

Delaware Supreme Court Finds Relationships Taint Director Independence, Promotes Internet Searches

December 20, 2016 | Client Update | 3-minute read

Recently, the Delaware Supreme Court reversed the Court of Chancery in *Sandys v. Pincus* on findings of director independence at Zynga. The Court of Chancery had dismissed the suit for failure to make pre-suit demand on the board or alleging that demand would have been futile, but the Delaware Supreme Court found that the plaintiff had created a reasonable doubt that the board could have properly exercised independent, disinterested business judgment in responding to a demand. If director independence is compromised, then demand is excused.

The plaintiff had brought suit for breach of fiduciary duties after the board exempted several insiders, both top managers and directors, from its insider trading policy. The policy prevented sales until three days after earnings are announced. Instead, insiders sold 20.3 million shares for \$236.7 million at \$12 a share in a secondary offering before earnings. The share price dropped to \$8.52 a share after earnings, and even lower to \$3.18 a share three months later.

The Supreme Court was critical of the lack of specific information pled by the plaintiff, who only sought books and records of the insider transactions and not the board's determination on director independence. The Supreme Court also indicated that "one of the most obvious tools on hand is the rich body of information that can now be obtained by conducting an internet search," and found that the internet showed more information than what the plaintiff pled about the directors' relationships with management. The Supreme Court ultimately disagreed with the Court of Chancery with respect to the independence of three of the company's directors.

The Supreme Court determined that one director was not independent from the company's former CEO, chairman and controlling stockholder since she and her husband co-owned a private airplane with him. The opinion noted that a private plane is not a business venture and sharing one is not a common occurrence, and decided that it requires "an extremely close, personal" relationship that needs "close cooperation" in use. The sharing of the plane implied "detailed planning" that was indicative of a "continuing, close personal friendship." The dissenting judge argued that this appeared to be small plane and not a Gulfstream jet, an issue that came up during oral argument.

With respect to two other directors who are partners at a venture capital firm that controlled more than 9% of the company's equity and had overlapping investments with the former CEO, other members of management and their family members, the Supreme Court found relevant that the company itself did not view those directors as independent under the Nasdaq listing standards. The court noted that the criteria Nasdaq articulated as bearing on independence are pertinent under and influenced by Delaware law. Although not dispositive and even without any records regarding the board's determination, the court presumed that the board did not "lightly" classify those directors as not independent.

Particularly in the context of a company with a controlling stockholder, it appears that Delaware courts will evaluate both business and personal relationships carefully. Companies should also be mindful of what may come up in internet searches about those relationships, and how the courts will give weight to their own boards' findings of independence.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Ning Chiu

+1 212 450 4908

ning.chiu@davispolk.com

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.