

## When Directors Breach Fiduciary Duty

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Delaware law imposes fiduciary duties on the directors of Delaware corporations requiring them to act in the best interest of the corporation and its stockholders, and they include the duties of loyalty and due care. Delaware law allows for corporate charters to include a free-from-blame provision, or an exculpatory provision in legal parlance, which shields directors from claims that they breached their duty of care. This provision, however, cannot protect directors against claims for breach of the duty of loyalty.

A Delaware Court of Chancery decision addressed how the court will review claims for the breach of duty of loyalty. The case, *Kahn v. Stern*, involved Kreisler Manufacturing Corp. Allegations were made that the board breached its duties as a result of side deals made in connection with a merger that personally and inappropriately benefited the directors. Allegations were also made that insufficient information was provided to stockholders before a majority approved the merger by written consent.

A critical determination was the court's finding that three of the five board members were considered independent and disinterested. This impacted the standard of review applied by the court. There also was an exculpatory charter provision. Therefore, in order to survive a motion to dismiss and pursue a post-closing

damages claim for breach of fiduciary duty, the plaintiff was required to plead facts making it "reasonably conceivable that a majority of the board acted in bad faith," wrote Vice Chancellor Sam Glasscock III. Bad faith will be found if a "fiduciary intentionally fails in the face of a known duty to act, demonstrating a conscious disregard for his duties."

Bad faith may also be found when "the decision under attack is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith." The allegations that board members approved the merger without knowledge of the side deals and that there were omissions and misstatements in the information provided to stockholders were insufficient to establish bad faith.

The court reasoned that the complaint did not plead facts that created a reasonable inference of bad faith because the amount of the reduction in the merger price allegedly based on the side deals was never described in detail. More important, details to negate the good faith of the independent directors who approved the merger in light of the side deals was absent from the complaint.

The court found insufficient facts to support the allegations that the board acted in bad faith, nor did it find that it was "reasonably conceivable that the board took action inexplicable on grounds

other than bad faith." Regarding the disclosure omissions and misstatements, the court noted that if the issues were presented in a pre-closing request for injunctive relief, the court would have employed enhanced scrutiny to review the disclosure allegations not to determine damages, but to appropriately afford equitable relief in aid of a stockholder pursuing statutory voting or appraisal rights.

By contrast, in this post-closing request for damages the focus was on whether the directors of the acquired entity were liable for damages based on a non-exculpated breach of fiduciary duty due to the alleged failure to make material disclosures. That would require the plaintiff to point to facts in the complaint to support an inference that the board acted in bad faith in issuing the disclosures, implicating the duty of loyalty—as opposed to a mere erroneous judgment in the failure to make a disclosure that would implicate the duty of care, which, in this instance, is exculpated by a provision in the charter.

The court explained that in a post-closing claim for damages, information deficiencies that might be found material in support of a claim for injunctive relief pre-closing may be insufficient to support a claim for damages where nothing in the record created an inference that the directors deliberately withheld information or disregarded a manifest duty.