Harvard Law School Forum on Corporate Governance
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What Exactly Is an Independent Director?

Posted by Shana Elberg, Lisa Laukitis, and Maxim Mayer-Cesiano, Skadden, Arps, Slate, Meagher & Flom LLP, on Thursday, March 17, 2022

Editor's note: Shana Elberg, Lisa Laukitis, and Maxim Mayer-Cesiano are partners at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden memorandum by Ms. Elberg, Ms. Laukitis, Mr. Mayer-Cesiano, Joseph O. Larkin, and Caroline S. Kim. Related research from the Program on Corporate Governance includes Independent Directors and Controlling Shareholders by Lucian Bebchuk and Assaf Hamdani (discussed on the Forum here).

Takeaways

- Independence is neither a fixed condition nor a universal status for all purposes. Events and relationships can disqualify an otherwise independent director from participating in decisions.
- No matter how pure a director's motives, if they are not alert to independence issues, plaintiffs may portray them as compromised, which could jeopardize board actions.
- Courts are sensitive to personal and business relationships they fear could make directors too deferential to management or controlling shareholders.

Independence is not as simple as it sounds. As a director, you may be considered independent for one purpose but not another, and the fact that you qualified as independent in the past does not mean you will in all future situations. It is essential to understand the rules governing director independence and to be sensitive to the circumstances that can trip up boards and directors.

The most important thing to bear in mind is that independence is not a once-and-for-all test, something to consider when you are appointed and then treat as settled. Circumstances change for both individual directors and companies, and independence is situational: It must be reassessed as events unfold, particularly where a company enters negotiations or transactions or makes decisions about management.

Who Sets the Rules?

There are several sources of standards governing director independence: stock exchange listing requirements, Securities and Exchange Commission (SEC) regulations, proxy advisories and the laws of the state of incorporation.

The SEC regulations and stock exchange rules are relevant mainly when directors are appointed and named to key committees. However, once on a board, the issue of whether a director is independent comes up primarily in litigation, when board actions are challenged by shareholders claiming that directors had ulterior motives, divided loyalties or conflicts of interest. Most often,

these cases are heard in the courts of Delaware, where more than two-thirds of Fortune 500 companies are incorporated.

Stock exchange rules. Both the New York Stock Exchange and Nasdaq require that listed company boards have a majority of independent directors, and each exchange sets criteria. The focus is on independence from management so directors can exercise autonomous judgment. To qualify as independent for this purpose, directors cannot hold management positions at the company, its parents or subsidiaries, and former executives are not considered independent for three years after their departures. Other rules are meant to ensure that independent directors are not overly reliant on the company financially. For example, a director does not qualify as independent if they or their families received more than $120,000 in compensation from the company in any 12-month period in the prior three years. These standards make sense, since their purpose is to ensure that board members act at an arm's length from management and controlling influences.

Directors also need to keep in mind that proxy advisory firms sometimes apply more stringent independence tests than the stock exchanges. A proxy advisor may not consider a director nominee independent and may recommend that shareholders not vote for that nominee, even if the person is deemed independent under the stock exchange standards.

Delaware law. Delaware law, by contrast, is much more situation-specific and has focused on ensuring directors remain free of conflicts during particular board actions.

Much of the relevant Delaware law governing director independence has evolved through litigation over transactions involving an insider or controlling shareholder, where approval by independent outside directors is required. These situations can place directors' conduct under a microscope. And, no matter how pure a director's motives and how dedicated they are to doing the right thing, if not alert to established guidelines on independence and not considering them on an ongoing basis, they may set themselves up to be attacked by plaintiffs as compromised and conflicted. They could also face personal liability for their role in board actions if they are ultimately found to have breached their fiduciary duties.

One decision referred to a controlling shareholder "as the 800-pound gorilla whose urgent hunger for the rest of the bananas is likely to frighten less powerful primates like putatively independent directors who might well have been hand-picked by the gorilla (and who at the very least owed their seats on the board to his support)."

Situations That Can Cast Doubt on Directors' Independence

Few shareholder lawsuits go all the way through a trial. As a consequence, much of the law governing director conduct stems from rulings made in the early stages of litigation, where judges are not evaluating both sides' evidence but must accept the plaintiffs' allegations as true. That is, the court is only considering whether the facts the plaintiffs allege would be sufficient to undermine the directors' independence if proven at trial.

Even if the matter is ultimately resolved favorably for the directors, being named as a defendant in a shareholder suit is not ideal. Using news reports and corporate records demands, plaintiffs can — and regularly do — frame detailed allegations that portray board decisions as

compromised due to conflicts of interest or divided loyalties. You do not want to provide anyone ammunition by doing something that could be misconstrued as conflicted.

Self-interest. Cases involving conflict due to self-interest are relatively straightforward. For example, in one case, directors refused at the last minute to execute a restructuring agreement for their company unless it included a broad release and indemnity for the directors and majority shareholder. When a shareholder sued the directors for breach of fiduciary loyalty, a court refused to dismiss the case on the pleadings. (A possible solution: Leave the decision about the releases to newly-appointed independent directors who were not involved in the actions that gave rise to the claims and who are not defendants.)

Relationships with interested parties. Less obvious examples of potential conflicts involve multidimensional relationships between outside directors and interested parties — typically management or large shareholders.

Delaware courts have repeatedly focused on ongoing business and personal ties that could make it hard in practice for nominally independent directors to exercise truly independent judgment in the company's interest. Plaintiff's lawyers are adept at mustering details to make it appear that outside directors are so cozy with management or a controlling shareholder that they are not independent.

Several leading cases involve a CEO, board chair or controlling shareholder alleged to be on both sides of a transaction — where the director's company acquired a company in which the insider had a sizeable stake, for example. Other cases are styled as shareholder derivative suits, where the plaintiffs, suing in the company's name, argue that the board should have sued management for some action or failing. Relationships between directors and management typically are front and center in such litigation.

For veterans of the business and financial world, some of the ties courts have cited as undermining independence may seem routine and harmless. For example, the independence of venture investors on public company boards has been challenged because their ties to management are valuable in their own businesses.

- In one case, an outside director was a partner in a venture capital firm that invested in a sector where the company regularly made acquisitions, and the director also served on the board and was an investor in another business that was dependent on the company for an important approval. A court said the director might be reluctant to disagree with management for fear of losing his board seat.
- In another case, a court said that outside directors might not be independent of the founder and controlling shareholder where their venture capital firm invested in the company early on and held shared investments with the founder. Venture capitalists "compete to fund the best entrepreneurs," the court noted, adding that, while "[t]here is nothing wrong with that, these relationships can give rise to human motivations compromising the participants' ability to act impartially toward each other… ."
- Where directors have been named to several boards by the same interested party or shareholder, that has raised red flags for some courts and other observers: In a 2021 case involving a special purpose acquisition company (SPAC), the court noted that most of the outside directors had served on at least five other SPACs formed by the same

sponsor, which the court said could suggest the directors might expect future board appointments. In addition, the sponsor had granted the directors founders' stock, the value of which would rise no matter what deal was consummated, while common shareholders would only benefit from a sound, well-priced acquisition.
- Similarly, where members of a special committee evaluated the acquisition of a business controlled by their company's chair, a court noted that one outside director had served on the boards of four companies controlled by the chair over two decades. Two other members of the special committee had also served as directors of other companies the chair controlled.
- A recent law review article noted that a group of 15 directors had served on 252 boards of bankrupt companies which were represented disproportionately by two law firms. The authors argued that such repeat players suffer from "structural bias," favoring the release of claims.

Directors should be mindful that serving on the board of a company with a long-time board chair, founder or controlling shareholder may give rise to scrutiny of transactions involving that person. Delaware judges have been attuned to the personal dynamics at such companies. Several decisions have cited newspaper and magazine articles portraying larger-than-life personalities. Reports that CEOs or chairs have a history of retribution against directors who opposed them have also been cited. For example:

- Where for five consecutive years, shareholders had voted against a compensation committee's recommendations for executive pay, and a majority of noninterested shareholders repeatedly withheld their votes for the committee members who approved the pay packages, a Delaware court concluded that "the only reason these directors have not been forced to resign is [the CEO's] continuing support." That support could suggest the committee members were beholden to the CEO, the court said.
- In particularly colorful language, one decision referred to a controlling shareholder "as the 800-pound gorilla whose urgent hunger for the rest of the bananas is likely to frighten less powerful primates like putatively independent directors who might well have been hand-picked by the gorilla (and who at the very least owed their seats on the board to his support)."

Finally, personal interactions that might seem innocent and routine to successful business people, such as shared charitable interests and personal favors, may be fodder in litigation where director independence is at issue:

- The independence of two outside directors on a special committee was called into question where the company chair was a longtime member of the board at his alma mater alongside two of his company's directors, and he had donated tens of millions of dollars to the college, including large sums while one director held a senior administrative position at the school. The chair also arranged a private museum tour in London for the wife and daughter of one of the directors while the special committee was evaluating the transaction with him.
- An outside director who, with her husband, owned a small private plane with the company's controlling shareholder and former CEO, whose actions the board had approved, was likely too close to the CEO to be considered independent, the Delaware Supreme Court held. "Co-ownership of a private plane involves a partnership in a

personal asset that is not only very expensive, but that also requires close cooperation in use, which is suggestive of detailed planning indicative of a continuing, close personal friendship …" the court said, "the type of very close personal relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment."

Conclusion

The takeaway is that outside directors need to closely monitor their independence and understand that the term can mean different things for different purposes.

A director who qualifies as independent to sit on an audit or compensation committee may not be deemed so when it comes to approving a transaction with an insider or assessing a shareholder demand to bring litigation claims against management. In the latter cases, courts will retroactively assess the possibility of subtle biases and conflicts stemming from personal or business relations — a more refined and less predictable standard of independence.

To ensure your ability to exercise independent judgment and reduce the chances of ending up in court, or losing there, be sensitive to both personal conflicts of interest and relationships and actions, whether recent or long-term, that could appear to create divided loyalties.

Sidebar: Where Directors Could Slip Up

Courts have allowed suits to go forward where plaintiffs alleged directors were not independent because they:

- were named to other unrelated corporate boards by the CEO, chair, controlling shareholder or financial sponsor.
- served on the board of a college alongside the interested party, who was a major donor to the school.
- were partners in a venture capital firm that invested in sectors where the company makes acquisitions.
- shared investments or assets such as a private plane with the CEO, chair or controlling shareholder.
- received token benefits from an interested party, such as a private museum tour for relatives, while a transaction was under consideration.