Revisiting Independence

Has your board's director independence been properly assessed?

BY DOUG RAYMOND

One of the pillars of corporate law is the directors' fiduciary duty of loyalty to the corporation and its shareholders. In general, the duty of loyalty requires that a director, in making decisions, act on a disinterested and independent basis, in good faith, with an honest belief that the action is in the best interests of the company and its stockholders.

The duty of loyalty may be breached if a director's ability to do this is compromised. The most obvious example is a director who has a direct personal interest in a transaction being considered by the board. However, a breach of fiduciary duties is possible even without a direct financial conflict if a director has significant relationships with an interested party that reasonably call the director's independence and impartiality into question, such as financial or long-standing personal or social connections. As the courts have held, independence turns on whether "the director's ability to act impartially on a matter important to the interested party can be doubted because that director may feel either subject to the interested party's dominion or beholden to that interested party."

Independent corporate directors and independent board committees have long been crucial in many different contexts. For example, boards frequently rely on review by an independent committee of directors to persuade courts to dismiss litigation, or to shift or ease the board's burden of proof in conflict of interest transactions, and to reduce judicial scrutiny even of the sale of the entire company to a majority stockholder. But notwithstanding the importance of independence, there frequently have been effective challenges to the actual independence of a crucial director, suggesting that many boards have not taken the requirement seriously enough.

The importance of properly assessing director independence was highlighted by a recent Delaware Supreme Court case, *McElrath v. Kalanick*, which related to Uber's 2016 acquisition of an autonomous vehicle startup, Ottomotto LLC. After the deal closed, Google sued Uber and asserted that the founders of the target company had misappropriated proprietary Google intellectual property. Uber ended up settling the lawsuit by issuing a large amount of stock to Google and firing the alleged wrongdoer. An

Uber shareholder subsequently sued the board, alleging that when they approved the acquisition, the directors had breached their fiduciary duties by ignoring red flags and failing to properly investigate known problems.

Uber argued that the shareholder should have made a pre-suit demand on the board before pursuing the claims. (Under Delaware law, the board of directors normally has the exclusive right to decide whether the corporation should pursue litigation against others. When the board is disabled from making the decision, however — because of a direct conflict or lack of independence from those who are interested — a stockholder can control the litigation decision.) The plaintiff denied that he should have first gone to the Uber board and argued that the directors' conflict of interest because of their wrongdoing (in approving the acquisition) and lack of independence from the CEO excused the requirement to first make demand on the board.

The court disagreed with the plaintiff, finding, among other things, that the shareholder had not shown that the majority of the directors either had a conflict of interest or were not independent. Most interestingly, the plaintiff had asserted that one of the Uber directors was not independent because he had been appointed by the CEO during a power struggle at Uber and therefore was likely to be loyal to him. The court disagreed, saying that this alone was not enough to disqualify the director, otherwise any director appointed during a board conflict would be automatically disqualified. However, the court stated that a director could potentially be found not to be independent if the plaintiff had alleged additional facts, such as that the challenged director had a personal or financial connection to the CEO or that the directorship was "of substantial material importance to him."

The court's suggestion refers to the 2019 case of *In re BGC Partners, Inc. Derivative Litigation*, in which being a "go-to choice" for membership on boards controlled by the conflicted person was seen as persuasive indication of lack of independence. That is because it suggests a continuing pattern of financial ties (e.g., director fees from several companies) that in the aggregate could create a sense of obligation and make a director less likely to take action that would be adverse to the conflicted party.

While it is important that boards function in a collegial fashion, and it is human nature to look to friends and others with whom one has had good experiences, boards must be mindful that such relationships can create problems if and when the day comes when the board needs an independent committee.

Financial relationships may signal a lack of independence even where there is not a clearly dominant party. Courts have also evaluated "networks … of repeat players who cut each other into beneficial roles in various situations" and concluded that "precisely because of the importance of a mutually beneficial ongoing business relationship, it is reasonable to expect that sort of relationship might have a material effect on the parties' ability to act adversely toward each other." Indeed, director independence may be compromised even by relationships that are not entirely financial — as a close personal relationship may also do the trick. Although Delaware courts have long held that merely being on friendly terms or traveling in the same social circles does not result in lack of independence, facts indicating a closer personal bond may create problems.

While it is important that boards function in a collegial fashion, and it is human nature to look to friends and others with whom one has had good experiences, boards must be mindful that such relationships can create problems if and when the day comes when the board needs an independent committee. It is much better to have directors who, if needed, can function as independent from management and controlling shareholders. In any event, their independence will likely serve the board well even when there are no conflicts. ■

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