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DELAWARE COURT OF CHANCERY LIMITS CHARTER PROVISION PURPORTING TO ALLOW INTERESTED DIRECTORS TO APPROVE SELF-DEALING TRANSACTIONS

Determines that the exculpatory provision cannot be read to eliminate the duty of loyalty

In *Sutherland v. Sutherland*,[1] Vice Chancellor Lamb recently rejected defendant directors' contention that a charter provision effectively allowed them to be considered disinterested for purposes of approving self-dealing transactions. In denying the defendants' motion to dismiss a derivative complaint alleging breach of fiduciary duty, the Vice Chancellor wrote that the charter provision, if construed in the manner urged by the defendants, "would effectively eviscerate the duty of loyalty of corporate directors as it is generally understood under Delaware law." The Vice Chancellor also noted, in contrast, that such a provision would be permissible in a limited liability company operating agreement, "where freedom of contract is the guiding and overriding principle."

Background

Dardanelle Timber Company, Inc. is a closely-held, family-owned corporation which, together with its wholly-owned subsidiary Sutherland Lumber-Southwest, Inc., operates retail lumber yards and stores. The founder's four surviving children (Perry, Todd, Martha and Dwight Jr.) each owns 25% of Dardanelle's common stock, while its voting preferred stock is held in trust for the founder's surviving spouse. In his capacity as the trustee of his mother's trust, Perry had voting control over both companies. Moreover, Perry and his twin brother Todd together effectively control the operations of the companies by constituting a majority of their three-member boards and serving as their principal officers. Their sister Martha had been the third director, but was replaced at the behest of Perry and Todd with a cousin, Mark, prior to her bringing the action described below.

[1] 2009 WL 750287 (Del Ch. March 23, 2009).

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Martha filed a derivative action in September 2006, supported by her brother Dwight Jr. [2] Her complaint alleged that defendants Perry and Todd used corporate funds for their own personal benefit (including for personal tax and accounting services, personal vacations and flights, cars, hotels, club memberships, parties and other personal living expenses), in breach of their fiduciary duties. The complaint also alleged that the directors breached their fiduciary duties by, on the day following Martha's removal as a director, approving employment agreements for Perry and Todd that provided for excessive pay and perquisites.[3]

In response, the defendant directors filed a motion to dismiss in which they argued, among other things, that an exculpatory provision in the companies' certificates of incorporation protected self-dealing transactions from attack by stockholders.[4] The Court, siding with Martha, rejected this argument and determined that her claims of breach of fiduciary duty on the part of the defendant directors could proceed.[5]

The Court's Analysis

The provision of the companies' certificates of incorporation relied upon by the defendant directors reads, in part, as follows:

> "Any director individually . . . may be a party to or may be pecuniarily or otherwise interested in any contract or transaction of the corporation, provided that the fact that he . . . is so interested shall be disclosed or shall have been known to the board of directors, or a majority thereof; and any director of the corporation, who is . . . so interested, may be counted in determining the existence of a quorum at any meeting of the board of directors of the corporation which shall authorize such contract or transaction, and may vote thereat to authorize any such contract or transaction, with like force and effect, as if he were not . . . so interested."

Generally, actions taken by directors of Delaware corporations are protected by the presumption of the business judgment rule, unless a plaintiff can rebut the presumption by producing evidence pointing to a breach of either the directors' duty of care or duty of loyalty. The *Sutherland* defendants asserted that their sister's attempt to deprive them of the protection of the business judgment rule was based solely on an alleged breach of their duty of loyalty resulting from their self-interest in approving the transactions in question. Accordingly, they argued that her complaint should be dismissed because the charter provisions effectively cleansed their self-interest. In other words, the defendants believed that "by virtue of this provision, [the] directors are by definition disinterested for the purpose of business judgment rule analysis, even with regard to transactions in which they would otherwise be thought to have an interest." To analyze this defense, the Court focused on two questions: (1) "does the [charter] provision mean what the defendants claim it means?" and, if so, (2) "is such a provision enforceable?"

[2] In an earlier ruling, the Court refused to dismiss Martha's action even though single-member Special Litigation Committees established by the companies' boards recommended that the companies *not* pursue her claims. This ruling is discussed in our Client Alert entitled "Delaware Chancery Court Looks to Documentation and Process in Determining that SLC Investigation of Derivative Action Was Not Conducted Reasonably and in Good Faith," dated June 2, 2008.
[3] The complaint also alleged that the defendants' actions resulted in corporate waste.
[4] The defendants also claimed that actions taken by the companies prior to September 6, 2003 were time-barred under the applicable statute of limitations.
[5] Although the Court noted that "statutes of limitation do not bind courts of equity with respect to purely equitable claims," the Court, in considering whether plaintiff's claims were barred by laches, analogized to the three-year statute of limitations on fiduciary duty claims in concluding that plaintiff's claims, to the extent arising out of actions occurring prior to September 6, 2003, were time-barred. That three-year period began to run at the time of the allegedly wrongful acts, but was tolled during the pendency of plaintiff's action under Section 220 of the Delaware General Corporation Law to obtain relevant books and records from the companies, and then for a "short window" thereafter during which plaintiff used the information so obtained to evaluate her potential claims.

As for the first question, the Court noted that similar charter provisions were "quite common" prior to the 1967 revision of the Delaware General Corporation Law ("DGCL"). The Court also observed that in 1952, the Delaware Supreme Court ruled in *Sterling v. Mayflower Hotel Corp.*[6] that "[s]uch a provision does no more than to permit the directors to act as a board, leaving untouched questions of alleged fairness or inequity that is the duty of the courts in a proper case to resolve." The *Sutherland* Court similarly concluded that "the provision at issue simply deals with issues of quorum, and *does nothing to sanitize disloyal transactions*." [emphasis added] Based on this reading, although the charter provisions were effective to remove the disability of interested directors for purposes of allowing them to participate in a quorum to vote on an interested transaction, the provisions did not go so far as to transform interested directors into disinterested ones.

Although the Court's answer to the first question made it unnecessary to turn to the second, the Court nevertheless addressed whether such a charter provision would be enforceable under Delaware law if it performed the function claimed by the defendants, and bluntly stated: "It would not." Otherwise, "all interested transactions would be immunized from entire fairness analysis," thereby "effectively eviscerat[ing] the duty of loyalty for corporate directors." The Court also noted that such a charter provision, if so interpreted, would stand in stark contrast to DGCL §102(b)(7) which, while allowing a corporate charter to eliminate personal liability of directors for breach of their duty of care, expressly does not permit exculpation of director liability for breach of the duty of loyalty. As a result, the effect of the Dardanelle and Sutherland Lumber charter provisions "would be to do exactly what is forbidden" by the DGCL and "would therefore be void as 'contrary to the laws of this State' and against public policy."

Finally, the Court explained that consistent with the Delaware Supreme Court's analysis in *Benihana of Tokyo, Inc. v. Benihana, Inc.*,[7] a board of directors can make use of DGCL §144[8] to retain the protection of the business judgment rule if a majority of disinterested directors approves an otherwise self-interested transaction. In *Benihana*, the plaintiff alleged that the Benihana directors breached their duty of loyalty in approving a preferred stock offering to an entity associated with Benihana's CEO. The Delaware Supreme Court found that because the board was adequately informed when it approved the transaction, and because it was approved by a majority of the disinterested directors, the safe harbor provision of DGCL §144 was invoked and subjected the transaction to review under the business judgment rule.

Conclusion

Not surprisingly, the *Sutherland* Court was not prepared to interpret the charter provisions before it in such a manner as to permit interested directors to bless self-dealing transactions. In addition to reminding corporate directors of the protections that are, and are not, afforded to them under Delaware law, the *Sutherland* decision illustrates one of the key differences between the corporate form and the limited liability company form of doing business. Although the exculpatory provisions contained in the Dardanelle and Sutherland Lumber charters were found to be inconsistent with both the DGCL and public policy, comparable provisions may properly be included in a limited liability company operating agreement under the Delaware Limited Liability Company Act, which permits the limitation or waiver of fiduciary duties of managers and directors to members. Limited liability companies, unlike corporations, are creatures of contract and Delaware courts have been hesitant to imply rights and obligations, including fiduciary duties, if the limited liability company agreement is clear on its face.[9]

[6] 93 A.2d 107 (Del. 1952).
[7] 906 A.2d 114 (Del. 2006).
[8] DGCL §144 provides a safe harbor for interested transactions if "[t]he material facts as to the director's or officer's relationship or interest and as to contract or the transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of disinterested directors . . ."
[9] For a relatively recent decision in which the Court of Chancery faced this very issue, *see* our Client Alert entitled "Delaware Chancery Court Grants Dismissal of Fiduciary Duty Claims Raised Against Members of a Limited Liability Company," dated June 2, 2008.

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