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# Skadden Discusses Director Disinterestedness and Independence in Delaware

*By Ronald N. Brown, III, Parker M. Justi and Keenan D. Lynch* May 23, 2017

**Comment**

Delaware law provides important tools for directors to maintain control of derivative lawsuits.[1] One such tool is the "demand requirement" embodied in Court of Chancery Rule 23.1, which requires that before a stockholder acts on behalf of the corporation, the stockholder must either demand that the board take action or establish that demand would be futile. The seminal opinion of the Delaware Supreme Court in *Aronson v. Lewis* established the test used by Delaware courts in determining whether a plaintiff stockholder's demand would have been futile: Has the plaintiff stockholder seeking to proceed with a claim on behalf of the company pleaded particularized facts creating a "reasonable doubt" that either (1) the directors are disinterested and independent, or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment? 473 A.2d 805, 814 (Del. 1984).

In two recent opinions — *Sandys v. Pincus*, 152 A.3d 124 (Del. 2016) and *Delaware County Employees Retirement Fund v. Sanchez*, 124 A.3d 1017 (Del. 2015) — the Delaware Supreme Court applied the *Aronson* test for demand futility under Rule 23.1. These two opinions, along with other recent cases, illuminate certain guideposts under Delaware law for assessing director independence and disinterestedness. As Chief Justice Leo E. Strine, Jr. observed in *Sanchez,* however, it remains true that "[d]etermining whether a plaintiff has pled facts supporting an inference that a director cannot act independently of an interested director for purposes of demand excusal under *Aronson* can be difficult." *Sanchez*, 124 A.3d at 1019.

## *Sandys* and *Sanchez*

In *Sandys*, 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 alleged that the directors and officers traded improperly on the basis of their inside knowledge of the company's declining performance. At the time the complaint was filed, the board was comprised of nine directors, only two of whom had sold shares in the secondary offering. The Court of Chancery held that the plaintiff had failed to allege facts that would create a reasonable doubt as to the ability of a majority of the board to act independently for purposes of considering a derivative demand, and it therefore dismissed the complaint.

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The plaintiff appealed, and the Delaware Supreme Court reversed. Specifically, the Supreme Court held that one director was not independent of the company's controlling stockholder/director/CEO for purposes of considering a derivative demand because the director and her husband co-owned a private airplane with the controlling stockholder. The Supreme Court found that the co-ownership "signaled an extremely close, personal bond between [the controlling stockholder and the director], and between their families," and that the "unusual fact" created an inference that the director could not act independently of the controlling stockholder. The court also held that two other directors were not independent of the company's controlling stockholder/director/CEO for purposes of considering a derivative demand because the directors were partners of a private equity firm that, in addition to owning Zynga stock, also had invested in a company co-founded by the controlling stockholder's wife and another company where a conflicted member of the board was 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."

In *Sanchez*, the Delaware Supreme Court reversed a finding of the Court of Chancery that a director was independent for purposes of analyzing demand excusal under Rule 23.1. 124 A.3d 1017 (Del. 2015). The Supreme Court held that "it is important that the trial court consider all the particularized facts pled by the plaintiffs about the relationships between the director and the interested party in their totality and not in isolation from each other." Specifically, the court found one director lacked independence because of the alleged facts that the director (1) was the interested director's "close personal friend of a half century," (2) "derives his primary employment from a company over which [the interested director] has substantial control" and "has a brother in the

same position." In so ruling, the court noted that plaintiffs' allegation of friendship went beyond "the kind of thin social-circle friendship" that was at issue in *Beam v. Stewart*, where the court rejected a challenge to directors' independence that was based on the allegation that the directors "moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends.'" *Id.* at 1022 (quoting *Beam*, 845 A.2d 1040, 1051 (Del. 2004)).

## Other Recent Delaware Opinions

Director independence is commonly understood in the context of stock exchange listing requirements, and while those standards are, in some ways, analogous to the analysis under Delaware law, they are not co-extensive. *Sandys*, 152 A.3d at 131 (Del. 2016). For example, in *Sandys*, while the Delaware Supreme Court considered a director's independence designation under the stock exchange listing requirements in determining independence under Delaware law, it explained that the two inquiries "do not perfectly marry," and stock exchange listing requirements are "relevant under Delaware law," though not dispositive. *Id*. In particular, the analysis under Rule 23.1 is specific to the transaction or board decision the stockholder plaintiff is challenging. There are several other Delaware opinions that address the independence of a director for Rule 23.1 demand excusal purposes that demonstrate the fact-intensive nature of the inquiry, which does not easily lend itself to any bright-line rules.

**Opinions Rejecting Challenges to Director Disinterestedness and Independence**

In one case, the Court of Chancery examined whether three directors were independent of the company's controlling stockholder for purposes of Rule 23.1, where the stockholder sought to challenge a company's acquisition of another business affiliated with the controlling stockholder. *Greater Pa. Carpenters' Fund v. Giancarlo*, C.A. No. 9833-VCP (Del. Ch. Sept. 2, 2015) (Transcript), *aff'd*, No. 531, 2015 (Del. Mar. 11, 2016) (Order). Specifically, the court found that each director was independent despite allegations that:

- one director had served as the CEO of other businesses in which a venture capital firm had invested, and the same venture capital firm had also invested alongside the controlling stockholder;
- a second director was a long-time partner of a venture capital firm that had co-invested in other businesses alongside the controlling stockholder, because the court found that the plaintiff failed to explain how the venture capital firm's history investing alongside the controlling stockholder was material to the director; and
- a third director was a partner in a private equity firm that had invested in several start-ups affiliated with the controlling stockholder, because the court found that the alleged conflict of interest did "not provide continuous ongoing revenue to" the private equity firm or present an opportunity for the firm to profit from the challenged transaction at issue in the case.

In another case, the Court of Chancery examined whether a director could impartially consider a demand to challenge a services agreement entered into between the company and its alleged controlling entity. *Teamsters Union 25 Health Services & Insurance Plan v. Baiera*, 119 A.3d 44, 59 (Del. Ch. 2015). The court found that the director was independent despite allegations that the director had been an executive of the controlling entity or the controlling entity's parent for 16 years, had been CEO of the controlling entity's affiliate and had been elected to the board of the company shortly after leaving employment with the controlling entity's affiliate.

In a third case, the Court of Chancery examined whether two challenged directors were independent of a compensation committee member who was the subject of the stockholder's derivative claim. *Friedman v. Khosrowshahi*, 2014 WL 3519188, at *11 (Del. Ch. July 16, 2014), *aff'd*, No. 442, 2014, 2015 WL 1001009 (Del. Mar. 6, 2015). The court held that each of the two directors was independent despite allegations that:

- one director had been the controlling stockholder, CEO or a director of other companies at which the compensation committee member had held management positions, and had served alongside the compensation committee member on the board of other companies; and
- the other had provided outside legal services to and later served as in-house counsel at another company at which the compensation committee member had been a senior vice president, and (like the compensation committee member) had joined the company's board as a nominee of the same other company where they had both previously worked.

**Opinions Finding That Challenged Directors Were Not Disinterested and Independent**

In one case, the Court of Chancery examined whether three directors were independent of a fellow director affiliated with the company's controlling stockholder, where the company's board had approved a transaction in which the controlling stockholder repurchased stock from the company. *Rux v. Meyer*, C.A. No. 11577-CB (Del. Ch. Dec. 16, 2016) (Transcript). The court found that each director was not independent of the company's controlling stockholder because:

- one director was also the CEO of another business of which the controlling stockholder was the founder, former CEO and a current director. The controlling stockholder also owned a 30 percent equity stake in the other business, and he had granted the director voting and purchase rights to that equity stake. The court found that the controlling stockholder "would have a meaningful say on [the director's] continued employment" as CEO of the other company, and that the relationship between the controlling stockholder and the director was "an unusually thick one" so that "one reasonably would doubt" whether the director could act independently;
- another director had held several executive positions at different companies in which the controlling stockholder held significant interests. The court found that "in almost all of the professional dealings" between the director and the controlling stockholder over the two-decade period, the director was "subordinate to and, it is reasonable to infer, dependent on maintaining [the controlling stockholder's] good graces"; and

- a board of another company previously determined that the third director was "too connected" with the controlling stockholder to play a significant role in the merger negotiation between that other company and a company owned by the controlling stockholder.

In another case, the Court of Chancery examined whether five directors could impartially consider a demand to challenge a services agreement entered into between the company and an affiliate of a controlling stockholder. *In re EZCORP Inc. Consulting Agreement Derivative Litigation*, 2016 WL 301245 (Del. Ch. Jan. 25, 2016). The court held that each of the five directors was not independent because:

- the first director had been the chief financial officer at the company, had been appointed as interim CEO by the controlling stockholder after the controlling stockholder "clean[ed] house," derived his principal source of income from employment at the company and was not independent under the Nasdaq listing rules;
- the second director was a managing director of an entity that was 33 percent owned by and in a joint venture with the company, and was not independent under Nasdaq listing rules;
- the third director was a consultant to and had been a managing director at the controlling stockholder's affiliate that was the counterparty to the services agreement, had participated in consulting agreements similar to the services agreements, was a director of entities affiliated with the company and was not independent under the Nasdaq listing rules;
- the fourth director's family owned a minority stake of an entity that was majority owned by the company and had several family members who were employees of the same entity; and the fifth director personally participated in the decisions to approve the services agreements, even after indications of problems had arisen, and, although retiring from the board since approving the services agreements, immediately returned to the board after the services agreements were terminated by other directors.

In a third case, the Court of Chancery examined whether three directors of a company were independent for purposes of derivative claims challenging certain loans that the company entered into with a "control group" of affiliated entities that together owned over 90 percent of the company's stock. *Caspian Select Credit Master Fund Ltd. v. Gohl*, 2015 WL 5718592 (Del. Ch. Sept. 28, 2015). The court held that each of three directors was not independent because:

- one director was a "dual fiduciary" who had been nominated to the company's board by the control group while also being a principal at one of the entities in the control group; and
- two other directors each were appointed to the board by the control group, were appointed to several other boards of other companies by the control group and had expectations of future dealings with the control group because all are in the same business of restructuring distressed companies.

## Key Takeaways

These opinions continue the development of Delaware law in assessing whether a director is sufficiently disinterested and independent to consider a demand impartially, and thereby whether a stockholder may pursue a claim derivatively on the corporation's behalf. Taken together, they suggest that Delaware courts will examine the totality of a plaintiff stockholder's factual allegations in each situation to evaluate whether a director's personal or business relationships "give rise to human motivations compromising the participants' ability to act impartially toward each other on a matter of material importance." *Sandys*, 152 A.3d at 126. The number of derivative lawsuit filings appears to be increasing, and in many instances, are preceded by a Section 220 demand on the company for books and records to support such a filing. Boards encountering this circumstance should carefully consider, along with their advisers, whether these rulings implicate their ability to maintain control over the corporation's claims under Rule 23.1.

ENDNOTES

1 Whether a claim is direct or derivative under Delaware law turns on whether it was the corporation or the suing stockholder, individually, who suffered the alleged harm and who would receive the benefit of the recovery or other remedy. *See Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004).

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