

Effect of Director Relationships on Director Independence

By **Gabrielle Levin**

A recent decision from the Delaware Supreme Court issued on Dec. 5, 2016, *Sandys v. Pincus*, --- A.3d ---- C.A. No. 9512-CB (Del. Dec. 5, 2016), highlights the potential impact that directors' business and financial arrangements can have on their independence in the context of considering shareholder demands on the board.

In *Sandys*, the plaintiff asserted derivative claims against the senior executives and directors at Zynga Inc., alleging that top Zynga insiders breached their fiduciary duties by selling shares while in possession of confidential information regarding Zynga's soon-to-be announced earnings. The plaintiff also asserted a duty of loyalty claim against the directors who approved the insider sales despite the company's standing rule preventing sales by insiders until three days after an earnings announcement.

At the time the complaint was filed, the Zynga board consisted of nine directors. Two of the directors participated in the insider sales at issue and therefore were indisputably incapable of impartially considering a demand. In ruling on the defendants' motion to dismiss

under Court of Chancery Rule 23.1 for failure to make a pre-suit demand on the board, the Court of Chancery found that at least five of the remaining directors were independent. The Court of Chancery thus dismissed the complaint for failure to make a pre-suit demand.

The Delaware Supreme Court reversed. The court determined that Zynga's CEO could not be considered independent. The court then found that plaintiff had pleaded sufficient facts to question the independence of at least three other board members, thus leaving only three independent directors on the board:

First, the Delaware Supreme Court determined that director Ellen Siminoff was not independent by virtue of the fact that she and her husband allegedly co-own a private airplane with Zynga's controlling shareholder. Despite the fact that the plaintiff characterized the co-ownership as "an existing business relationship," the Supreme Court drew the inference that co-ownership of an airplane "suggests that the ... families are extremely close to each other and are among each other's most



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important and intimate friends." This was enough to raise a "reasonable doubt" that the director could act impartially, in the court's view.

Second, the Delaware Supreme Court determined that two other directors were not independent by virtue of their status as partners at a venture capital firm that controls approximately 9.2 percent of Zynga's equity. The venture capital firm was also invested in a company that is co-owned by the wife of Zynga's controlling shareholder. In addition, one of the Zynga directors who participated in the

insider sales at issue served on the board of another company with another partner from the venture capital firm. Further, the plaintiff had alleged that the Zynga board did not consider the two directors independent under the NASDAQ rules. This determination, along with the relationships highlighted above, raised a “reasonable doubt” that the directors could consider a demand impartially.

Even though the Delaware Supreme Court ruled in favor of the plaintiff, the court was critical of plaintiff’s pre-suit conduct. The court repeatedly noted the plaintiff’s “lack of diligence” in preparing his complaint. For example, the court observed that the plaintiff’s books and records demand on the company failed to seek information bearing on the independence of the board. The court added that the plaintiff failed to conduct basic internet research that would have enabled the plaintiff to plead particularized facts that would have aided the Court of Chancery’s decision. “The plaintiff’s lack of diligence put the Court of Chancery in a compromised and unfair position to make an important determination regarding these directors’ pleading stage independence,” the court concluded.

Notably, both the majority opinion and the dissent from Justice Karen L. Valihura appeared to consider this a “close” case. In her dissent, Valihura stated that she would have affirmed the Court

of Chancery’s decision on the grounds that the two directors’ positions as partners of a venture capital firm did not make them interested for pleading stage purposes. Without more information regarding the size, profits or materiality of the venture capital firm’s investments or interests to the two directors, Valihura concluded that the alleged relationships and overlapping investments alone were not enough to create a reasonable doubt as to the directors’ independence. Valihura noted that independence under the NASDAQ rules is “relevant” but not “dispositive,” and that a director could be deemed “not independent” under NASDAQ rules and independent for demand futility purposes.

There are two important take-aways from the *Sandys* decision. First, Delaware courts clearly expect plaintiffs to diligently research director independence issues both at the pre-suit demand and complaint stages. Second, the decision calls into question whether directors can have any pre-existing relationships with other directors or the company and still be independent for pre-suit demand purposes. Specifically, with respect to the two directors who are partners at a well-known Silicon Valley venture capital firm, it is notable that the firm’s investments and relationships were imputed to the directors irrespective of whether the directors had any involvement.

Despite the presumptive independence of directors under Delaware law, *Sandys* is the latest in a line of Delaware decisions finding arguably attenuated personal and business connections sufficient to call into question the independence of board members, at least at the pleadings stage. Further confusing matters, *Sandys* appears to conflict with other Delaware Supreme Court cases recognizing that personal friendships or relationships are not enough to create reasonable doubt as to a director’s independence. Public companies should continually assess whether board members’ relationships—including friendships, personal investments and connections involving companies where directors are employed—will undermine directors’ independence and their ability to consider pre-suit demands on the company. •

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