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Delaware Supreme Court Provides Guidance on Director Independence

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Seyfarth Synopsis: The Delaware Supreme Court recently reversed the dismissal of a derivative complaint for failure to plead demand excusal because it found that certain directors of Zynga Inc. were not independent due to their relationships with the Company's founder and an interested director. The opinion makes clear that directors' independence must be carefully evaluated by companies faced with stockholder derivative suits and their counsel because of the potentially far-reaching implications.

Background

Plaintiff stockholder filed a derivative suit alleging that certain directors and officers of the Company who participated in an April 2012 secondary offering breached their fiduciary duties by selling shares while in possession of non-public, adverse information concerning the Company. Plaintiff further asserted a duty of loyalty claim against the directors who approved the sale. The Delaware Chancery Court dismissed the suit in February 2016 in an opinion by Chancellor Andre Bouchard because it found that the plaintiff failed to demonstrate that the procedurally required demand upon Zynga Inc.'s board of directors to initiate such litigation would have been futile.[1] The Delaware Supreme Court in an unusual 4-1 split decision reversed the Chancery Court's opinion on December 5, 2016. In doing so, the Supreme Court in a majority opinion written by Chief Justice Leo Strine found that the plaintiff had pled "particularized facts regarding three directors that create[d] a reasonable doubt that these directors can impartially consider a demand."

Takeaways

1. Facts Signaling a Close, Personal Bond Between Directors May Preclude a Finding of Independence. The Court of Chancery found that director Ellen Siminoff was independent even though she and her husband co-owned an airplane with founder and controlling stockholder Pincus. The Delaware Supreme Court in finding otherwise relied on plaintiff's argument that "owning an airplane together is not a common thing, and suggests that the Pincus and Siminoff families are extremely close to each other and are among each other's most important and intimate friends." Both the majority and the dissent called the decision on independence a close call and questioned the adequacy of the work done on behalf of the plaintiff. The majority supported its analysis with Delaware opinions that (1) found that a director was not independent for pleading stage purposes where the director had a friendship of over 50 years with an interested party and the director's primary employment was

1 Both the Chancery Court and the Delaware Supreme Court applied the test for demand futility articulated in Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993), whereby a plaintiff must plead particularized factual allegations that "create a reasonable doubt that, as of the time the complaint [was] filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."

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as an executive of a company over which the interested party had a substantial influence and (2) noted that if a friendship involved the parties serving as each other's maids of honors, being college roommates, sharing a beach house with their families each summer for a decade, and generally being as thick as blood relations, that context is different from parties who occasionally had dinner over the years, went to some of the same annual gatherings and referred to each other as "friends."

2. Designating a Certain Director As Non-Independent Under Stock Exchange Rules May Also Affect Whether a Director Can Be Considered Independent Under Delaware Law. The Court of Chancery likewise found that directors William Gordon and John Doerr were independent even though the Zynga board had previously determined that Gordon and Doerr did not qualify as independent directors under the NASDAQ Listing Rules. The Delaware Supreme Court in reversing the Chancery Court wrote that "to have a derivative suit dismissed on demand excusal grounds because of the presumptive independence of directors whose own colleagues will not accord them the appellation of independence creates cognitive dissonance that our jurisprudence should not ignore." The Court further noted that the fundamental determination a board must make to classify a director as independent under the NASDAQ rules—whether a director has a relationship which, in the opinion of the Company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director—is also relevant (but not dispositive) under Delaware law.

3. Mutually Beneficial Ongoing Business Relationships May Affect the Court's View on a Director's Independence. The plaintiff alleged that Gordon and Doerr were both partners at a venture capital firm that controlled 9.2 percent of Zynga's equity and that the same venture capital firm is also invested in a company that the controlling stockholder's wife co-founded and additionally invested in a company that another interested director serves on and invests in. Defendants attempted to argue that the relationships among these directors flowed all in one direction in which Pincus was beholden to the other directors for financing. In rejecting this contention, the Delaware Supreme Court noted that venture capital firms "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." The Court found that the combination of these facts and the Zynga board's determination that these two directors did not qualify as independent under the NASDAQ rules created a pleading stage reasonable doubt as to the ability of the directors to act independently.

For a full copy of the opinion, click here.

If you have any questions, please contact your Seyfarth attorney, Gregory A. Markel at *gmarkel@seyfarth.com* or Heather E. Murray at *hmurray@seyfarth.com*.

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