

Delaware Supreme Court: Approval of a “Flawed Transaction” After Consideration of Its Risks Does Not Give Rise to an Inference of Bad Faith

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On January 13, 2020, the Delaware Supreme Court held that a board’s approval of a “flawed transaction” that implicated the misappropriation of a competitor’s confidential information did not give rise to an inference of bad faith, where “the directors considered the risks and nonetheless proceeded with the transaction.” *McElrath v. Kalanick*, 2020 WL 131371 (Del. 2020) (Seitz, C.J.). The court underscored that “there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties.”

The court explained that because of the exculpation clause in the company’s Certificate of Incorporation, the directors could face personal liability only if “their conduct [was] motivated by an actual intent to do harm,” or if there was “an intentional dereliction of duty.” The court emphasized that “[p]leading bad faith is a difficult task and requires that a director acted inconsistent[ly] with his fiduciary duties and, most importantly, that the director *knew* he was so acting.”

Here, plaintiff alleged that the “directors heard a presentation that summarized the transaction [proposed by the CEO], reviewed the risk of litigation . . . , generally discussed due diligence, asked questions, and participated in a discussion.” While the court recognized that the CEO “might have a background that would lead a reasonable board member to dig deeper into representations he made about the transaction,” there were “no allegations that [the CEO] had a history of lying to the board.” Moreover, the court found “the record supports the conclusion that the diligence presented to the board was, in fact, ‘okay.’” The court acknowledged that it was “unusual” that the transaction indemnified the target company’s employees for certain pre-merger conduct. However, the court rejected plaintiffs’ contention that these provisions put the directors on notice that “the transaction was nothing more than a vehicle to steal [its competitor’s] proprietary information.” The court found “the reasonable inference is that the board should have done more, not that it acted in bad faith.”

The court concluded that “[t]he complaint’s allegations do not lead to a reasonable inference that the board intentionally ignored the risks of the transaction.” The court noted that the case before it was unlike *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003), where the Chancery Court found the allegations sufficient to plead bad faith because the directors allegedly “devoted very little time, had no presentations, and asked no questions” before approving the hiring of the company’s president. *McElrath*, 2020 WL 131371 (discussing *Disney*). Here, the “board met to consider the [] acquisition,” hired outside counsel and an investigative firm to conduct due diligence, listened to a presentation from the company’s CEO, and “discussed the terms of the deal and its risks.” The court determined that “the board’s failure

to investigate further cannot be characterized fairly as an intentional dereliction of its responsibilities.”

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