April 8, 2020

Delaware Court of Chancery Rejects Challenge to CEO Separation Agreement

The Delaware Court of Chancery last week dismissed a stockholder challenge to a board's decision to negotiate a separation agreement with the CEO—rather than fire him for cause—in response to allegations of inappropriate behavior. *Shabbouei* v. *Potdevin*, C.A. No. 2018-0847 (Del. Ch. April 2, 2020). The Court's ruling reaffirms the discretion that independent directors enjoy when deciding how best to ensure the swift and effective transition of top management.

The apparel company lululemon athletica inc. announced in February 2018 that its CEO, Laurent Potdevin, had resigned after he "fell short" of its "standards of conduct." His separation agreement provided for $5 million in severance payments. A stockholder then brought a derivative complaint claiming that the board had breached its fiduciary duties by approving the separation agreement instead of terminating Potdevin "for cause." The plaintiff did not allege that any of the lululemon directors had a financial interest in the separation agreement or some other personal interest that would cause them to prioritize Potdevin's interests above those of the company. Straining to cast doubt on the directors' independence, the plaintiff asserted that the board should have responded sooner to Potdevin's alleged improprieties and that it therefore faced "a substantial likelihood of liability" for a "failure of oversight."

Vice Chancellor Slights sensibly rejected this novel use of a "failure of oversight" theory to show that "the Board was somehow interested in the Separation Agreement." Liability predicated on a failure of oversight—also known as *Caremark* liability—arises when a board's conscious failure to institute or monitor an effective compliance system leads to avoidable corporate legal violations and resulting losses, usually in the form of fines and settlements. As the Court explained, the board's proactive response to Potdevin's inappropriate behavior "is inconsistent with a theory of liability exposure predicated on 'conscious indifference' to 'red flags.'" And, the Court found, the benefits of the board's decision to avoid an embarrassing legal battle with the company's former CEO were clear. The decision thus exemplifies the deference Delaware has long accorded to the considered decisions of financially disinterested directors—even when those decisions concern controversial or delicate matters.

William Savitt
Ryan A. McLeod
Anitha Reddy

If your address changes or if you do not wish to continue receiving these memos, please send an e-mail to Publications@wlrk.com or call 212-403-1443.

W/3713489