

# BUSINESS LAW TODAY

## Delaware Insider:

### *Sandys v. Pincus*: Personal Relationships and Director Independence

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In a recent decision, the Delaware Supreme Court reversed a Court of Chancery ruling in a stockholder derivative action, holding that a majority of the board of directors of Zyn-ga, Inc. was not independent for purposes of presuit demand excusal. The reversal turned, in part, on the independence of one of the directors whose personal relationship with an interested director was the focus of the Supreme Court's reasoning. At first glance, this decision could be read as one that deviates from Delaware's longstanding presuit director independence jurisprudence, as articulated in the Delaware Supreme Court case of *Beam v. Stewart*, that mere allegations of personal friendships with interested directors are insufficient for the court to find an otherwise independent director interested in the demand futility context. However, a closer review of *Sandys* demonstrates that the stockholder plaintiff had, according to the court, alleged the kind of rare intimate relationship mentioned, though not present, in *Beam* and its progeny that can arise to a level to cause the court to doubt, at the pleading stage, a director's ability to exercise impartial judgment in the face of a demand to initiate a lawsuit against a fellow director. Accordingly, the *Sandys* decision does not appear to deviate from Delaware precedent, but rather provides some addi-

tional clarity regarding the types of unique personal relationships that can alone affect director independence.

#### **Personal Relationships: Beam and Its Progeny**

Court of Chancery Rule 23.1 requires a stockholder plaintiff asserting claims derivatively on behalf of a corporation to demonstrate either that (i) she made a presuit demand on the corporation's board to bring the claims directly and her demand was denied, or (ii) a majority of the corporation's directors are incapable of impartially considering the demand, thereby rendering demand futile and excused. A stockholder can demonstrate demand futility with respect to a specific director in a number of ways, including by pleading, with particularity, that the director is "beholden" to an interested director (or controlling stockholder) and unable to impartially exercise business judgment with respect to the demand. In those cases where a stockholder has successfully alleged that a director is beholden to an interested director, it is most typically by alleging the existence of a material financial relationship between the two. In only a handful of cases have Delaware courts held that allegations of a non-familial personal relationship with an interested

director render a director interested for purposes of demand futility.

As noted above, the Delaware Supreme Court's 2004 decision in *Beam* is generally cited as the standard for analyzing allegations of personal relationships among directors for presuit demand purposes. In *Beam*, the plaintiff asserted a derivative claim on behalf of Martha Stewart Living Omnimedia, Inc. (MSO) against Martha Stewart for breach of fiduciary duty arising out of Stewart's allegedly illegal sale of stock of another company. The stockholder plaintiff alleged that three MSO directors were not disinterested for purposes of a presuit demand because of their personal relationships with Stewart, a concededly interested director and the target of the derivative claim. With respect to two of these directors, plaintiffs alleged that they were both "longstanding" friends of Stewart's. The *Beam* court, however, held that "[m]ere allegations" that directors "move in the same business and social circles, or a characterization that they are close friends, is not enough to negate independence for demand excusal purposes." This oft-quoted passage has been recognized since as the default standard Delaware courts will apply where allegations of lack of independence are based upon personal, as opposed to financial, relationships.

Despite the result and reasoning for which the *Beam* case has since been repeatedly cited, the decision also makes clear that the *Beam* court did not rule out, and in fact explicitly left open, the possibility that allegations of certain types of personal relationships alone could cause the court to find an otherwise independent director interested for purposes of demand futility. While the allegations of personal relationships at issue in *Beam* were held insufficient to excuse presuit demand as to any director, the court nonetheless explained that a pleadings-stage finding of lack of independence “might arise either because of financial ties, familial affinity, [or] a particularly close or intimate personal or business affinity.” The court cautioned that these types of disabling personal relationships are rare: “Not all friendships, or even most of them, rise to this level and the Court cannot make a reasonable inference that a particular friendship does so without specific factual allegations to support such a conclusion.” The court further explained that in order for allegations of personal relationships to create a reasonable doubt as to a director’s independence, “a plaintiff must plead facts that would support an inference that because of the nature of a relationship . . . the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.” Notwithstanding the court’s explanation that pleading demand futility based upon personal relationships is possible, examples of a plaintiff successfully doing so following *Beam* are exceedingly rare.

Almost a decade after *Beam*, in *In re MFW S’holders Litig.*, the Court of Chancery provided a few concrete examples of the kinds of personal relationships that could cause a court to reasonably doubt director independence, albeit in the context of evaluating the effectiveness of a special committee in a going private transaction. Commenting on the current state of Delaware law regarding director independence, then-Chancellor Strine appeared to take issue with the assumption that allegations of personal friendships with interested directors, post-*Beam*, can never

render a director beholden or self-interested. To the contrary, while a relationship between directors who “occasionally had dinner over the years, go to some of the same parties and gathering annually, and call themselves ‘friends’” would not render a director interested, the *MFW* decision indicated that a friendship “where the parties had served as each other’s maids of honor, had been each other’s college roommates, shared a beach house with their families each summer for a decade, and are as thick as blood relations” might.

More recently, the Delaware Supreme Court decided that a personal relationship was of such a nature that it, along with other allegations of financial conflicts, constituted a material conflict in the demand futility context. Writing for the court in *Del. Cty. Emps. Ret. Fund v. Sanchez*, Chief Justice Strine held that a director was not independent for presuit demand purposes in part because the director was alleged to have been friends with an interested director for over fifty years. According to the court, this relationship is not like the “thin social-circle friendship” that was at issue in *Beam*. Rather, the court found that the plaintiff had pled facts quite different from the relationships at issue in *Beam* because “[c]lose friendships of that duration [*i.e.*, fifty years] are likely considered precious by many people, and are rare.” On that basis, together with other allegations suggesting a material financial relationship between the two directors, the court held that demand was excused as futile.

#### The Sandys Decision

As noted above, the holding in *Sandys* provides another rare example of a personal relationship significant enough to support a finding that a director lacked independence for purposes of demand excusal. In *Sandys*, the plaintiff stockholder asserted derivative claims against certain directors and officers of Zynga, including its controlling stockholder Mark Pincus, arising out of the board’s decision to grant these individuals an exemption to a company policy preventing sales of Zynga stock by insiders. The Court of Chancery had found a majority of

the nine-member board independent and on that basis dismissed the case pursuant to Court of Chancery Rule 23.1.

On appeal, the Supreme Court, as the Court of Chancery had, determined that Pincus and another director, Reid Hoffman, were interested for purposes of demand futility. The court’s analysis therefore focused on the independence of three of the remaining six directors. One of those directors, Ellen Siminoff, was alleged by the plaintiff to have a disabling personal relationship with Pincus, evidenced by co-ownership of a private airplane. The plaintiff also asserted that Siminoff was a “close family friend” of Pincus. In the proceedings below, the Court of Chancery held that co-ownership of a private airplane was not enough, standing alone or together with the other allegations regarding her relationship with Pincus, to excuse demand as to Siminoff. The Court of Chancery based its decision on *Beam*, holding that “[p]laintiff’s allegations concerning co-ownership of an asset and friendship do not reveal a sufficiently deep personal connection to Pincus so as to raise a reasonable doubt about Siminoff’s independence from Pincus.”

The Supreme Court, however, agreed with the plaintiff, reasoning that this type of relationship was not common, and that co-ownership of a plane suggests that the two families were “extremely close to each other and are among each other’s most important and intimate friends.” The court further reasoned that 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,” a circumstance that the court found “suggestive of detailed planning indicative of a continuing, close personal friendship.” The type of relationship suggested by co-ownership of a private airplane, the court continued, is a relationship that “like family ties, one would expect to heavily influence a human’s ability to exercise impartial judgment.” Thus, the court held, the fact that Siminoff and Pincus co-owned a private airplane, alone, created a reasonable doubt as to Siminoff’s ability to impartially decide whether to proceed with a lawsuit

against Pincus and demand as to Siminoff was excused as futile.

As to the two other directors, William Gordon and John Doerr, plaintiff alleged that both (i) had previously been determined by the Zynga board not to qualify as independent directors under NASDAQ listing rules; and (ii) are partners at Kleiner Perkins Caufield & Byers, a venture capital firm that owns 9.2 percent of Zynga's equity and is also invested in another company co-founded by Pincus's wife. The Court of Chancery had held that demand was not excused as to Gordon and Doerr because a determination of independence under NASDAQ listing rules, though potentially persuasive, is not dispositive of independence under Delaware law and plaintiff had not pled anything suggesting why the board had reached this decision. With respect to Gordon and Doerr's alleged financial conflict by virtue of their affiliation with Kleiner Perkins, the Court of Chancery held that these and other similar allegations of interlocking relationships were not sufficient to raise a reasonable doubt as to these directors' independence.

The Supreme Court disagreed, holding that the allegations regarding Gordon and Doerr together created a reasonable doubt as to their ability to impartially consider a demand that the company bring claims against Pincus. While the Supreme Court agreed with the lower court that the "context specific" independence standard under Delaware law "does not perfectly marry with" the NASDAQ independence standards, it countered that the NASDAQ independence criteria are nonetheless "relevant under Delaware law and likely influenced by our law." According to the court, the "bottom

line" determination to be made by a board regarding director independence under the NASDAQ rules is whether the director has a relationship that the board believes "would interfere with the exercise of independent judgment" in carrying out her responsibilities. That the Zynga board could not classify Gordon and Doerr as independent under this standard, coupled with the fact that Zynga was majority owned by Pincus, weighed heavily in the court's analysis. Together, these facts reflected a "reality" that the court believed it should consider when making the potentially case-dispositive determination of director independence in the demand futility context.

Another "reality" that influenced the court's decision arose from additional allegations regarding Gordon and Doerr and their overlapping business interests with Zynga and Pincus. Though none of those allegations alone suggested a lack of independence, the court found them indicative of a broader point relevant to Gordon and Doerr's independence: the importance of relationships between "firms like Kleiner Perkins" and "talented entrepreneurs like Pincus." According to the court, it is reasonable to expect that such a "mutually beneficial ongoing business relationship" could "have a material effect on the parties' ability to act adversely toward each other." Accordingly, because plaintiff had pled such a relationship on the part of Gordon and Doerr, in addition to alleging that the Zynga board had itself determined that those directors cannot be considered independent, the court held that a reasonable doubt as to their independence existed and demand was also excused as to them.

## Conclusion

*Sandys* does not appear to have changed the standard Delaware courts will apply when considering allegations of director conflicts in the demand futility context. Rather, the case demonstrates, consistent with *Beam*, *MFW*, and *Sanchez*, that certain personal relationships are sufficiently close and material as to render an otherwise disinterested director interested for purposes of a pleadings-stage demand futility analysis. To the extent practitioners had formed the belief, following *Beam*, that personal relationships alone cannot serve as a basis to excuse demand, *Sandys* serves as an example, not likely to be repeated often, of a disabling personal relationship outside the norm of interrelationships present in many boardrooms. If nothing else, the *Sandys* case provides some specific guidance to practitioners regarding the types of relationships among board members that could compromise the independence of directors thought to be free of conflict. The *Sandys* court's discussion of stock exchange independence rules also provides useful guidance regarding the extent to which those rules will be considered by a Delaware court in analyzing director independence under Delaware law.

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