Old friends on the board

A recent case offers guidance on whether a close friendship may be seen as impairing a director's independence.

BY DOUG RAYMOND

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A recent Delaware Supreme Court opinion provides an important new touchstone in assessing the independence of directors. Director independence is crucial not only in derivative litigation, which was the issue in that case, but also in determining whether the directors are protected by the business judgment rule or have complied with their fiduciary duty to act solely in the best interests of the corporation and its stockholders.

Boards frequently review transactions involving a counterparty in which a director, officer or significant stockholder has a meaningful stake. These related party transactions often benefit the company, but they create potential conflicts of interest that need to be addressed. Where there is no conflict, courts give very broad deference to board action under the business judgment rule. However, when a conflict is asserted, this deference can vanish. If the board can show that its actions were not affected by the conflict, it can recover the protection of the business judgment rule.

In almost every case, the best way to do this is to show that the review and approval of a conflicted transaction were given only to disinterested directors who were not infected by the conflicts. This makes the disinterested director extremely important to effective governance.

In many companies, especially in more regional companies, there are many inter-relationships among the directors, officers and stockholders. Typical examples include: directors who served together on other boards, business associates or former co-workers, or country club friends. However, courts have usually rejected challenges to these sorts of relationships. Without a direct financial interest, courts have been understandably reluctant to parse which social or business relationships call into question a director's ability to satisfy the duty of loyalty.

In the recent case, *Delaware County Retirement Fund v. Sanchez*, the Delaware Supreme Court considered whether one of the directors was disinterested. This director of Sanchez Energy Corp. came under scrutiny for his several connections with the chairman of the corporation who was alleged to have engaged in several conflicted transactions with the company. The plaintiffs alleged that the director and his brother were executives of a company where the chairman was a director and the largest stockholder, he had been close friends with the chairman for over 50 years, he had donated $12,500 to the chairman's gubernatorial campaign, and the directors fees paid to him constituted over 30% of his total income. The lower court had examined each of these connections and concluded that they did not raise a reasonable inference that the outside director could not be objective in considering the demand for the litigation.

The Supreme Court reversed. It noted that the social, professional and other relationships should not be seen as separate issues, and should not be analyzed separately. Acknowledging that it was a close question, the court looked at all these relationships as part of a single tapestry. The court seemed especially influenced by the allegations that the director had been close friends with the interested party for a half century: "Close friendships of that duration are likely considered precious by many people, and are rare. People drift apart for many reasons, and when a close relationship endures for that long, an inference arises that it is important to the parties." But the court also focused on the parties' business relationships and distinguished prior case law that had rejected similar challenges based on allegations that the directors moved in the same business and social circles, and that they were close friends. These were distinguished as "thin social-circle friendships," not the deep connection that could impair a director's independence.

Earlier cases examining whether non-financial relationships could impair independence had focused on power relationships — whether a director was "beholden" to the targeted person, or needed to curry favor to retain benefits or avoid retaliation. Although *Sanchez* examined the directors' interlocking business relationships, which were an important aspect of its reasoning, the court was clearly influenced by the friendship between the two men, shifting away from focusing on relationships of power and control to, instead, considering their affinity. While in a footnote the court acknowledged that there could be a power relationship between the two friends, in light of the *Sanchez* case, boards now need to wrestle with the subtle issues of whether a court might conclude that a close friendship impairs the independence of their directors.

The independence of a director can be extremely significant to the corporation, with devastating consequences for a wrong judgment. *Sanchez*, while reflecting a truth about human relationships, has made it more difficult for boards to draw the line between old friends whose judgment could be clouded and "social circle friendships." ■

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