

Delaware Supreme Court Rules on Director Independence

Skadden

12/19/16

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Edward B. Micheletti

Wilmington
302.651.3220
edward.micheletti@skadden.com

Edward P. Welch

Wilmington
302.651.3060
edward.welch@skadden.com

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One Rodney Square
920 N. King Street
Wilmington, DE 19801
302.651.3000

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

The Delaware Supreme Court recently issued an important decision on the subject of director independence. In *Sandys v. Pincus*, No. 157, 2016 (Del. Dec. 5, 2016), the Delaware Supreme Court held that certain directors of Zynga, Inc. (Zynga or the company) were not independent because of personal and professional connections to Mark J. Pincus, the company's founder and controlling stockholder, and Reid Hoffman, an outside director. The *Sandys* opinion and the Supreme Court's reasoning underlying its specific decisions concerning director independence should be carefully considered by boards of directors of companies faced with stockholder derivative lawsuits, particularly for companies that have a controlling stockholder.

Background

A Zynga stockholder brought derivative claims for breach of fiduciary duty against certain directors and officers of the company who sold shares in a secondary stock offering in April 2012. Shortly after the secondary offering, the company's per-share trading price fell dramatically. The plaintiff asserted that the directors and officers who sold in the secondary offering did so improperly on the basis of their inside knowledge of the company's declining performance. The plaintiff further alleged that current and former members of the Zynga board of directors (the board) breached their fiduciary duties by approving exceptions to certain lockup agreements and other trading restrictions, thereby permitting the allegedly wrongful stock sales.

In an opinion dated February 29, 2016, Chancellor Andre G. Bouchard of the Delaware Court of Chancery dismissed the complaint under Rule 23.1 for failure to plead that the demand was excused as futile. At the time the complaint was filed, the board was comprised of nine directors, only two of whom — Mr. Pincus, Zynga's founder, former CEO and controlling stockholder, and Mr. Hoffman, an outside director — had sold shares in the secondary offering. After considering the allegations against five of the board members, Chancellor Bouchard held that the plaintiff had failed to allege facts that would create a reasonable doubt as to the ability of a majority of the nine-member board to act independently of Mr. Pincus and Mr. Hoffman for purposes of considering a derivative demand. The court therefore dismissed the complaint under Rule 23.1 for failure to plead that the demand was futile. The plaintiff appealed.

The Supreme Court's Opinion in *Sandys v. Pincus*

On appeal, the Delaware Supreme Court, in a 4-1 split decision, reversed Chancellor Bouchard's ruling. Writing on behalf of the majority, Chief Justice Strine held that the plaintiff had pleaded "particularized facts regarding three directors that create a reasonable doubt that these directors can impartially consider a demand." As a result, he found that the plaintiffs had adequately pled that the demand was futile because five board members out of nine were conflicted for purposes of considering a demand. Specifically, the Supreme Court concluded that one of the three directors in question — Ellen Siminoff, an outside director — was not independent for purposes of considering the demand because she and her husband co-owned a private airplane with Mr. Pincus. Chief Justice Strine wrote that the co-ownership "signaled an extremely close, personal bond between Pincus and Siminoff, and between their families," and that the "unusual fact" created an inference "that Siminoff cannot act independently of Pincus."

The Supreme Court also rejected Chancellor Bouchard's determination as to the independence of directors William Gordon and John Doerr, who both were partners at Kleiner Perkins Caufield & Byers (Kleiner Perkins), which owned equity in Zynga. Chief Justice Strine's opinion emphasized that the company did not consider Mr. Gordon and Mr. Doerr independent under the NASDAQ listing standards. Chief Justice

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Strine stated that “although we do not know the exact reason the board made this determination,” the court was persuaded that because Zynga was controlled by Mr. Pincus and because neither Mr. Gordon nor Mr. Doerr had been designated as “independent” for NASDAQ purposes, neither of them could independently consider whether to initiate a derivative suit under the circumstances. The majority’s opinion also noted that in addition to owning 9.2 percent of Zynga’s equity, Kleiner Perkins also was invested in One Kings Lane (a company co-founded by Mr. Pincus’ wife) and Shopkick, Inc. (another company where Mr. Hoffman is a director). The court found that this “mutually beneficial ongoing business relationship ... might have a material effect on the parties’ ability to act adversely toward each other.” Because Mr. Gordon, Mr. Doerr and Ms. Siminoff were found to lack independence, the board did not have a majority of disinterested and independent directors for purposes of considering the plaintiff’s derivative demand.

Justice Karen L. Valihura dissented. Though describing it as “a close case,” Justice Valihura wrote that she would have affirmed Chancellor Bouchard’s dismissal because these “relationships among venture capitalists and entrepreneurs, as alleged, are not sufficient to raise a reasonable doubt as to Gordon and Doerr’s independence.” As to Ms. Siminoff, Justice Valihura stated that the complaint alleged “[n]othing more” than a business relationship, “let alone facts suggesting th[e] kind of familial loyalty and intimate friendship” that the majority’s opinion inferred from her co-ownership of the airplane with Mr. Pincus.

Implications

The Delaware Supreme Court’s opinion in *Sandys v. Pincus* is a rare example of a non-unanimous ruling on a matter of fundamental importance to corporation law — namely, the determination of when a director is interested or lacks independence in connection with a particular transaction. Boards of directors should carefully consider with their advisers several aspects of this notable opinion:

- A company’s decision as to whether a certain director is independent under the relevant stock exchange rules may affect whether that director is considered independent for purposes of Delaware law.
 - In holding that Mr. Gordon and Mr. Doerr were not independent for purposes of the stockholder’s derivative claim in this case, Chief Justice Strine wrote that although “the Delaware independence standard is context specific and does not perfectly marry with the standards of the stock exchanges in all cases,” it nevertheless “creates cognitive dissonance” to presume that directors are independent when their “own colleagues will not accord them the appellation of independence[.]” On the other hand, Justice Valihura dissented in part because the complaint “lack[ed] of any explanation as to why Gordon and Doerr were identified as ‘not independent’ for NASDAQ purposes.” Companies determining to designate a certain director as non-independent under stock exchange rules should consider the potential impact of future litigation, regardless of the underlying reason for the non-independence determination.
- The *Sandys* opinion is particularly pertinent for controlled companies. In a seemingly categorical assertion, Chief Justice Strine held that “[i]n the case of a company like Zynga, which has a controlling stockholder, Pincus, who wields 61% of the voting power, if a director cannot be presumed capable of acting independently because the director derives material benefits from her relationship with the company ... she necessarily cannot be presumed capable of acting independently of the company’s controlling stockholder.”
- Close personal and professional relationships between directors may be considered by the court to affect the board’s ability to maintain control of derivative lawsuits.
 - Delaware courts long have held that personal or business relationships do not render a director incapable of considering a derivative demand unless the relationship is significant enough to be “bias-producing.” The majority opinion in *Sandys* held that this standard “does not require a plaintiff to plead a detailed calendar of social interaction to prove that directors have a very substantial personal relationship rendering them unable to act independently of each other.” By contrast, Justice Valihura’s dissent emphasized that in cases such as *Beam v. Stewart*, the Delaware Supreme Court has considered directors still to be independent despite allegedly being a “longtime personal friend” or of having a “longstanding personal relationship” with the defendant director. 845 A.2d 1040, 1047-49 (Del. 2004). Agreeing with Chancellor Bouchard’s ruling, Justice Valihura viewed the *Sandys* complaint as failing to create a reasonable inference that the challenged directors’ relationships with Mr. Pincus and Mr. Hoffman were so substantial that the director would “put at risk her reputation by disregarding her duties.”
 - In *Sandys*, the majority opinion contains strong language about the fact that Ms. Siminoff and her husband co-owned a private airplane with Mr. Pincus, stating it “suggests that the Pincus and Siminoff families are extremely close to each other and are among each other’s most important and intimate friends,” because an airplane is “a personal asset” that “requires close cooperation in use, which is suggestive of detailed planning indicative of a continuing, close personal friendship.” The Court found the relationship between airplane co-owners to be “the type of very close personal relationship that, like family ties, one would expect to heavily influence a human’s ability to exercise impartial

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judgment.” This language is especially notable because, as Justice Valihura noted in her dissent, the complaint’s allegations on this point were sparse and repeatedly described the co-ownership as a “business relationship.”

- The *Sandys* opinion also contains notable language about relationships among venture capital investors and board nominees. Because of the overlapping involvement of Gordon, Doerr, Pincus and Hoffman in several different companies, the majority’s opinion found that “Gordon and Doerr have a mutually beneficial network of ongoing business relations with Pincus and Hoffman that they are not likely to risk by causing Zynga to sue them.”

- Chief Justice Strine opined that “the reality is that firms like Kleiner Perkins compete with others to finance talented entrepreneurs like Pincus, and networks arise of repeat players who cut each other into beneficial roles in various situations.” While Chief Justice Strine found “nothing at all wrong with that,” he nevertheless held that it undermined the independence of Mr. Gordon and Mr. Doerr for purposes of evaluating the stockholder derivative demand. The majority’s holding on this point is notable because, as Justice Valihura’s dissent emphasized, “the plaintiff failed to plead any facts about the size, profits, or materiality to Gordon and Doerr of these investments or interests.”