts That Are Not Sufficient to Establish a *Caremark* Claim

In general, *Caremark* claims are considered "possibly the most difficult theory in corporation law on which a plaintiff might hope to win a judgment". To illustrate, in a decision regarding the General Motors board's conduct when it learned of the company's ignition-switch failures, the court held that the plaintiffs had failed to plead sufficient facts to demonstrate bad faith, because the board had not failed to establish **any** oversight plan. Allegations of the board's negligent controls and apathetic culture were still not enough to establish bad faith. (*General Motors*, 2015 WL 3958724, at *14-15 (Del. Ch. June 26, 2015).)

Other examples of *Caremark* claims that failed because the plaintiff did not demonstrate that the board either failed to implement a reporting system or consciously disregarded its duty to oversee the company's compliance with applicable laws by ignoring red flags, include:

- *Melbourne Mun. Firefighters' Pension Trust Fund v. Jacobs*, 2016 WL 4076369, at *9 (Del. Ch. Aug. 1, 2016), ***aff'd***, 158 A.3d 449 (Del. 2017). The complaint alleged that the directors of Qualcomm Inc. allowed the company to repeatedly violate international antitrust laws after being aware of previous violations. The court held that the plaintiff did not adequately plead facts showing that the board's response to the red flags in question constituted bad faith, noting that while the board may have responded insufficiently, it did not completely fail to act, and at all times believed that the company's conduct did not violate antitrust laws.

- *Reiter v. Fairbank*, 2016 WL 6081823 (Del. Ch. Oct. 18, 2016). The complained alleged that directors of Capital One Financial Corporation failed to monitor the bank's check-cashing business for the risk of money laundering. The court dismissed the claim because the plaintiff did not identify a key event or particular document that would constitute a red flag that the board overlooked. The court observed that the documents made the directors aware there was escalating compliance risk, but the documents did not state the company was involved in illegal or fraudulent conduct. The court described the plaintiff's complaint as pleading "at most flags of a different hue, namely yellow flags of caution…" (*Reiter*, 2016 WL 6081823, at *13).

- *Horman v. Abney*, 2017 WL 242571, at *11-14 (Del. Ch. Jan. 19, 2017). The complaint alleged that the directors of United Parcel Service, Inc. failed to oversee the company's compliance with cigarette-transportation laws. The court held that the plaintiff had failed to demonstrate that the board had overlooked any red flags, noting that it is insufficient to allege that the board must have received the pertinent information since the officer charged with passing that information to the board had received the information. Instead, the plaintiff must plead with particularity that the officer actually reported the information to the board. The court also noted that when the board was eventually made aware of the red flags, it was also informed of efforts underway to ensure compliance with the relevant laws.

- *Oklahoma Firefighters Pension & Ret. Sys. v. Corbat*, 2017 WL 6452240 (Del. Ch. Dec. 18, 2017). The complaint alleged that the directors of Citigroup, Inc. failed to prevent violations of money-laundering and other rules. In finding that there were insufficient facts to demonstrate bad faith, the court relied on evidence showing that the board took steps to address the compliance issues, even though the steps were ultimately unsuccessful. The court noted that because the issue concerns the duty of loyalty, "a board's efforts can be ineffective, its actions obtuse, its results harmful to the corporate weal, without implicating bad faith." (*Oklahoma Firefighters*, 2017 WL 6452240, at *17.)

- *Rojas v. Ellison,* 2019 WL 3408812, at *8-13 (Del. Ch. July 29, 2019). The derivative complaint alleged the directors of J.C. Penney failed to oversee the company's compliance with price-comparison advertising laws by ignoring a red flag consumer class action settlement and failing to ensure the company complied with the terms of the settlement. In finding that there were insufficient facts to support a reasonable inference of *Caremark* liability, the court noted that the board had an audit committee to monitor compliance with laws. The court also determined that the class action settlement was not a red flag because it did not notify the board of ongoing violations of law or contain an admission of liability, and there were no facts alleging the directors knew the company was violating laws.

- *In re LendingClub Corp. Derivative Litigation*, 2019 WL 5678578, at *9-14 (Del. Ch. Oct. 31, 2019). The derivative complaint alleged that LendingClub's board breached their fiduciary duties by failing to implement internal controls and monitor the company's compliance with laws, after a whistleblower and internal investigations uncovered several issues. In dismissing the claims because the complaint did not contain any facts that showed bad faith by the directors, the Chancery Court relied on evidence that the company had an audit committee that met monthly and an oversight system. The court also found it persuasive that the board took prompt remedial actions to address the issues once discovered.

- *Pettry v. Smith,* 2021 WL 2644475, at *9 (Del. Ch. June 28, 2021). The derivative complaint alleged that the Federal Express directors consciously ignored red flags regarding illegal cigarette shipments. The Chancery Court dismissed the claims because the board was regularly updated on the status of the enforcement actions, reprimanded employees permitting the shipments, formed a committee to investigate board misconduct, eventually banned most tobacco shipments, and introduced training programs and implemented measures to detect illegal shipments. Although the plaintiff argued these remedial measures came too late, the court noted that focusing on the manner and timing of a board response to a red flag "misses the mark" and acknowledged the board had rationale for waiting to implement remedial measures because the company was actively engaged in litigation regarding the matter.

- *Firemen's Retirement System of St. Louis v. Sorenson,* 2021 WL 4593777, at *11-15 (Del. Ch. Oct. 5, 2021). The derivative complaint alleged that the board breached their fiduciary duty by failing to remedy Starwood's deficient information security system, which caused a security breach that exposed the personal information of Marriot hotel guests. Under *Caremark's* first prong, the Chancery Court dismissed the claims because Marriot's board audit committee received regular reports on cybersecurity issues and engaged outside consultants to audit their cybersecurity practices. The court also dismissed claims that the board ignored red flags that the company was violating the law because their data systems did not comply with industry standards. The court held that the board's knowledge of the company's failure to meet non-binding industry standards did not rise to the level of *Caremark* liability because the failure to meet those standards did not involve violations of positive law.

- *City of Detroit Police and Fire Retirement System v. Hamrock,* 2022 WL 2387653 (Del. Ch. June 30, 2022). The derivative complaint alleged that energy company NiSource's board oversight system was not rigorous enough to address the mission-critical risk of pipeline safety after a pipeline explosion caused a fatality and injuries and significant property damage. The Chancery Court found, however, that the board made a good faith effort to put a reasonable oversight system in place because it had a board committee that oversaw safety, the committee met multiple times a year, and it received extensive reports from management. Regarding the second *Caremark* prong, although the court found that the board generally knew of serious risks related to recordkeeping requirements and of specific recordkeeping issues at other subsidiaries, the plaintiff did not show the board knew of specific near-misses at the subsidiary involved in the explosion. The court found that the board's knowledge of general risks and issues at other subsidiaries was too attenuated from the corporate trauma.

Facts That Are Sufficient to Plead a *Caremark* Claim

Even though *Caremark* claims often fail, they are possible to establish.

In *Marchand v. Barnhill* (Blue Bell) the company's board members were sued for a breach of fiduciary duty after a listeria outbreak resulted in the death of several customers who ate the company's ice cream. The Delaware Supreme Court held that for a company that relied solely on one product (ice cream), the board's failure to establish a board committee or board-level process overseeing food safety and the lack of established protocol to advise the board about food safety were sufficient facts to support a reasonable inference that the company's board had breached its duty of loyalty by failing to implement an oversight system and then monitor it. In coming to that conclusion, the Court specifically noted that if "a board has undertaken no efforts to make sure it is informed of a compliance issue intrinsically critical to the company's business operation," then the board has not met the good faith effort required by *Caremark*. (212 A.3d 805, 822-23 (Del. 2019).)

While *Blue Bell* focused on the first prong of the *Caremark* test, *In re Clovis Oncology, Inc. Derivative Litigation* focused on the second prong of the *Caremark* test. In *Clovis Oncology*, the company's board members were sued for a breach of fiduciary duty for failing to adequately oversee a clinical trial of the company's flagship experimental lung cancer drug. The complaint alleged that the Clovis Oncology board knew that the company was incorrectly calculating and inaccurately reporting the drug's clinical trial results in violation of the established clinical trial protocol and associated U.S. Food and Drug Administration (FDA) regulations, but ignored and failed to correct these problems. This placed the drug's FDA approval in jeopardy.

The Delaware Chancery Court held that these facts supported a reasonable inference that the company's board had breached its duty of loyalty by consciously ignoring red flags of non-compliance. The court distinguished between "board oversight of the 'company's *management of business risk*' from board oversight of the 'company's *compliance with positive law* – including regulatory mandates.'" The court emphasized that "when a company operates in an environment where externally imposed regulations govern its 'mission critical' operations, the board's oversight function must be more rigorously exercised." (2019 WL 4850188, at *12-13 (Del. Ch. Oct. 1, 2019).)

In another case involving the highly regulated pharmaceutical industry, in the demand futility context, the Delaware Chancery Court found that there was substantial likelihood of *Caremark* liability, where AmerisourceBergen Corporation (ABC) had a subsidiary that illegally filled syringes of cancer drugs and to avoid FDA oversight, it sold the syringes using sham prescriptions. The court focused on the fact that for ABC, drug health and safety was a mission critical compliance risk. Applying the second prong of the *Caremark* test, it explained that the red flags must be "visible to the careful observer," and a careful observer in this context is "one whose gaze is fixed on the company's mission critical regulatory issues." The court determined that it was reasonably conceivable that the board knew of red flags putting the board on notice that the company was engaged in illegal conduct. The red flags included a law firm report that identified deficiencies in ABC's compliance program, a whistleblower action from a former executive, and a FDA subpoena. Notably, the court inferred the board knew of the whistleblower action and FDA subpoena because they were described in the 10-K the board signed. However, there was no evidence of board follow-up on, and "nothing to show tangible action taken to remedy," the underlying issues, including no references in the board or audit committee meeting minutes or materials, causing the court to find that the plaintiff had adequately pled that the board in bad faith consciously ignored these reg flags. (*Chou*, 2020 WL 5028065, at *17-25.)

In *Hughes v. Hu* on a motion to dismiss, the Delaware Chancery Court upheld a *Caremark* claim that the company's audit committee failed to adequately oversee its financial reporting, after the company publicly announced material weaknesses in its financial reporting and oversight system and restated three years of financial statements. The court found sufficient evidence to support a reasonable inference that the company's board failed to use good faith efforts to implement a reasonable board-level system of oversight for the company's financial statements and related-party transactions. Factors that the court found persuasive, included that the audit committee only met about once a year when required for securities law purposes, the meetings were less than an hour, and the meetings overlooked important issues, even though the board had clear notice there were serious accounting irregularities regarding related-party transactions. This pattern of behavior indicated the board was blindly deferring to management, instead of separately establishing its own information and reporting system that would "allow management and the board, *each within its own scope*, to reach informed judgments concerning both the corporation's compliance with law and its business performance." (2020 WL 1987029, at *13-16 (Del. Ch. Apr. 27, 2020) (quoting *Caremark*, 698 A.2d at 970).) For a discussion of this case, see Legal Update, Hughes v. Hu: Delaware Court of Chancery Finds Substantial Likelihood of Caremark Liability from Failure of Audit Committee's Duty of Oversight.

Most recently, in *In re The Boeing Company Derivative Litigation,* in the demand futility context, the Delaware Chancery Court denied a motion to dismiss by upholding *Caremark* claims regarding the safety of Boeing's 737 MAX airplanes after two planes crashed killing everyone on board. The court held there were sufficient facts to support a *Caremark* claim under the first prong of the *Caremark* test. Comparing this case to *Blue Bell*, the court emphasized the fact that although airplane safety (like food safety in *Blue Bell*) was "mission critical" and "externally regulated," there was no board committee specifically charged with, or regularly allocated board time spent, monitoring airplane safety. There was also no established protocol for management to report known safety issues to the board. The court noted that management's discretionary ad hoc safety reports to the board were insufficient for mission-critical safety issues, particularly when the board did not require the reports, passively relied on the reports, and did not request additional information. Further, the company's nominal compliance with FAA regulations did not fulfill its obligation to monitor airplane safety at the board level. The court also found the plaintiff pled sufficient facts to support a *Caremark* claim under the second prong, because after the first airline crash (a red flag), the board did not request information about the crash from management, and when it received information about it, the board passively accepted management's position that the airplane was safe, despite a contrary media report. (2021 WL 4059934 (Del. Ch. Sept. 7, 2021).)

Notably, while in recent years an increasing number of *Caremark* claims have survived dismissal, many issues remain open about what is necessary to actually establish *Caremark* liability, because as observed by the *Hamrock* court, "[n]o *Caremark* case has yet gone to trial, or proceeded meaningfully past the pleading stage" (*Hamrock,* 2022 WL 2387653, at *20).

Practical Caremark Guidance

To reduce the likelihood of a successful *Caremark* claim, directors should:

- Establish a board-level oversight system. Directors should not just rely on management or outside regulators for oversight.
- Ensure the oversight system focuses on mission-critical compliance with law or regulatory mandates.
- Actively monitor and use the oversight system to identify red flags of non-compliance.
- If there are red flags, follow-up on and take actions to try remedy the red flags.
- Maintain an adequate board record of the oversight system and response actions, including a record showing the directors:
    - established an oversight system or protocols;
    - reviewed and discussed compliance issues;

- followed-up on red flags; and
- implemented and monitored remediation efforts.

Oversight liability is a risk for all companies, but based on recent cases, particularly rigorous oversight is required of directors for companies operating in highly regulated industries where regulatory compliance is critical to their operations or that involve personal health and safety (such as the pharmaceutical, airline, and food industries).

Emerging Areas of Oversight Claims

Emerging areas of potential oversight claims include:

- ESG issues (see Practice Note, Best Practices for Establishing ESG Disclosure Controls and Oversight: Board Oversight).
- Cybersecurity risk.

In *Sorenson,* although the Chancery Court dismissed the *Caremark* claims because it found no violation of law, it acknowledged the increasing cybersecurity risks faced by companies and the emerging regulatory and legal frameworks governing cybersecurity. The court observed that the "corporate harms presented by non-compliance with cybersecurity safeguards increasingly call upon directors to ensure that companies have appropriate oversight systems in place." (2021 WL 4593777, at *11-12.) However, this does not necessarily mean there will be an increase in successful cybersecurity-related *Caremark* claims. Similar to the result in *Sorenson*, the Chancery Court has recently observed that absent violations of positive law, cybercrimes by third parties is a business risk and the Delaware courts have been cautious about applying *Caremark* liability to business risks (*Constr. Indus. Laborers Pension Fund v. Bingle*, 2022 WL 4102492, at *7 (Del. Ch. Sept. 6, 2022)).

Other Reasons for Oversight

Apart from the analysis of the board's fiduciary duties, directors have compelling reasons to monitor the company's business and risks closely. A corporation can be held responsible for the actions of its management and employees. Since the board of directors is charged with overseeing those managers and employees on behalf of the corporation, the board needs a functioning oversight and compliance system in place. The **Federal Sentencing Guidelines** impose large penalties on corporations for violation of federal criminal laws, but these penalties can be significantly reduced if corporations put appropriate oversight and compliance programs in place.

For a public corporation, the board must consider the additional compliance requirements of the SEC and the applicable stock exchange. Federal regimes of corporate governance have their own standards of review that may be stricter on directors than Delaware corporate law. These regimes require their own compliance procedures. For more information on the obligations of directors under those regimes, see Practice Note, Corporate Governance Standards: Board of Directors.

Caremark Claims Against Directors of Foreign-Based Corporations

The Delaware Court of Chancery has more readily found a basis for a *Caremark* claim when directors of foreign-based Delaware corporations fail to oversee their corporations' activities, particularly when they do little more than hold a handful of telephonic meetings. In *In re Puda Coal, Inc.*, the court refused to dismiss a claim against the independent directors of a China-based corporation, holding that it was "perfectly conceivable" that the directors had failed to make a good-faith effort to monitor the company's management. The court advised that to meet the bare minimum for avoiding personal liability under *Caremark*, a director must:

- Be frequently present in the country the corporation is based.
- Have in place a system of adequate controls and retain accountants and lawyers who are equipped to maintain those controls.
- Have "the language skills to navigate the environment in which the company is operating."

(*In re Puda Coal, Inc. S'holders Litig.*, 2013 WL 769400 (Del. Ch. Feb. 6, 2013) (TRANSCRIPT).)

The court further developed this guidance in *Rich ex rel. Fuqi Int'l, Inc. v. Chong*. There the court held that although the corporation nominally had controls in place, its own disclosures of its material weaknesses showed that it had no "*meaningful*" controls. Moreover, although the board had regular meetings, it had no system at all for regulation of the company's operations "*in China*" (emphasis in original). The court also highlighted the board's repeated failure to identify and respond to red flags that should have warned of the company's material weaknesses in its controls, which rose to the level of a conscious failure to monitor. (*Rich*, 66 A.3d 963, 982-85 (Del. Ch. 2013).)

Nonresident Directors

The other side of the situation in which courts review the conduct of directors of Delaware corporations based overseas is the situation in which Delaware courts review the conduct of nonresident directors. Foreign-based directors cannot evade Delaware courts just because they are not resident in Delaware, or even in the United States. Under Delaware’s **long-arm statute**, non-resident directors and officers of Delaware corporations implicitly accept **personal jurisdiction** in Delaware courts in:

- Any action or proceeding against the individual for violation of a duty in their capacity as a director or officer (an action for breach of fiduciary duty).
- Any civil action or proceeding brought in Delaware, by or on behalf of, or against the corporation, in which the individual is a necessary or proper party.

(10 Del. C. § 3114.)

Nonresident officers and directors are exposed to liability as a necessary or proper party if:

- The claim is brought against the corporation.

- The director or officer is either a necessary or proper party to the case.
- The director's or officer's actions were taken in their capacity as such a representative.

(*Hazout v. Tsang Mun Ting,* 134 A.3d 274, 289-90 (Del. 2016).)

Therefore, Delaware courts have jurisdiction over the officer or director of a Delaware corporation even if the plaintiff does not allege a breach of fiduciary duties, if the traditional minimum-contacts test set out in *International Shoe* and its progeny is met (*Hazout*, 326 134 A.3d at 291 referring to *Int'l Shoe Co. v. Wash., Office of Unemployment Comp. & Placement*, 326 U.S. 310 (1945)).

Conflict Transactions and Entire Fairness

The entire fairness standard of review applies in three general circumstances:

- **Conflicted-board transactions.** If a majority of the directors who approved the transaction were not disinterested and independent. See Conflicted-Board Transactions: Director Disinterest and Independence for further discussion.
- **Controlling-stockholder transactions.** When a controlling stockholder has a conflict. For example, when a controlling stockholder:
  - stands on both sides of the transaction (*In re KKR Fin. Hldgs. LLC S'holder Litig.*, 101 A.3d 980, 990 (Del. Ch. 2014), *aff'd sub nom. Corwin v. KKR Fin. Hlds. LLC,* 125 A.3d 304 (Del. 2015) (citing *Williamson v. Cox Commc'ns Inc.*, 2006 WL 1586375, at *4 (Del. Ch. June 5, 2006))); or
  - receives different consideration from the other stockholders or a unique benefit (*In re Crimson Exploration Inc. S'holder Litig.*, 2014 WL 5449419, at *12 (Del. Ch. Oct. 24, 2014)).

  See Conflicted Controlling-Stockholder Transactions for further discussion.
- **Fraud on the board**. If a self-interested fiduciary (such as a director or officer) manipulates or withholds material information from the board, and this causes the board to act or not act in an outcome-determinative way. See Fraud on the Board for further discussion.

The Delaware courts have traditionally applied the entire fairness review to conflicted-board transactions and controlling-stockholder transactions. The Delaware courts' application of the entire fairness standard of review when there is fraud on the board is not a new concept, but it has recently become a focus area.

Entire Fairness Standard of Review

When the entire fairness review applies the defendant directors must establish both:

- **Fair dealing.** This evaluates how the transaction was timed, initiated, structured, negotiated, disclosed by management to the directors, and approved by the board and stockholders.

- **Fair price.** This evaluates the economic and financial considerations, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic value of the stock.

(*Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).)

Although demonstrating entire fairness is an onerous burden, for a discussion of a case where the Delaware Chancery Court found that a transaction satisfied entire fairness despite process flaws, see Practice Note, Fiduciary Duties in M&A Transactions: Entire Fairness Standard of Review.

Even if a transaction passes an entire fairness review, if the board's actions interfere with corporate democracy or disenfranchise the stockholders, the Delaware courts may require an additional review (see Interference with Stockholder Vote).

Unitary Conclusion on Process and Price

The distinction between price and process is "not always neatly distinguishable" (*Hamilton Partners, L.P. v. Highland Cap. Mgmt., L.P.*, 2016 WL 612233, at *5 (Del. Ch. Feb. 2, 2016)). The inquiry is not bifurcated. The court conducting an entire fairness review examines the transaction for both procedural and substantive fairness and reaches a "unitary conclusion" (*In re Nine Systems Corp.*, 2014 WL 4383127, at *47 (Del. Ch. Sept. 4, 2014), *aff'd sub nom*, *Fuchs v. Wren Holdings, LLC*, 129 A.3d 882 (Del. 2015) (Table)). Usually, a fair process results in a fair price, and evidence of fair dealing can help convince the court that the board obtained a fair price (*Americas Mining Corp. v. Theriault*, 51 A.3d 1213, 1244 (Del. 2012)). However, this is not always the case.

For example, in one decision, the Delaware Chancery Court concluded that a merger satisfied entire fairness in spite of an unfair process that led to it. The court held that the directors were personally interested in the transaction and that the board had wrongfully considered only the interests of the preferred stock, to the exclusion of the interests of the common stockholders. However, the court deemed the deal fair based on price, because the value of the common stock in the company as a going concern would have been worthless. (*In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 78 (Del. Ch. 2013) (*Trados II*).)

By contrast, in *Nine Systems*, the Delaware Chancery Court held that a recapitalization transaction whose price was fair to the common stockholders still failed entire fairness review because of an unfair process. To rationalize the apparent conflict with *Trados II*, the court distinguished recapitalizations, in which the company's stockholders remain on as stockholders in the company, from third-party mergers, where price might be the more critical element. (*In re Nine Systems*, 2014 WL 4383127, at *46.)

Liability for Failing to Satisfy Entire Fairness Review

Directors are not automatically liable if entire fairness is not met. Courts analyze each director's conduct to determine if they breached the duty of care or loyalty. (*Firefighters' Pension Sys. of City of Kansas City, Mo. Tr. v. Presidio*, 251 A.3d 212, 250-51 (Del. Ch. Jan. 29, 2021). Directors have a defense against liability for breach of the duty of care if the corporation's charter contains an exculpation clause under Section 102(b)(7) of the DGCL (see Exculpation from Liability). Alternatively, the directors may be able to claim that in spite of a failure to satisfy the price prong of entire fairness review, the directors themselves justifiably relied on their advisors, as authorized by Section 141(e) of the DGCL.

Breaches of the duty of loyalty, however, cannot be exculpated. If a transaction subject to the entire-fairness review has been found unfair and the corporation has an exculpatory provision, the directors can still be found liable in three primary ways:

- **Self-interest.** A director may be liable and cannot have a claim dismissed at the pleading stage under an exculpatory provision if the director harbored self-interest adverse to the stockholders' interests (see Director Disinterest).

- **Lack of independence.** A director may be liable and cannot have a claim dismissed at the pleading stage under an exculpatory provision if the director acted to advance the self-interest of the interested party from whom the director is not independent**.** This is a two-part test. Lack of independence alone is not sufficient. The director must also have taken steps to further the conflicted party's interest. Therefore, a director can have their claim dismissed under an exculpatory provision if the director either:

  - is independent from the conflicted party; or

  - did not act to advance the conflicted party's self-interest.

  (*In re BGC Partners, Inc. Deriv. Litig.*, 2021 WL 4271788, at *10 (Del. Ch. Sept. 20, 2021).)

  For a discussion on determining director independence, see Director Independence.

- **Bad faith**. Directors that are disinterested and independent can be held liable only if they are found to have approved the transaction in bad faith. This finding requires an inquiry into each director's state of mind (see Breach Committed in Bad Faith). Furthermore, if facts are not pled supporting a reasonable inference of bad faith, the disinterested and independent directors can win dismissal of the complaints against them at the pleading stage without having to remain as a defendant until the ultimate conclusion of the litigation.

(*Cornerstone*, 115 A.3d 1173, at 1179-81.)

Conflicted-Board Transactions: Director Disinterest and Independence

If a majority of the directors approving a transaction are not disinterested and independent, the decisions of the board are reviewed for their entire fairness. If a majority of the directors approving a transaction are disinterested and independent, the board remains entitled to the presumptions of the business judgment rule, unless the business judgment rule is otherwise rebutted (see Rebutting the Business Judgment Rule).

To determine whether a majority of directors approving the transactions are disinterested and independent, the court conducts a director-by-director analysis. (*Trados II*, 73 A.3d at 43-45).

Director Disinterest

Under Delaware law, the test for finding a disabling interest on the part of a director is met if either:

- The director has a material financial interest in a transaction (a material personal benefit that is not shared equally by the stockholders).
- A corporate decision has a detrimental impact that applies solely to the director, not the corporation or other stockholders (such as a substantial likelihood of director liability).

  (*Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993); *Orman v. Cullman,* 794 A.2d 5, 23 (Del. Ch. 2002).)

- The transaction involves any self-dealing on the part of the director, in which case no materiality standard applies. Director self-dealing is traditionally a situation where the director is on both sides of a transaction (for example, payment of compensation to themselves). (*Cambridge Ret. Sys. v. Bosnjak*, 2014 WL 2930869, at *4 (Del. Ch. June 26, 2014).)

The materiality of a financial benefit to a director is determined in the context of the director's personal financial circumstances. The benefit must make it improbable that the director could perform their fiduciary duties without being influenced by their overriding personal interest (*N.J. Carpenters Pension Fund v. infoGROUP, Inc.*, 2011 WL 4825888, at *9 (Del. Ch. Sept. 30, 2011)).

For there to be a disabling interest, the benefit must cause the director's personal interest to diverge from the stockholders' interests at large. The fact that a director owns shares in a company being sold and would stand to gain from the sale does not itself represent a disabling interest, absent a a compelling or idiosyncratic need for liquidity (*Crimson Exploration*, 2014 WL 5449419, at *19-20).

A disabling interest may also be present if a director is a dual fiduciary, owing fiduciary duties to more than one entity, and the interest of the beneficiaries diverge (*Trados II*, 73 A.3d at 46-47) (referencing *Weinberger*, 457 A.2d 701 at 710)). In the context of a *Revlon* review involving a director that was a dual fiduciary of both the target company that was sold and a hedge fund that owned stock in the company, the Chancery Court acknowledged that the activist director had a disabling conflict because the plaintiff pled that the director acted according to a known playbook that implemented a short-term investment strategy (*Goldstein v. Denner,* 2022 WL 1671006, at *32 (Del. Ch. May 26, 2022) (*Goldstein I*).)

The Delaware courts have found that certain factors, standing alone, do not automatically render directors conflicted, such as:

- The mere threat of a proxy contest.
- The possibility of change-in-control benefits from a pre-existing agreement. However, this has recently been questioned (*Goldstein I*, 2022 WL 1671006, at *43; see the following paragraph for further discussion).
- Appointment to directorship by stockholders.
- Interest in post-closing employment with a potential acquiror where no employment discussions take place.

(See *Rudd v. Brown,* 2020 WL 5494526, at *7-12 (Del. Ch. Sept. 11, 2020).)

Though several Delaware cases have stated that change-of-control benefits from pre-existing agreements do not create a conflict of interest as a matter of law, this is an open question. In *Goldstein I*, the Chancery Court held that those cases went too far, and reasoned that a director may be conflicted based on severance payments or change-of-control benefits the director is eligible to receive from a transaction, even if the benefits are pursuant to a pre-existing agreement and are not triggered by the specific transaction. In *Goldstein I*, the court relied on the fact that the severance payments were equal to several years of the director's annual salary in finding a disabling conflict. (*Goldstein I*, 2022 WL 1671006, at *43).

Directors, however, are considered to be conflicted when the board decision concerns the director's own compensation (*Cambridge Ret. Sys.*, 2014 WL 2930869, at *3).

Director Independence

Director independence means a director's decision is based the corporate merits of the transaction or issues before the board, and not on outside influences or considerations. Under Delaware law, there is a rebuttable presumption of director independence. A director is presumed to be independent even when appointed by a controlling stockholder or other allegedly interested party. (*Aronson*, 473 A.2d at 816.)

To successfully challenge a director's independence, plaintiffs must show that the director is so beholden to the controller or so under its influence that "the director's discretion would be sterilized" (*Rales*, 634 A.2d at 936). Bare allegations that a director is friendly with or has had past business relationships with the controller who is a proponent of the transaction are not enough to rebut the presumption of independence (*Kahn v. M & F Worldwide Corp.*, 88 A.3d 635, 649 (Del. 2014) *overruled on other grounds by Flood v. Synutra Int'l, Inc.,* 195 A.3d 754 (Del. 2018) (*MFW*)). The mere fact of compensation from the corporation is also not enough (*In re The Limited, Inc. S'holders Litig.*, 2002 WL 537692, at *5 (Del. Ch. Mar. 27, 2002)). Rather, the director's ties to the controller must be sufficiently substantial, from a subjective point of view, that the director could not have objectively evaluated the transaction (see *MFW*, 88 A.3d at 648-49 (Del. 2014)).

Determining whether a director is independent is often a fact-specific inquiry. For example, in various contexts, the Delaware Court of Chancery has held that:

- A director was independent from the CEO of the corporation even though the director maintained a 15-year long professional and personal relationship with the CEO (*Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 981 (Del. Ch. 2000)).
- Where a director had served on the boards of two other companies owned by a venture capital firm with a financial interest in the challenged transaction and served as a high ranking executive in other companies owned by that firm, there was a reasonable doubt regarding the director's independence (*Goldman v. Pogo.com, Inc.*, 2002 WL 1358760, at *3 (Del. Ch. Jun. 14, 2002)).
- The members of a **compensation committee** were independent even though they had been appointed by the controlling stockholder, had served on the board for many years, served on the boards of other entities controlled by the stockholder, and were otherwise retired (*Friedman v. Dolan*, 2015 WL 4040806, *6-7 (Del. Ch. Jun. 30, 2015)).
- Back-channel communications between a director and the controller regarding a proposed recapitalization transaction during the transaction negotiations between the board's special committee and the controller, were a factor in finding that the director lacked independence from the controller for demand futility purposes. However, for another director, the court found that a shared interest in philanthropy and a shared belief in the benefits of founder control were insufficient to support a finding of non-independence. The court also held that for another director, the mere allegation that a director affiliated with a venture capital firm may rely on the controller for "deal flow," without

additional allegations, was insufficient to rebut the presumption of independence. (*United Food and Com. Workers Union v. Zuckerberg*, 250 A.3d 862, 893-96 (Del. Ch. 2020) *aff'd*, 262 A.3d 1034 (Del. 2021).)

- In denying a motion to dismiss, the Delaware Chancery Court found it was reasonably conceivable that the directors were not independent of the controller, in part because the controller had a history of removing directors who were disloyal to the controller. The court asserted that it could infer that a stockholder's willingness to take retributive action affects a director's independence, regardless of how material the directorship was to the director, when coupled with other facts. The court also considered that the directors were of a "controlled mindset" because the controlling stockholder dominated the board committee and how the board committee negotiated the transaction. (*In re Viacom Inc. S'holders Litig.*, 2020 WL 7711128, *21-25 (Del. Ch. Dec. 29, 2020, corrected Dec. 30, 2020).)

- In reviewing the independence of members of a special committee in an *MFW* analysis, a director who served as a director or employee of the controller or its affiliates for over 20 years, who relied on the controller for his primary employment, and who made at least $58 million from his work with the controller and its affiliates, was not independent (*In re Match Grp., Inc. Derivative Litig.*, 2022 WL. 3970159, at *19-20 (Del. Ch. Sept. 1, 2022))

The Delaware Supreme Court has cautioned that a director's personal and business ties to an interested party cannot be analyzed separately from each other, but must be considered in their totality. The *Sanchez* court also held that a long-term friendship supports a greater inference of compromise of independence than do "thin, social-circle friendships." As a result, the *Sanchez* court held, for purposes of demand futility, that a director deriving primary employment and income from the company and having a close friendship of more than 50 years with the company's chairman and largest stockholder was not independent. (*Delaware Cty. Emps. Ret. Fund v. Sanchez*, 124 A.3d 1017, 1021-1022 (Del. 2015).)

In a similar vein, in reviewing demand futility, the Delaware Supreme Court ruled that a network of business relationships and venture capital investments between two directors and the company's controlling stockholder and co-ownership of an airplane between the controlling stockholder and another director, raised a reasonable doubt as to those directors' impartiality (*Sandys v. Pincus*, 152 A.3d 124, 129-134 (Del. 2016) (*Zynga*)).

In a series of cases over several years, the Delaware Chancery Court considered the independence of directors in *In re BGC Partners, Inc., Derivative Litigation* both for purposes of demand futility and dismissal under a Section 102(b)(7) exculpatory provision. Most recently, the court held that one director was not independent for demand futility purposes because his gratefulness for the directorship, which allowed him to support his family and pursue his passions, would likely impair his ability to consider a litigation demand against the controller who appointed him. (*In re BGC Partners, Inc. Derivative Litig.*, 2022 WL 3581641, at *15-16 (Del. Ch. Aug. 19, 2022).)

Although the *Sanchez, Zynga*, *BGC* and other recent decisions may signal a greater willingness on the part of Delaware courts to question a director's independence, at least in the context of demand futility, the Delaware Supreme Court has confirmed there is still a strong presumption of director independence.

The Court explained that to overcome this presumption, the plaintiff must plead facts showing that the director's relationship to the interested party is of a "bias-producing nature" showing either a personal or financial connection or that the directorship was of substantial material importance to the director. In *McElrath*, the plaintiff argued that the interested party, Uber's ex-CEO, could nominate and remove the director, and suggested the director might be loyal to him because the director was appointed during a power struggle. The Delaware Supreme Court found that in a demand futility context, without more this was not enough to show a bias-producing nature because the plaintiff did not present any facts to show a personal or financial connection or that the directorship was of substantial material importance to the director. (224 A.3d 982, 995-96 (Del. 2020).)

While Delaware courts have often considered how the receipt of past benefits influence a director's independence because the director may feel a sense of owingness to the person who granted the benefits, the Chancery Court has also discussed the possibility that the prospect of future directorships and financial rewards could render a director not independent.

In deciding dismissal under a Section 102(b)(7) exculpatory provision, the court in *Goldstein I* held there was a reasonable inference a director was not independent from an activist investor who had responsibility for naming directors to the board, where the transaction terms were questionable, it was the investor's practice to reward supportive directors with lucrative directorships, the director had previously supported a similar transaction coordinated by the activist investor and financially benefitted from it, and shortly thereafter was appointed by the investor to the board. The court also found it was reasonably conceivable that another director was not independent, who was unemployed before being put on the board by the investor and then was later placed on another of the investor's boards resulting in a financial gain. Although the court noted these were both close calls, this may indicate a willingness of the courts to consider questioning the independence of directors placed on board by activist investors or other repeat players (such venture capital and private equity firms) with a pattern of rewarding directors that support their transactions. (*Goldstein I,* 2022 WL 1671006, at *46-50.)

These cases do not necessarily demonstrate shifting positions of the Delaware courts, but may be a reflection that any case can only be determined on its own specific facts, taking into account the specific context for which independence is being considered.

The context in which the court evaluates independence may affect the analysis. For example, independence can be reviewed to determine whether a director is independent for purposes of either:

- Evaluating a transaction.
- Considering a pre-suit demand in the context of demand futility. For an explanation of demand futility and for further discussion of decisions from the Delaware judiciary on director independence in the context of demand futility, see Practice Note, Shareholder Derivative Litigation: When Demand Requirement Is Excused.

Some Delaware cases have suggested that it may be easier for a plaintiff to successfully dispute a director's independence in the demand futility context than in the context of voting on a transaction because directors are naturally reluctant to sue fellow directors. (*Sciabacucchi v. Liberty Broadband Corp.*, 2022 WL 1301859, at *13- *15 (Del. Chan. May 2, 2022).) Hence, a court may find a director is independent for purposes of approving a transaction but not for demand futility. For example, in *BGC Partners*, the Chancery Court found a director was not independent for demand futility because the personal importance of the directorship to the director could have clouded his consideration of a litigation demand against the person who appointed him. However, in evaluating the independence of a special committee during an entire fairness analysis the court found no evidence that the same director was not acting independently when negotiating against the controller. (*BGC Partners,* 2022 WL 3581641, at *20-*21).)

An exception to the presumption of director independence is special litigation committees. Directors on special litigation committees do not enjoy a presumption of independence but have the burden of establishing their independence. For a discussion of special litigation committees, see Practice Note, Special Litigation Committees in Shareholder Derivative Litigation.

Ratification for a Conflict of Interest

Although entire fairness presumptively applies to review of transactions in which half the directors are not disinterested and independent, the business judgment rule can be restored if the stockholders ratify the action taken by the board.

A common scenario in which stockholder ratification arises is in the context of equity incentive awards to directors, because directors are considered to be interested in their own compensation, with no materiality standard (see Director Disinterest). The Delaware Supreme Court has recognized three scenarios that involve the ratification defense in connection with stockholder-approved equity incentive plans and awards made under those plans:

- When the stockholders approve the specific director awards.
- When the plan is "self-executing," meaning that the directors have no discretion when making the awards.
- When the directors exercise discretion and determine the amount and terms of the awards after stockholder approval.

(*In re Investors Bancorp*, *Inc. S'holder Litig.*, 177 A.3d 1208, 1222 (Del. 2017).)

The first two scenarios, in the court's words, "present no real problems" (*Investors Bancorp*, 177 A.3d at 1222). But in the third scenario, the ratification defense cannot be used to extinguish the entire fairness standard of review when a breach of fiduciary duty has been properly alleged, despite the incentive plan's limits. The board must still exercise its authority equitably, consistent with its fiduciary duties.

Controlling-Stockholder Transactions

A transaction does not trigger entire fairness review just because the company has a controlling stockholder. The controller must engage in a conflicted transaction. (*In re Crimson Exploration*, 2014 WL 5449419, at *12.)

Conflicted Controlling-Stockholder Transactions

The application of the entire fairness review typically arises in transactions where the controller is conflicted because the controller either:

- **Stands on both sides of the transaction.** The transaction is with the company's controlling stockholder, even if a majority of the directors are disinterested and independent (*Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994)). The entire-fairness review applies if there is a conflicted controlling-stockholder transaction, even if there is no proof of actual coercion by the controlling stockholder, because the transaction is presumed to be inherently coercive under Delaware law (*In re Tesla Motors, Inc. S'holder Litigation*, 2020 WL 553902, at *4-7 (Del. Ch. Feb. 4, 2020)). However, in *Viacom*, the Chancery Court discussed in dicta whether it is settled law that the mere presence of a controller on both sides of a transaction is enough to trigger the entire fairness review. Although the court discussed the arguments presented by both sides for whether the presence of a controller alone is sufficient to require the application of the entire fairness test, the court ultimately held that it did not have to decide this issue as a matter of law because the plaintiffs had sufficiently pled facts indicating that the controller received a non-ratable benefit. (*Viacom,* 2020 WL 7711128, at *12-15).)

- **Competes with the other stockholders for consideration.** This occurs when the controller receives a non-ratable benefit because it receives different consideration or a unique benefit not shared with the other stockholders (*Crimson Exploration*, 2014 WL 5449419, at *12). For examples of non-ratable benefits, see Non-Ratable Benefits.

Even in a transaction in which the controlling stockholder's interests conflicted with the minority stockholders', the plaintiff must allege that the controller used their power in an unfair manner for there to be a breach of fiduciary duty (*In re Molycorp., Inc. S'holder Deriv. Litig.*, 2015 WL 3454925, at *7 (Del. Ch. May 27, 2015)). A transaction between a controlling stockholder and the company is not *per se* invalid under Delaware law. A controller transaction is perfectly acceptable if it satisfies entire fairness (*Monroe Cnty. Emp. Ret. Sys. v. Carlson*, 2010 WL 2376890, at *2 (Del. Ch. June 7, 2010)).

For a discussion of whether the entire fairness review applies to non-transformative transactions in which the controlling stockholder receives a non-ratable benefit (such as executive compensation), see Non-Transformative Controlling-Stockholder Transactions.

Non-Conflicted Controlling-Stockholder Sale Transactions

It is presently not clear which standard of review applies in a sale of control transaction if the target company has a non-conflicted controlling stockholder (when the controller is not the buyer, receives the same consideration as the other stockholders, does not receive any other side benefits, and its interests do not otherwise diverge from the other stockholders). One line of cases, the *Synthes* safe harbor line, seems to indicate that the business judgment rule is the applicable standard of review for non-conflicted controlling stockholder sale of control transactions (*In re Synthes, Inc. S'holder Litig.*, 50 A.3d 1022, 1033 (Del. Ch. 2012); *In re Morton's Rest. Grp. Inc. S'holders Litig.*, 74 A.3d 656, 666 n. 53 (Del. Ch. 2013)). A recent case seems to indicate that enhanced scrutiny under *Revlon* is the proper standard of review (unless *Corwin* cleansing applies; see Practice Note, Fiduciary Duties in M&A Transactions: Restoring the Business Judgment Rule with a Stockholder Vote: Corwin and its Progeny) (see *Presidio*, 251 A.3d 212, at 265-67). Therefore, until the Delaware Supreme Court decides this issue it may remain an open question.

For a more detailed discussion of this issue, see Practice Note, Fiduciary Duties in M&A Transactions: Non-Conflicted Controlling-Stockholder Transactions (Controller Is Not the Buyer and No Differential Consideration).

Non-Ratable Benefits

Non-ratable benefits that can create a conflict of interest arise in a variety of scenarios, including when the controller receives:

- Greater monetary consideration than the other stockholders.
- A different form of consideration than the other stockholders.
- A unique benefit that is uniquely valuable to the controller.

(*Flannery v. Genomic Health, Inc.*, 2021 WL 3615540, at *17 (Del. Ch. Aug. 16, 2021)).

For example, the Delaware Chancery Court applied the entire fairness standard after it concluded that a company's decisions to accumulate cash conferred a non-ratable benefit on a controlling stockholder, where the controlling stockholder had a preferred stock redemption that required the company to have cash available for the redemption (*Frederick Hsu Living Trust v. Oak Hill Cap. Partners III, L.P.,* 2020 WL 2111476, at *33 (Del. Ch. May 4, 2020)).

The non-ratable benefit does not need to be extracted from the minority stockholders for entire fairness to apply (for example, tax benefits that the controller received but that were never available to, and therefore were not taken from, the minority stockholders). Entire fairness "presumptively applies *whenever* a controller extracts a non-ratable or unique benefit" (emphasis in the original) (*In re Tilray, Inc. Reorganization Litig.*, 2021 WL 2199123, at *13-14 (Del. Ch. June 1, 2021)).

Even if all stockholders receive the same basic consideration, a non-ratable benefit can arise if:

- The controller eliminates something bad for it and good for the other stockholders. For example, the elimination of derivative claims can be a non-ratable benefit.
- All parties suffer a reduced price, but the controller receives cash needed to solve an idiosyncratic liquidity issue. For example, the Chancery Court has inferred a unique benefit to a controller, based among other factors, on the timing of a sale where a private equity fund stockholder was under pressure to sell the company quickly so it could close its fund (*Manti Holdings, LLC v. Carlyle Grp. Inc.*, 2022 WL 1815759, at *9 (Del. Ch. June 3, 2022)).
- The controller perpetuates its control. For example, in litigation involving the Viacom and CBS merger, the Delaware Chancery Court found that the entire fairness review should apply because it was reasonably conceivable that the controlling stockholder of Viacom received a unique benefit at the expense of the minority stockholders where the plaintiff alleged that the controlling stockholder of both companies used the merger in question to consolidate control of the two companies and install management and directors loyal to it to lead ViacomCBS, ensuring the controller could retain and expand its control position. The controlling stockholder held around 80% of the voting power, but only around 10% of the economic value of the companies and Viacom made a significant price concession in exchange for the controller's governance demands for the combined company. (*In re Viacom,* 2020 WL 7711128, at *16-18.)

Defining Control for Entire Fairness

The threshold issue in the court's review of the board's conduct in controlling-stockholder transactions is whether the controller was in fact a controlling stockholder. Delaware law defines a controlling stockholder as a stockholder who either:

- Owns 50% or more of the voting power of the corporation.
- Exercises control over the business and affairs of the corporation.

(*Kahn*, 638 A.2d at 1113-14.)

A person can have voting power in a corporation even if they do not own the stock that the voting power relates to. For example, in *Blue v. Fireman,* a proxy that gave an entity the ability to exercise a majority of a corporation's voting power was sufficient to establish controller-status, even though the entity did not own the stock associated with the proxy (2022 WL 593899, at *16 (Del. Ch. Feb. 28, 2022).)

In addition to determining whether a stockholder is a controlling stockholder for purposes of triggering the entire fairness review, a determination that a stockholder is a controlling stockholder is also relevant to determining whether:

- That controlling stockholder owes fiduciary duties to the minority stockholders (see Who Owes Duties to Whom).
- *Corwin* can be used to restore the business judgment rule with a fully informed, uncoerced voted of a majority of the disinterested stockholders. *Corwin* cannot cleanse a transaction that has a conflicted controlling-stockholder (*Larkin v. Shaw,* 2016 WL 4485447, at *13 (Del. Ch. Aug. 25, 2016). For more information, see Practice Note, Fiduciary Duties in M&A Transactions: Restoring the Business Judgment Rule with a Stockholder Vote: Corwin and its Progeny and Corwin Cleansing.

Control by Minority Stockholders

Based on the control test, a stockholder can be a controlling stockholder and owe fiduciary duties to the other stockholders even if it owns only a minority of the company's shares. However, a minority stockholder is not considered a controlling stockholder unless it "exercises control over the business affairs of the corporation" (*KKR Fin. Holdings,* 101 A.3d 980 at 991).

To plead that a minority stockholder exercises actual control, a plaintiff must show facts that support that the stockholder has "such formidable voting and managerial power" that, as a practical matter, it is no differently situated than if it had majority voting control. The Delaware Chancery Court reaffirmed this standard in *In re Essendant, Inc. Stockholder Litigation*, explaining that the court must be able to conclude that the minority stockholder's position was "so potent that the independent directors [could not] freely exercise their judgment." In this case, the court found none of the markers of control, and noted it would have been difficult for the minority stockholder to achieve these markers of control when two other entities had larger voting blocks. (2019 WL 7290944, at *8-9 (Del. Ch. December 30, 2019).) For a discussion of some of the markers of control, see Markers of Control for Minority Stockholders.

The question of whether a stockholder should be deemed controlling can only be answered on the facts of the particular case. For example, in different cases:

- A 27.7% stockholder with two representatives on a board with ten members was not considered a controlling stockholder (*Morton's Rest. Grp.*, 74 A.3d at 661).
- A 49.7% stockholder with two representatives on a board with nine members was not considered a controlling stockholder (*Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987)).
- A 43.3% stockholder with five representatives on a board with 11 members was considered a controlling stockholder (*Kahn*, 638 A.2d at 1114).

In *Crimson Exploration*, the Delaware Chancery Court surveyed several previous decisions that had addressed the definition of control and concluded that there is no "linear, sliding-scale approach whereby a larger share percentage makes it substantially more likely that the court will find the stockholder was a controlling stockholder" (*Crimson Exploration,* 2014 WL 5449419, at *10).

Rather, the test for control is whether the stockholder exercised actual control over the board, not just management (see *In re Sanchez Energy Deriv. Litig.*, 2014 WL 6673895, at *8 (Del. Ch. Nov. 25, 2014), *rev'd on other grounds by Delaware Cnty.*

Emps. Ret. Fund, 124 A.3d at 1024); *KKR Fin. Holdings,* 101 A.3d at 995). A minority stockholder is deemed a controlling stockholder if they either:

- Controlled the corporation, its board, or the transaction deciding committee by dominating the board's "corporate decision-making process" while it considered the transaction.
- Controlled a majority of the board generally. A board's awareness of the minority stockholder's ability to make board changes or take other coercive actions if they are displeased with the board or its decisions is evidence of general board control.

(*In re GGP, Inc. S'holder Litig.*, 2021 WL 2102326, at *13 (Del. Ch. May 25, 2021), *aff'd in part and rev'd in part and remanded on other grounds*, 2022 WL 2815820 (Del. July 19, 2022).)

The exercise of "day-to-day managerial supremacy" has also led to a finding of general control (see *In re GGP*, 2021 WL 2102326, at *23 (noting *In re Cysive, Inc. S'holder Litig.* (836 A.2d 531, 552 (Del. Ch. 2003)), as an aggressive example of Delaware controller jurisprudence, where managerial supremacy along with other factors led to a finding of control in that case)).

For more detailed examples of cases where minority stockholder were controllers, see Examples of Minority Stockholders as Controlling Stockholders.

Markers of Control for Minority Stockholders

Minority stockholders ordinarily are not considered controllers, but certain factors weigh in favor of a finding of control, including:

- Board member nominations.
- Outsized influence by the stockholder.
- Past actions indicating exertion of control.
- Acknowledgments by the company in its SEC filings of the stockholder's influence.
- Whether the board took steps to neutralize the stockholder's control.
- Personal relationships with board members.
- Commercial relationships with the corporation that would give it leverage (such as status as a key customer or supplier).
- Threats of removal, challenges, or retaliation against board members.

- Coercive contractual rights. For example, the Delaware Chancery Court has suggested that a stockholder's separate contractual rights, when combined with significant stock holdings, can support a finding that a particular stockholder is controlling, especially if the contractual right is used to induce the board to take, or refrain from taking, certain actions (*Superior Vision Servs. Inc. v. ReliaStar Life Ins. Co.*, 2006 WL 2521426, at *5 (Del. Ch. Aug. 25, 2006)).

Indications of a stockholder's general control over the board include, but are not limited to, the ability to:

- Elect directors.
- Amend the certificate of incorporation.
- Take other transformative actions (such as, break-up the corporation, merge the corporation, cash-out the public stockholders, or sell all or substantially all of the corporation's assets).
- Materially alter the nature of the corporation and the public stockholders' interests.

(*In re GGP*, 2021 WL 2102326, at *20.)

Examples of Minority Stockholders as Controlling Stockholders

Examples of situations where Delaware courts have found that at the pleading stage it was reasonably inferred that a minority stockholder is a controlling stockholder, include:

- A 39% stockholder who was also the CEO and chairman of the board and who "used his influence on the corporation ... to his own benefit and to the detriment of the interests of the minority stockholders" (*La. Mun. Police Emp. Ret. Sys. v. Fertitta*, 2009 WL 2263406, at *7 (Del. Ch. July 28, 2009)).
- A stockholder who held 48% of a corporation's stock, 82% of its debt, and entered into short-term forbearance agreements with the corporation to time the corporation's restructuring (*Hamilton Partners L.P. v. Highland Cap. Mgmt., L.P.*, 2014 WL 1813340, at *13 (Del. Ch. May 7, 2014)).
- A 26% stockholder with significant veto rights over the company's ability to raise new debt financing or file for a voluntary bankruptcy (*Calesa Assoc., L.P. v. Am. Cap., Ltd.*, 2016 WL 770251, at *10 (Del. Ch. Feb. 29, 2016)). Notably, the *Calesa* court distinguished *Superior Vision Services* and discounted the stockholder's contractual rights in its analysis, even though those rights gave the stockholder effective control over the company's decision-making. The decisions can potentially be reconciled in light of the fact that the Calesa stockholder's 26% stake may not be significant enough even under *Superior Vision Services*.
- Elon Musk, as CEO, Chairman, and 22.1% stockholder, who was the company's "visionary" and whose own "outsized influence" over Tesla and its stockholders had been acknowledged in the company's SEC filings (*In re Tesla Motors, Inc.*, 2018 WL 1560293, at *13-19 (Del. Ch. Mar. 28, 2018)).

- Two brothers who together owned 15% of the target and who were also founders and controlling stockholders of the asset management firm that managed the target company. In finding that the brothers were controlling stockholders despite their minority ownership, the court relied on a majority of the special committee's directors' lack of independence from the brothers as proof that the brothers had dominated and controlled the negotiations and special committee's approval of the transaction. (*FrontFour Cap. Grp. LLC v. Taube*, 2019 WL 1313408 at *22-25 (Del. Ch. March 11, 2019).)

- A less than 35% stockholder because among other factors:

  - the stockholder had the ability to nominate 4 of the 12 directors (along with proportionate representation on board committees) and had longstanding ties with two other directors (who worked for, and served as directors on, other portfolio companies of the stockholder, where the income received for these positions was material to them);

  - the director CEO was hired when the stockholder was a majority owner and the compensation from his position was a bulk of his income;

  - the existence of certain blocking rights in the stockholders agreement gave the stockholder more power than a majority owner normally has; and

  - the stockholder had existing relationships with the company's advisors.

  (*Voigt v. Metcalf,* 2020 WL 614999, at *13-22 (Del. Ch. Feb. 10, 2020).)

- Minority members of a limited liability company that exercised actual control of the company when they used blocking rights to block all of the company's efforts to finance its operations, leading to the company's bankruptcy and the subsequent sale of the company to the minority members at a discounted price. Although a blocking right by itself is not enough to find control, because the company was financially struggling, the blocking rights gave the members "the unilateral power to shut [the company] down," which they used in a scheme to advance their own interests. (*Skye Mineral Inv., LLC v. DXS Cap. (US) Ltd.,* 2020 WL 881544, at *26-27 (Del. Ch. February 24, 2020).) (This case involved members of a limited liability company, and not stockholders, but the court applied the same common law fiduciary duty analysis.)

Legal Standard for a Control Group

Even if no individual stockholder owns enough shares or exerts enough control to qualify as a controlling stockholder, two or more stockholders, working in tandem, may collectively be considered a control group for purposes of the standard of review for controlling-stockholder transactions.

For a control group to exist there must be both:

- A legally significant connection between the members of the group.

- An exercise of actual control of the board by the group, either generally or regarding the transaction in question.

(*In re Pattern Energy*, 2021 WL 1812674, at *41.)

To constitute a control group, allegations of mere "parallel interests" between the stockholders are insufficient (*Cox Commc'ns*, 2006 WL 1586375, at *6). In *Sheldon v. Pinto Tech. Ventures, L.P.,* the Delaware Supreme Court adopted the "legally significant connection" standard to determine whether a control group exists. This standard requires showing the stockholders are connected in a legally significant way to work together toward a common goal. Examples of a legally significant connection include a contract or agreement, common ownership, or other arrangement. (220 A.3d 245, 251-52 (Del. 2019).)

To show that there is a legally significant connection, there must be an actual agreement, though it does not need to be a formal or written agreement. (*Garfield v. Blackrock Mortg. Ventures, LLC,* 2019 WL 7168004, at *8 (Del. Ch. Dec. 20, 2019) (citing *Sheldon*, 220 A.3d at 251-52).) The agreement should require the parties to work toward a common goal related to the transaction at issue, not merely govern the parties' relationship if it has no bearing on the transactions (see *Riskin v. Burns*, 2020 WL 7973803, at *17 (Del. Ch. Dec. 31, 2020), *cert. denied*, 2021 WL 303999 (Del. Ch. Jan. 29, 2021), and *appeal refused*, 2021 WL 640552 (Del. Feb. 18, 2021)). This is a fact-intensive inquiry that reviews both:

- Historical ties.
- Transaction-specific ties.

Examples of cases where plaintiffs have pled sufficient facts for Delaware courts to infer a control group, include:

- *In re Hansen Medical, Inc.*, where the Delaware Chancery Court found that among other factors, a long history of cooperation and coordination between the group members in their investments in multiple entities, self-description as a group in SEC public filings, and direct negotiation with the acquiring company and concurrent entry into the principal documents for the transaction in question was sufficient to infer the existence of a control group (2018 WL 3030808, at *7 (Del. Ch. Jun. 18, 2018)).
- *Garfield*, where the Delaware Chancery Court found that two stockholders' ten-year history of co-investment in the subject company, description in public offering documents as "strategic partners," and direct "collective unit" negotiation with management about a restructuring was sufficient to infer the existence of a control group (2019 WL 7168004 *9-10 (Del. Ch. Dec. 20, 2019)).

By contrast, examples of cases where Delaware courts have found that at the pleading stage there were not sufficient facts to infer a control group, include:

- *Van der Fluit v. Yates*, where the Chancery Court held that agreements executed by the stockholders did not support the existence of a control group because the agreements did not relate to the challenged transaction and the agreements were signed by all of the stockholders, not just the stockholders that were alleged to be part of the control group. Regarding the two co-founders, the court noted there were no facts pled showing they acted together or had a personal relationship or that described their working relationship. The facts pled only demonstrated the existence of a concurrence of self-interest, not a control group. (2017 WL 5953514, at *6 (Del. Ch. Nov. 30, 2017).)
- *Patel v. Duncan*, where the Chancery Court found there was no legally significant connection to establish a control group in part due to the historical ties between the venture capital defendants being weaker than in *Garfield*, where other than the co-investment in the subject company the venture capitalists were "alleged to have crossed paths

only once" in another investment. In arriving at this conclusion, the court specifically noted that "[a]llegations that 'venture capital firms in the same sector crossed paths in a few investments' are insufficient to show the 'long history of cooperation and coordination'" necessary to establish a legally significant connection constituting a control group. (2021 WL 4482157, at *12 (Del. Ch. Sept. 30, 2021) (quoting *Sheldon v. Pinto Tech. Ventures, L.P.*, 2019 WL 336985, at *9 (Del. Ch. Jan. 25, 2019), *aff'd*, 220 A.3d 245 (Del. 2019)).

Control Group That Includes a Controlling Stockholder

It is theoretically possible for a control group to include both a controlling stockholder (who on its own is a controlling stockholder) and one or more minority stockholders. The Delaware Chancery Court recently considered this issue and applied a two-part test (both parts of which must be met) for determining whether a control group exists when one of the group members on its own is a controlling stockholder:

- The "legally significant connection" standard that applies to determine whether a control group is present when there is no individual stockholder that qualifies as a controlling stockholder (see Legal Standard for a Control Group).

- The independent controlling stockholder agrees "to share ... or to impose limitations on, its own control power (such as through a voting agreement) for some perceived advantage as part of [that] legally significant relationship."

(*Gilbert v. Perlman*, 2020 WL 2062285 at *7 (Del. Ch. Apr. 29, 2020) (quoting *Almond v. Glenhill Advisors LLC*, 2018 WL 3954733, at *26 (Del. Ch. Aug. 17, 2018), *aff'd*, 224 A.3d 200 (Table) (Del. 2019)).)

As evidenced by the court's decision in *Gilbert v. Perlman*, however, pleading the second part of the test is difficult because entering into a voting agreement alone is insufficient. Instead, the plaintiff must also show that the independent controlling stockholder limited its control power with the minority stockholders as part of an exchange to obtain their necessary participation in the transaction (*Gilbert*, 2020 WL 2062285 at *8-9).

Control by Non-Stockholders

It is an open question under Delaware law whether non-stockholders that have and use soft power (non-voting power) to control the board can be controllers with fiduciary duties and that can trigger an entire fairness review. Examples of soft power include:

- Relationships with directors or key advisors.

- The exercise of contractual rights that direct the company to a particular outcome.

- Commercial relationships that provide leverage over the company (for example, a key customer or supplier).

In *Pattern Energy*, the Chancery Court suggested that the exercise of soft power by a non-stockholder may be sufficient to trigger an entire fairness review in certain cases, but declined to make a decision on control without additional facts. The Chancery Court explained that the non-stockholders in a potential control group had three sources of soft power, including long historical relationships between the non-stockholders and corporate officers, control of an entity that was an essential part of the company's supply chain, and a contractual consent right over the company's major transactions that it actively inserted into discussions regarding the transaction (*In re Pattern Energy,* 2021 WL 1812674, at *37-46.)

Controllers and Exculpation

It is unclear if exculpatory provisions benefit controlling stockholders in their role as controllers under current Delaware law. Several Chancery Court decisions have held that exculpatory provisions do not benefit the controlling stockholders themselves in their role as controllers (*In re Dole Food Co., Inc. S'holder Litig.*, 2015 WL 5052214, at *39 (Del. Ch. Aug. 27, 2015) (citing *In re Emerging Commc'ns, Inc.*, 2004 WL 1305745, at *38 (Del. Ch. May 3, 2004))). However, in *Presidio*, the Chancery Court described this as an open question that it need not decide given that it found that the controller had not breached its duty of care, after noting that in *Shandler v. DLJ Merchant Banking, Inc.*, the court had held that a controlling stockholder could not have breached its duty of care if its director representatives had been exculpated from duty of care liability (2010 WL 2929654 (Del. Ch. Oct. 1, 2014)). Therefore, until the Delaware Supreme Court decides this issue it may remain an open question (*Presidio,* 251 A.3d at 285).

A controller engaging directly or indirectly in an interested transaction is potentially liable for breach of fiduciary duty even if it participated in the transaction through intervening entities. The plaintiff does not have to make a case that the controller aided and abetted breaches committed by the directors (*In re EZcorp Inc. Consulting Agreement Deriv. Litig.*, 2016 WL 301245, at *9 (Del. Ch. Jan. 25, 2016), *reconsideration granted in part*, 2016 WL 727771 (Del. Ch. Feb. 23, 2016).)

Non-Transformative Controlling-Stockholder Transactions

The extent to which the entire fairness review is applied to non-transformative transactions in which the controlling stockholder receives a non-ratable benefit is unsettled in Delaware law. In one line of cases, the Delaware Court of Chancery has held that decisions that are not transformative, such as decisions over annual compensation to a controlling stockholder, are entitled to more deference than entire fairness, even without a full set of procedural protections (*In re Tyson Foods, Inc. Consol.*, 919 A.2d 563, 587 (Del. Ch. 2007)). The *Dolan* court held that absent concerns of an informational advantage on the part of the stockholder or concerns that the controller will exercise leverage over the other stockholders, the business judgment rule applies, even to a decision involving the controlling stockholder, if the decision was made by a body composed of a majority of independent directors (*Dolan*, 2015 WL 4040806, at *6).

In another line of cases, the Chancery Court ruled that the weight of authority demonstrates that despite *Dolan*, the entire fairness framework applies not only to squeeze-out mergers (the context in which it arises most frequently), but to any transaction in which the controller extracts a non-ratable benefit, including compensation arrangements. In contrast to *Dolan*, the *EZcorp* court stated that the approval of **either** an independent board committee or a majority of the minority stockholders was insufficient to justify the application of the deferential business judgment rule, and instead would only result in a burden shift to the plaintiff to show that the transaction was not fair. (*In re EZcorp*, 2016 WL 301245, at *11-12.)

In a more recent case, *Tornetta v. Musk*, the Chancery Court sided with the *EZcorp* line of cases, finding that the entire fairness review standard applied to decisions of executive compensation for a controlling stockholder who was also the chief executive officer. In reaching its decision, the court focused on the potential for coercive influence by an "800-pound gorilla," (Elon Musk) over directors and unaffiliated stockholders. (250 A.3d 793, 708-800 (Del. Ch. 2019).) The court also held that if the board's decision had complied with the dual procedural protections set out in *In re MFW Shareholders Litigation,* , the business judgment rule would have applied, instead of the entire fairness review (67 A.3d 496 (Del. Ch. 2013), *aff'd, Kahn v. M&F Worldwide Corp.* 88 A.3d 635 (Del. 2014)). To comply with these procedural protections, the transaction must have been conditioned up front on the approval of **both**:

- An independent, fully functioning special committee of the board.
- An uncoerced and informed vote by a majority of the minority stockholders.

Notably, these dual protections previously only applied in the context of transformational transactions, such as mergers. (*Tornetta*, 250 A.3d at 800).)

For a detailed discussion of the application of the dual procedural protections of *MFW* in transformational transactions, see Practice Note, Fiduciary Duties in M&A Transactions: Business Judgment Rule Using Procedural Protections.

Fraud on the Board

The standard of review if there has been fraud on the board is entire fairness. The application of the entire fairness standard of review when there is fraud on the board has recently become an increased focus area of the Delaware courts. The fraud on the board theory of fiduciary duty liability requires that only one director (or other corporate fiduciary) be conflicted.

A recent case, *In re Pattern Energy*, outlines the requirements to show fraud on the board at the pleading stage, which include:

- **A self-interested fiduciary.** The fiduciary (such as director or officer) committing the alleged fraud on the board must be materially interested (a material conflict) in the transaction or matter (for example, if the transaction is a merger, and the fiduciary committing the alleged fraud is trying to seek control or a benefit from the company post-merger). The court noted in dicta that fraud on the board can also be committed by an advisor.
- **An inattentive or ineffective board.** The board must be "inattentive or ineffective" and permit the manipulation.
- **Deception or manipulation of the board.** The fiduciary must deceive or manipulate the board. For example, if the fiduciary:
  - deceives the board into favoring a certain bidder; or
  - fails to disclose its conflict of interest in the transaction to the board.
- **A material misstatement or omission.** The deception must be material. An omission is material "if the undisclosed fact is relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking."
- **The effect is outcome-determinative.** It must be reasonably conceivable that the deception tainted the decisionmaking of the disinterested and independent directors and caused the board "to take action or inaction that was outcome-determinative."

(*In re Pattern Energy*, 2021 WL 1812674, at *33.)

Two of these factors involve materiality, a self-interested fiduciary (resulting from a material conflict) and a material misstatement or omission. Generally, if the conflict is material to the conflicted fiduciary, the board will view the information as material to its decisionmaking (*In re Mindbody, Inc.*, 2020 WL 5870084, at *24 (Del. Ch. Oct. 2, 2020)).

In the context of a sale of control, these factors are distinguishable from the factors that trigger enhanced scrutiny review under *Revlon* (see Sale of Control). *Revlon* enhanced scrutiny applies in situations where because of the situational dynamics potential conflicts exist as compared to entire-fairness review which applies if actual conflicts exists. Therefore, the conduct that triggers the entire fairness review must be more egregious than the conduct that triggers a *Revlon* enhanced scrutiny review. The Chancery Court explained this difference in *In re Pattern Energy*, by stating that to find fraud on the board that triggers an entire fairness review, as compared to an enhanced scrutiny review:

- The conflicted fiduciary must be more than overweening, they must be fraudulent or outright manipulative.
- The board must be more than supine, it must be deceived and allow the deception.
- The deception must affect the outcome.

The Chancery Court determined there were not sufficient facts to find fraud on the board and elevate the standard of review from enhanced scrutiny to entire fairness because there was not "outcome-determinative deception." The court explained that the belated half-truths by the officer did not appear to have an effect on the sales process and that although the board did not vigorously enforce its instructions or manage conflicts, these deficiencies did not facilitate the officer's deception. (*In re Pattern Energy*, 2021 WL 1812674, at *33-36.)

Delaware courts have, however, applied or considered an entire fairness standard of review based on fraud on the board allegations in other cases. For example:

- In *Mills Acquisition Co. v. Macmillan, Inc.*, self-interested officers did not disclose that they tipped off their favored bidder in a way that tainted and manipulated the board's process. Not only was there deception by the officers, but the board's lack of oversight of the auction process allowed the officers to engage in the misconduct. The court explained that this "illicit manipulation of the board's deliberative processes by self-interested corporate fiduciaries" triggered the entire fairness review. (559 A.2d 1261, 1279-1280 (Del. 1989).)
- In *Fort Myers Gen. Emps'. Pension Fund v. Haley*, allegations of a director's failure to disclose his post-closing compensation discussions with the other merger party to the company's board, when the director was negotiating the transaction on behalf of the company during a time of deal uncertainty, was sufficient to rebut the business judgment rule (235 A.3d 702, 719-24 (Del. 2020)).
- In *In re Mindbody,* allegations of undisclosed material conflicts by an officer to the board, along with other evidence that it was reasonably conceivable the board did not adequately oversee the officer, led the Chancery Court to note that it was an open question as to whether entire fairness, rather than *Revlon* may ultimately apply at trial (*In re Mindbody,* 2020 WL 5870084, at *23-25, n.229).

Avoiding Entire Fairness Review with Procedural Protections

In virtually all cases where entire fairness presumptively applies, the parties can structure the transaction either to shift the burden of proof of the transaction's fairness back to the plaintiff or to qualify for the presumptions of the business judgment rule.

For example, if a corporation does not have a controlling stockholder, and the board lacks an independent and disinterested majority, the board can potentially still qualify for business judgment review by empowering a committee of independent and disinterested directors to make the relevant decision (DGCL § 141(c)). If the board delegates its full power to address an issue to a board committee, then the judicial analysis focuses on the committee. A decision made by a disinterested, independent, and informed majority of the committee is protected by the business judgment rule. (*Frederick Hsu Living Trust*, 2017 WL 1437308, at *33; *Trados II,* 73 A.3d at 65 n.39.). For a more detailed discussion on how the business judgment rule may be restored in conflicted-board transactions, see Practice Note, Fiduciary Duties in M&A Transactions: Restoring the Business Judgment Rule in Conflicted-Board Transactions.

These structures are used most frequently in the context of M&A transactions between a corporation and its controlling stockholder and are discussed in depth in Practice Note, Fiduciary Duties in M&A Transactions: Lowering the Standard of Review or Burden of Proof with Procedural Protections. The use of procedural protections in the context of executive compensation for a controlling stockholder is a more recent expansion of these protections (see Non-Transformative Controlling-Stockholder Transactions).

Intermediate Standard of Review: Enhanced Scrutiny

In certain situations, the possibility of a conflict of interest triggers heightened scrutiny of the board's conduct when determining if the directors carried out their fiduciary duties. This means the business judgment rule is not available until certain standards are met, because the directors' action or inaction could potentially have a more damaging effect on the stockholders.

Defensive Measures Against Takeovers

In a successful contested takeover, management and the board of directors are frequently replaced by the hostile actor. Because of the possibility that the directors will act to save their seats on the board rather than in the best interests of the corporation, Delaware courts apply a heightened test when examining anti-takeover defensive measures (*Unocal v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985)). When implementing defensive measures, the directors must show:

- Reasonable grounds for believing a danger existed to the operation or policies of the corporation. Because the *Unocal* analysis is fact-intensive, the board of directors should ensure that there is a reasonable and good faith investigation by non-management directors (if possible) before any defensive measures are put in place.
- Defensive measures were reasonable in relation to the threat. Defenses that preclude all offers for the corporation or coerce stockholders to approve a management-sponsored bid are generally considered unreasonable in relation to a threat.

If the directors fail to prove the two elements above, they must show that the actions they took were entirely fair to the corporation (*Unitrin, Inc. v. Am. Gen. Corp.,* 651 A.2d 1361, 1377 n.18 (Del. 1995)).

For further discussion of defensive measures in the context of hostile takeovers, see Practice Notes, Defending Against Hostile Takeovers and Poison Pills: Defending Against Takeovers/Stockholder Activism and Protecting NOLs.

Interference with Stockholder Vote

Stockholders can influence the management of the corporation by:

- Electing (or withholding votes for) directors.
- Selling their shares of stock.

The right to elect directors is important because it allows stockholders to influence the management of the corporation without selling their shares. Therefore, the Delaware courts apply special standards of review, and sometimes multiple levels of review, to board actions affecting corporate elections. However, Delaware courts have struggled to define the standard of review the courts should use to evaluate this type of director action (*Coster v. UIP Cos., Inc.*, 2022 WL 1299127, *8 n.58 (Del. Ch. May 2, 2022)).

Inequitable Purposes: *Schnell*

One standard of review Delaware courts have used to evaluate director action impacting director elections is based on *Schnell v. Chris-Craft Indus., Inc*. Under *Schnell,* Delaware courts may invalidate board actions taken for inequitable purposes, even if the board's actions are legally authorized (285 A.2d 437, 440 (Del. 1971)). The Chancery Court has explored the meaning of inequitable purposes and held that in the context of stockholder-franchise challenges, *Schnell* should be applied sparingly in the limited scenario where directors have no good faith reason for approving the disenfranchising action (*Coster,* 2022 WL 1299127, at *9).

Compelling Justification: *Blasius*

In *Blasius Indus., Inc. v. Atlas Corp.*, the Delaware Chancery Court held that even if the board is acting in good faith, if the board acts with the primary purpose of interfering with the fundamental right to elect directors, the board must show it had compelling justification for doing so (564 A.2d 651, 661 (Del. Ch. 1988)). If the board can show it had a compelling justification, then the business judgment rule applies. Meeting the compelling justification standard is difficult, so courts typically apply it only when the board truly acts with the primary purpose of disenfranchising the stockholders (see *Rosenbaum v. CytoDyn Inc.,* 2021 WL 4775140, *14 (Del. Ch. Oct. 13, 2021)). Although uncommon, Delaware courts have found circumstances where a board has a compelling justification. For example, on remand from the Delaware Supreme Court, the Chancery Court in *Coster* found that there was a compelling justification for the board to issue stock to a new stockholder to break a deadlock for the election of directors, based in part on the fact that the stock issuance:

- Both rewarded an essential employee and was part of a succession plan the original stockholders desired prior to the deadlock.
- Avoided a custodial action that would have put the company in default under key contracts.

(*Coster,* 2022 WL 1299127, at *11-14.)

Modified *Unocal* Standard

In *Mercier v. Inter-Tel, Inc.,* the Delaware Chancery Court proposed another standard for reviewing the board's postponement of a stockholder vote to get more votes for a merger that was going to be voted down. Deciding that *Blasius* was too strict a standard, the court applied a modified *Unocal* standard that required the directors to show that:

- They pursued a legitimate corporate objective motivated by a good faith concern for the stockholders' best interests and did not preclude the stockholders from their right to vote or coerce them to vote in a particular way.
- Their actions were reasonable in relation to the legitimate objective.

Although the court applied a modified *Unocal* standard, it also found that the directors had a compelling justification for their actions. (929 A.2d 786, 810-11 (Del. Ch. 2007).)

For a discussion of how the modified *Unocal* standard has been applied in the context of enforcing advance notice by-law provisions, see Board's Enforcement of Advance Notice By-Laws.

Additional Review May Be Required Even if the Action Satisfies Entire Fairness

An additional review of the board's actions may be necessary in circumstances involving stockholder disenfranchisement, particularly a stockholder's right to elect directors, even if the board's actions survive an entire fairness review. In reversing and remanding *Coster* to the Chancery Court, the Delaware Supreme Court held that even though a stock issuance to break a deadlock passed an entire fairness review, the board's actions must still be reviewed to show:

- The board did not act for inequitable purposes (based on *Schnell*).
- If the board acted in good faith but for the primary purpose of disenfranchisement, the board had a compelling justification to do so (based on *Blasius*).

(*Coster v. UIP Co., Inc.,* 255 A.3d 952 (Del. 2021) (calling this a *Schnell/Blasius* review).)

Fitting the Standards Together

It is unclear how the various standards of review work together.

The Chancery Court has suggested that *Schnell* should only apply if there is no good faith basis for approving the action and that *Blasius* should apply if there is a good faith basis for approving a disenfranchising action. However, the court acknowledged that it remains unclear whether *Blasius* and *Schnell* are two sides of a unified standard or if *Schnell* is an independent standard. (*Coster,* 2022 WL 1299127, at *8-9, n.59.)

The Delaware Supreme Court in *Coster* did not consider how a *Unocal* analysis should fit in with the *Schnell/Blasius* review (*Coster,* 255 A.3d at 963 n.66). The Delaware Chancery Court has further noted the need to bring the *Blasius* and *Unocal* standards together. (*Coster,* 2022 WL 1299127, at *8 n.58).

Board's Enforcement of Advance Notice By-Laws

Delaware courts have also applied enhanced scrutiny to review the board's enforcement of advance notice by-law provisions (provisions requiring stockholders to follow certain procedures to nominate directors for election; see Standard Clause, By-Laws (DE Public Corporation): Advance Notice). Even if stockholders do not technically comply with unambiguous advance notice by-laws that were adopted on a clear day, Delaware courts may still review the conduct to determine if the board was justified in enforcing the by-law against the stockholder or whether it should have waived compliance (*Strategic Inv. Opportunities LLC v. Lee Enter. Inc.,* 2022 WL 453607, at *14-15 (Del. Ch. Feb. 14, 2022); *CytoDyn,* 2021 WL 4775140, at *15).

In *CytoDyn*, dissident stockholders submitted their board nomination notice one day before the deadline, which the board rejected a month later claiming the notice was deficient. The Chancery Court indicated that *Blasius* could apply to advanced notice by-law disputes, but did not apply *Blasius* to the case because it found no evidence of manipulative conduct. Instead, after applying a contractual analysis to find that the notice was deficient the court reviewed the board's rejection of the nomination under *Schnell*, but found no inequitable conduct. The court focused on the fact that the dissident shareholders waited until the day before the deadline to submit the notice, leaving them no time cure a deficient notice. The court suggested that the stockholders would have had a stronger argument that the board's conduct was inequitable if they had submitted the notice well in advance of the clear deadline. (*CytoDyn*, 2021 WL 4775140, at *14-22.)

In *Lee*, the Chancery Court applied the modified *Unocal* standard used in *Mercier* to review the board's rejection of a nomination notice. The court reasoned that it could not "ignore the defensive mindset" the board was operating under when it rejected the notice because the rejected nominations were part of a hostile takeover bid. In finding that the board's actions were reasonable, the Chancery Court relied on the fact that:

- The by-laws were unambiguous and were adopted on a clear day.
- The by-law requirements were reasonable.
- There was no evidence of bad faith or manipulative or inequitable conduct by the board.
- It was the stockholder's own delay that prevented it from satisfying the requirements.

(*Lee,* 2022 WL 453607, at *15-18.)

Sale of Control

Once a change of control of the corporation becomes inevitable, both the focus of the directors' efforts and the standard of review under which the directors' conduct is judged change. The business judgment rule ceases to be available until certain hurdles are met, because the specter of a conflict of interest exists in which the directors will take action to benefit or entrench themselves at the expense of the stockholders. The burden is on the board of directors to obtain the highest value reasonably available to the stockholders ("*Revlon* duties") (*Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc.*, 506 A.2d 173, 182 (Del. 1986)). Usually the highest value is interpreted to mean the highest purchase price, but the board of directors can consider other factors such as certainty of completion in light of required financing and governmental consents.

Revlon duties attach only once the directors have initiated an active bidding process or decided to sell the company in a change-of-control transaction or if a sale of control or break-up of the company has become inevitable. The board is not subject to *Revlon* duties merely because the corporation is in play or a candidate for takeover (see *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 242 (Del. 2009)).

For detailed discussion of *Revlon* scrutiny in change-of-control transactions, including the types of transactions that trigger *Revlon*, satisfying enhanced scrutiny, liability for failure to satisfy *Revlon*, and restoring the presumptions of the business judgment rule under the *Corwin* decision, see Practice Note, Fiduciary Duties in M&A Transactions: Sale of Control.

No Enhanced Scrutiny for Dissolutions

The Delaware Chancery Court has held that a board's decision to adopt and implement a plan of **dissolution** does not trigger enhanced scrutiny under *Revlon* or *Unocal* (*Huff Energy Fund, L.P. v. Gershen*, 2016 WL 5462958, at *13 (Del. Ch. Sept. 29, 2016)). The court explained that *Revlon* applies only to final stage transactions like a sale or break-up of the company. Dissolutions, by contrast, require a three-year wind-up period during which the directors maintain their duty to act in the best interests of the corporation (see Practice Note, Dissolving a Delaware Corporation: Continuation of Corporation after Dissolution).

The court also rejected the argument that the dissolution constituted an unreasonable **poison pill** under *Unocal* since it would prevent the plaintiff stockholder from buying any more shares of the company. Given that the company must wind up its affairs following dissolution, there is not a specter of entrenchment on the part of the directors.

Subsidiary Duties

The duty of care and the duty of loyalty represent the two main fiduciary duties of the board of directors, but certain components of those duties are sometimes singled out and discussed as stand-alone duties.

Duty of Good Faith

Good faith is not a separate fiduciary duty, but is a component of the duty of care and the duty of loyalty, as follows:

- **Duty of care.** A director must use good faith when exercising the duty of care. If a plaintiff can prove that the director acted in bad faith, then the presumptions of the business judgment rule do not protect the director from liability. Similarly, directors cannot seek limitation of liability under Section 102(b)(7) of the DGCL for actions taken in bad faith. Consequently, if a corporation's charter exculpates the directors under Section 102(b)(7) for breaches of the duty of care, a plaintiff must demonstrate bad faith on the directors' part to succeed on a fiduciary duty claim.

- **Duty of loyalty.** A director acting in bad faith does not act in the best interest of the corporation. In *Stone v. Ritter*, the Delaware court said the failure to act in good faith does not automatically result in a breach of duty, but becomes a factor when determining a breach of the duty of loyalty (*Ritter*, 911 A.2d at 369-70).

Duty to Obey the Law

Directors have a duty to comply with the law. If a director knowingly breaks the law, which is evidence of bad faith, the director is denied the protection of the business judgment rule and cannot benefit from limited liability under Section 102(b)(7) of the DGCL. Breaking the law for the interest of the corporation is not an excuse. For example, directors breach their fiduciary duties when they pay bribes to foreign officials even if it results in a large profit for the corporation (*Metro Commc'n Corp., BVI v. Advanced Mobilecomm Tech., Inc.,* 854 A.2d 121, 131 (Del. Ch. 2004)).

Duty of Disclosure

Directors also hold a fiduciary duty to communicate honestly with the stockholders and to make full and fair disclosures. The duty of disclosure is a specific application of the directors' fiduciary duties of care and loyalty (*In re GGP, Inc. S'holder Litig.*, 2022 WL 2815820, at *16 (Del. July 19, 2022)). This duty, also referred to as a duty of candor, does not obligate the board to provide all of the corporation's financial or business information to the stockholders. Rather, the information must meet a materiality standard of a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable stockholder as having significantly altered the total mix of information made available (*Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985)).

Delaware law does not require the board of directors to disclose information simply because that information "might be helpful" (*Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170, 1174 (Del. 2000)). The courts have similarly admonished against "the fallacy that increasingly detailed disclosure is always material and beneficial disclosure" (*Zirn v. VLI Corp.*, 1995 WL 362616, at *4 (Del. Ch. June 12, 1995), *aff'd*, 681 A.2d 1050 (Del. 1996)). The board is also entitled to keep certain information confidential in order for the corporation to succeed (*Stroud v. Grace*, 606 A.2d 75, 89 (Del. 1992)).

The Delaware Court of Chancery has identified four recurring scenarios where the duty of disclosure may arise:

- When the board of directors seeks a statutorily required stockholder approval for an action, directors have a fiduciary duty to disclose fully and fairly all material information that the board controls. For example, a **proxy statement** for the approval of a merger would be misleading if it failed to disclose a CEO's personal financial interest in the merger (*In re Lear Corp. S'holder Litig.*, 926 A.2d 94, 114 (Del. Ch. 2007)).

- When the board of directors seeks a stockholder ratification that is not required by the DGCL of a transaction in which a director or officer has a personal interest that conflicts with the corporation's interest, directors must disclose all material facts that the board controls.

- When a director communicates publicly or directly with stockholders, with or without a request for stockholder action, the director must not speak falsely so as to misinform the stockholders. In other words, if a director discloses information, it must be truthful. The duty to disclose if the disclosure is not part of a request for stockholder action, is only breached if the director deliberately misinforms the stockholders (*In re Zimmer Biomet Hldgs., Inc.*, 2021 WL 3779155, at *12 (Del. Ch. Aug. 25, 2021)).

- When a director either directly buys or sells shares from or to an outside stockholder in a private stock sale, the director must disclose any material information that qualifies as special facts or circumstances, including knowledge of important transactions, prospective mergers and probable sales of entire assets or business. The duty to disclose in this scenario only arises if the director also deliberately misleads the stockholder about those facts.

(*In re Wayport, Inc. Litig.*, 76 A.3d 296, 314-15 (Del. Ch. 2013).)

In sales of public corporations, the SEC's rules promulgated under the **Securities Exchange Act of 1934** govern much of the disclosure that the target company is required to make. For information about these rules, see Practice Note, Proxy Statements: Public Mergers. Beyond these required disclosures, stockholder plaintiffs frequently bring *Revlon* claims alleging that the board of directors of the target company failed to disclose other material information to the stockholders in the proxy statement, such as:

- Management's projections for the company on a stand-alone basis.
- The compensation and potential conflicts of the financial advisor.
- Details of the background to the transaction and how the board reached a decision to approve a sale.

The courts measure each of these claims against the reasonable-investor standard, with the analysis turning on the specific facts of the case.

For further discussion of the requirements for disclosures to stockholders in the context of public merger transactions, see Practice Note, Fiduciary Duties in M&A Transactions: Duty of Disclosure.

Abdication of Duty of Disclosure

The Chancery Court recently issued an opinion in the *Pattern Energy* case, at the motion to dismiss phase, finding it reasonably conceivable that the board acted in bad faith by its total delegation of the preparation of a merger proxy statement to conflicted management in violation of the directors' fiduciary duty of loyalty, and that therefore, the breach could not be exculpated under DGCL § 102(b)(7).

A finding of bad faith is very rare. However, in this case, the board delegated full authority to prepare and execute the merger proxy to officers that the board knew were conflicted and did not "reserve authority to review, alter, or discuss" the proxy before it was filed. As a result the court held that it was reasonably conceivable that the board had abdicated its duty of disclosure in violation of the duty of loyalty as "[b]ad faith is reflected in the choice of agent and the complete scope of delegation." (*In re Pattern Energy*, 2021 WL 1812674, at *26, *60-61.)

Directors should take note of this decision and ensure that their board processes allow them to maintain oversight over the disclosure in any merger proxy statement or other similar material disclosures to stockholders and that the related board minutes sufficiently document their disclosure review process.

Fiduciary Duties and Director Oversight During COVID-19

The outbreak of **COVID-19** has significantly affected companies and the way they conduct business. Directors should focus intently on their fiduciary duties as they navigate the complex issues and challenges caused by the COVID-19 pandemic. The fiduciary duties of directors, and the protection of the business judgment rule, remain unchanged. However, the weakened economic environment increases the likelihood that stockholders with the benefit of hindsight, may try to bring derivative claims for breaches of fiduciary duties.

Boards should ensure they are implementing and maintaining the appropriate board-level reporting and oversight systems (see Failure of Oversight). To accomplish this, among other actions, boards should consider:

- Creating new monitoring or oversight systems to respond to issues specific to the COVID-19 pandemic or updating their existing monitoring or oversight systems to more effectively respond to the COVID-19 pandemic. Heightened areas focus will vary by business, but may include:
    - employee health and safety;
    - regulatory compliance;
    - business continuity and supply chain issues;
    - financial health; and
    - technology and cybersecurity.
- Creating and tasking a separate board committee with overseeing COVID-19 issues.
- Meeting more frequently in order to respond quickly to a rapidly evolving environment.
- Ensuring that COVID-19 matters are discussed at each meeting.
- Keeping a detailed record of COVID-19 issues discussed during board meetings.
- Maintaining a robust record of all documents related to and reviewed in connection with its monitoring and oversight systems.

