Director independence after Zynga

The second case in little over a year expands the grounds on which a director's independence may be challenged.

BY DOUG RAYMOND

The Delaware courts have seen many cases challenging transactions between a corporation and one or more directors or significant shareholders. More often than not, these transactions create conflicts of interest, as the interests of the director or shareholder diverge from those of the corporation. Such transactions can be challenged on the basis of that conflict of interest.

In its October 2015 decision *Del. Cty. Emps. Ret. Fund v. Sanchez*, the Supreme Court reversed a Chancery Court decision and held that a "close friendship" between a director and an interested party, unlike a "thin social-circle friendship," could undermine that director's independence. The Court gave little guidance on how to distinguish a close friendship from a less meaningful relationship, however, beyond emphasizing the parties' 50-year friendship as signaling the former.

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Recently, in its December 2016 decision in *Sandys v. Pincus ("Zynga"),* the Supreme Court again reversed the Chancery Court on the issue and revisited what relationships may prevent friends from being independent. Along the way, it created confusion for boards that need to have a clear understanding of where to draw these lines.

In *Zynga*, the plaintiff claimed that certain officers had breached their fiduciary duties to the corporation by selling shares on the basis of material, non-public information. The plaintiff also claimed the directors had breached their duty of loyalty when they exempted these sales from a blackout policy that would have otherwise barred them until after an earnings announcement. The sales instead occurred before the announcement, and after the announcement the stock price dropped sharply.

As these claims were derivative, under Delaware law, the plaintiff first needed to either ask that the board address the issue or show that this request would be futile. The defendants filed a motion to dismiss for plaintiff's failure to make such a demand on the board. The plaintiffs, in turn, claimed the demand would have been futile because a majority of the directors had relationships with the alleged wrongdoers that made them unable to exercise independent judgment on the issue. The Chancery Court sided with the defendants, reasoning that under the facts pleaded by the plaintiff, a majority of the board was independent.

The Supreme Court, however, disagreed. It focused particularly on one director. The Court found that she shared an "extremely close, personal bond" with ex-CEO and controlling stockholder Mark Pincus at the time she approved his stock sale.

This close bond was inferred by the Court because she and her husband co-owned a private airplane with Pincus. The plaintiff had alleged this co-ownership, but only as evidence of a business relationship, not a close personal friendship. The Court, however, found this co-ownership to suggest the existence of a close friendship.

The Court opined that two families owning an airplane together is not "a common thing," and, without additional evidence, that it demonstrated that the families had to be "extremely close to each other and are among each other's most important and intimate friends." The Court added that it "requires close cooperation in use," and that it is "suggestive of detailed planning indicative of a continuing, close personal friendship."

Indeed, the Court likened co-ownership to family ties, concluding that it would "heavily influence a human's ability to exercise impartial judgment." The Court thus found the director was interested.

Zynga signals the Supreme Court's willingness to look beyond economic ties and power relationships and focus on personal relationships. In doing so, the Court has shown it is more willing to look skeptically even at relationships where one party is not economically dependent upon another, but is simply a close, or allegedly close, friend. While the co-ownership of the airplane was an economic relationship, that was not the source of the lack of independence. The Court found that this economic relationship signaled not a power relationship, but such a close and ongoing personal connection that the director might not be impartial in considering the plaintiff's demand.

Corporate boards, and those who advise them, need to be able to identify which of their directors are independent. They must look beyond the business and financial ties that typically have been thought to undermine director independence, and must carefully scrutinize social and personal relationships among the directors, senior management and significant shareholders. This includes more than the friendship's duration, as was observed in *Sanchez*. In *Zynga*, it was co-ownership of a significant shared asset. It is not clear where the courts will go next. ■

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