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## CORPORATE GOVERNANCE

# Delaware Supreme Court Revisits Director Independence in Considering Derivative Demands

*In a recent decision, the Delaware Supreme Court has provided insight into the factors the Delaware courts will consider in assessing director independence in the context of derivative suits. These factors include personal relationships and the board's previous determinations under the stock exchange rules.*

*By John Mark Zeberkiewicz and Stephanie Norman*

In *Sandys v. Pincus*,[1] the Delaware Supreme Court reversed the Delaware Chancery Court's decision dismissing claims brought derivatively in the name of Zynga Inc. for plaintiff's failure to make a pre-suit demand or establish demand futility. In its reversal, the Supreme Court found that the plaintiff had pled particularized facts creating a pleading-stage reasonable doubt that a majority of Zynga's board was capable of impartially considering plaintiff's demand.[2] The Supreme Court's opinion provides insight as to the factors the Delaware courts will consider in assessing director independence in the context of derivative suits, including personal relationships and the board's previous determinations under the stock exchange rules.

## Background

Social gaming developer Zynga consummated its initial public offering on December 16, 2011.[3] In connection with the IPO, Zynga and its directors and officers entered into lock-ups prohibiting them from selling their shares until May 28, 2012.[4] On March 7, 2012, Zynga's board approved a secondary offering and granted exemptions to specified directors and executive officers (the "secondary offering participants"), permitting them to sell shares in the offering before the lock-up expiration.[5] At that time, the board consisted of eight directors, four of whom, including three directors who were also members of management, participated in the offering.[6]

In early April 2012, Zynga announced the completion of the secondary offering, in which a total of 49 million shares were sold at a price of $12 per share, with the secondary offering participants selling approximately 20 million shares for approximately $236 million in the aggregate.[7] Later that month, Zynga released its earnings, triggering a fairly precipitous drop in its stock price.[8] Disappointing results in the ensuing months led to further declines.

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On October 5, 2012, following Zynga's earnings announcement on October 4, 2012, in which it provided its updated full-year outlook and announced an impairment charge relating to an earlier acquisition, the stock was trading at $2.29 per share.[9]

Approximately two years after the completion of the secondary offering, after conducting an inspection of Zynga's books and records relating to the secondary offering under Section 220 of the Delaware General Corporation Law, plaintiff Thomas Sandys, the holder of 400 shares of Zynga's Class A Common Stock, commenced a derivative suit in the Chancery Court.[10] Plaintiff asserted three principal claims: (1) a so-called *Brophy*[11] claim against the secondary offering participants, alleging that they breached their fiduciary duties by misusing confidential information when they participated in the secondary offering while in possession of materially adverse, non-public information; (2) a claim for breach of fiduciary duty against the directors that approved the offering; and (3) a so-called *Caremark*[12] claim against all of the defendants, alleging breach of fiduciary duty for failing to put controls in place that would ensure public disclosures would not contain material omissions.[13] In making the claims, plaintiff alleged, among other things, that the prospectus for the secondary offering failed to disclose recent trends in Zynga's operating metrics, such as average booking per user and daily average users, that had begun to deteriorate.[14] Plaintiff also alleged that, although the prospectus listed Zynga's reliance on Facebook as a risk factor, it failed to disclose imminent changes to Facebook's newsfeed that were expected to negatively affect Zynga's performance.[15]

## The Chancery Court's Demand Futility Analysis

After finding that all of plaintiff's claims were derivative in nature,[16] the Chancery Court addressed whether plaintiff's requirement to make a demand on the board had been excused.[17] As a threshold matter, the Court considered whether to apply the test under *Aronson*[18] or *Rales*[19] for addressing demand futility.[20] Under *Aronson*, the plaintiff is required to "plead facts creating a reasonable doubt either that the 'directors are disinterested and independent' or that 'the challenged transaction was otherwise the product of a valid exercise of business judgment.' "[21] By contrast, under *Rales*, which applies in those situations in which "the board that would be considering the demand did not make a business decision which is being challenged in the derivative suit," the key inquiry is whether the plaintiff pled facts creating "a reasonable doubt that 'the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand' *at the time the complaint was filed*."[22]

The decision of which test to apply to each claim was complicated in some respects by the change in the composition of Zynga's board between the time that the board approved the secondary offering and the time at which plaintiff's complaint was filed. At the time of the secondary offering, there were eight directors, consisting of Mark J. Pincus, Zynga's founder and controlling stockholder who served as Chief Executive Officer from 2007 to 2013, John Schappert, who served as Chief Operating Officer from May 2011 to August 2012, Owen Van Natta, who served as Executive Vice President and Chief Business Officer from August 2010 to November 2011, Reid Hoffman, William Gordon, Jeffry Katzenberg, Stanley J. Meresman and Sunil Paul.[23] The directors who had held executive offices, as well as Reid Hoffman, were secondary offering participants; the other directors were not. By the time the complaint was filed, however, two members of the board, Schappert and Van Natta, had left the board, and three new directors, John Doerr, Ellen Siminoff, and Don Mattrick (who was then serving as Chief Executive Officer), had joined the board.[24]

The Court determined that *Rales* applied to each of the claims. As to the *Brophy* claim, the Court found that, although four of the defendants were directors at the time of the offering, their decision to sell was individual to them, and not the result of a business decision of the board.[25] On the breach of fiduciary duty claim relating to the secondary offering, the Court noted that "a good argument could be made" for the application

of *Aronson*, given that a majority of the directors who had approved the second offering continued to serve on the board. Nevertheless, it determined to apply *Rales*, pointing to the change in the composition of the board between the time of the secondary offering and the time of plaintiff's complaint.[26]

The Court indicated that *Aronson*, the application of which relates to the board that approved the transaction rather than the board charged with deciding how to respond to a demand, introduced various challenges.[27] Although it acknowledged that none of the exceptions to the application of *Aronson* identified in *Rales* applied by its terms,[28] the Court found that "enough of the interested members of that board were replaced (and an additional director was added)" such that the board charged with considering the demand—*i.e.*, the board in place at the time the complaint was filed, or the "demand board"—was composed of a majority of directors who had received no personal benefit from the underlying transaction.[29] Finally, as to the *Caremark* claim, the Court found that the *Rales* test applied, given that the underlying claim—a failure of the board's duty of oversight—did not involve a business decision on the part of the board.

Applying *Rales*, the Court proceeded to assess whether plaintiff had pled particularized facts creating a reasonable doubt that at least five of the nine directors on the demand board were disinterested and independent. With respect to the *Brophy* claim, the Court noted that only two members of the demand board, Pincus and Hoffman, had participated in the offering—and were therefore interested.[30] Thus, plaintiff's burden was to create a reasonable doubt as to the independence of the other seven members of the demand board vis-à-vis the two participating directors.

Conducting a director-by-director analysis, the Court found that plaintiff had not pled facts creating a reasonable doubt as to the independence of five of the nine directors. The Court found that plaintiff had alleged no facts challenging Katzenberg's independence, and that plaintiff's only fact calling into question Meresman's independence was that Meresman and Hoffman served together on the board of LinkedIn.[31] On the latter point, the Court found that common membership on a board, standing alone, is insufficient to challenge a director's independence.[32]

The Court then noted plaintiff had challenged Siminoff's independence on the basis that she and her husband jointly owned a private airplane with Pincus, that she was a "close family friend" of Pincus, and that she and Pincus both served as directors of Mozilla Corporation. The Court found that the co-ownership of the airplane, as well as the allegation, without further factual development, of a close personal friendship, standing alone, "did not reveal a sufficiently deep personal connection" between Siminoff and Pincus to raise doubts as to Siminoff's independence from him.[33] Additionally, as with Meresman, Siminoff's common membership with Pincus on Mozilla's board was insufficient to challenge her independence.[34]

Next, the Court reviewed plaintiff's challenges to the independence of Gordon and Doerr, most of which were based principally on their status as partners of venture capital fund Kleiner Perkins Caufield & Byers.[35] Plaintiff first argued that Gordon and Doerr were not independent of Hoffman, because Hoffman invested in and sits on the board of a company in which Kleiner Perkins had invested.[36] The Court rejected plaintiff's argument that the relationships left Gordon and Doerr disinclined to threaten their business relationship with Hoffman, finding that "an alleged risk of straining a relationship is a far cry from an allegation that one director is beholden to or deeply connected to" another director.[37] Next, plaintiff argued that Gordon and Doerr had " 'interlocking business relationships' " with Hoffman and Pincus due to the fact that Kleiner Perkins and Hoffman both invested in a company that Pincus' wife founded.[38] The Court found that plaintiff failed to explain how Hoffman and Kleiner Perkins' investments rendered Gordon or Doerr beholden to Pincus or Hoffman.[39] The Court then considered plaintiff's allegation that Zynga and certain of its executive officers had invested $500,000 in funds of Kleiner Perkins, but found it lacking. It explained that plaintiff had not alleged that the invested amount was so

material to Kleiner Perkins as to render its partners beholden to Pincus.[40]

The Court then addressed plaintiff's allegation that Zynga's 2013 proxy statement did not list Gordon and Doerr as independent directors under the NASDAQ listing rules.[41] The Court indicated that qualifications under the stock exchange rules, while useful in assessing independence, are not dispositive, as they set forth "bright-line tests" and do not precisely replicate the fact-specific and fact-intensive inquiry involved in assessing independence under Delaware law.[42] The Chancery Court found that plaintiff had made "no specific allegations as to why Gordon and Doerr lack independence under the NASDAQ rules, or whether they lack independence under those rules due to a relationship with Pincus, with another executive, or with Zynga itself."[43] As there were no such allegations, the Court was unable to determine whether Gordon's and Doerr's failure to satisfy the independence tests under the NASDAQ rules was the result of factors that the Court had already considered (and found wanting) or from factors other than those alleged.[44]

## The Supreme Court's Reversal

In an opinion highlighting "the wisdom of the representative plaintiff bar heeding the repeated admonitions" of the Delaware courts to make a pre-suit investigation into the directors' independence,[45] the Delaware Supreme Court reversed the Chancery Court, holding in a *de novo* review that the plaintiff had managed "to plead particularized facts regarding three directors that create a reasonable doubt that these directors can impartially consider a demand."[46] Finding that Pincus and Hoffman, both of whom participated in the secondary offering, were not disinterested, and that Mattrick, as CEO, could not be considered independent in considering a demand involving Zynga's controlling stockholder (Pincus), the Supreme Court focused its inquiry on whether the plaintiff had pled particularized facts creating a reasonable doubt as to the independence of at least two of the other six directors.[47]

Because neither party contested its application on appeal, the Supreme Court applied the *Rales* test to determine whether the Chancery Court had erred in finding that a majority of the directors at the time of plaintiff's complaint were, for pleading-stage purposes, disinterested and independent.[48] The Supreme Court stated that, at the pleading stage, the question of director independence hinges on " 'whether the plaintiffs have pled facts from which 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.' "[49]

Notably, the Supreme Court found that the Pincus and Siminoff families' co-ownership of an airplane was an "unusual fact" creating an inference that Siminoff could not act independently vis-à-vis Pincus.[50] "Co-ownership of a private plane involves a partnership in a personal asset that is not only very expensive, but that also requires close cooperation in use, which is suggestive of detailed planning indicative of a continuing, close personal friendship."[51] The Supreme Court found that the arrangement was indicative of the type of "close personal relationship" that would influence a director's ability to act impartially.[52] In reaching this conclusion, the Supreme Court noted its recent opinion in *Sanchez*,[53] where it had found that a director whose friendship with an interested party spanned over 50 years and who was employed as an executive of a company over which the interested party had substantial influence was sufficient to create an inference at the pleading stage that the director could not act impartially toward the interested party.

Turning to Gordon and Doerr, the Supreme Court agreed with the Chancery Court's assessment that Delaware law does not defer automatically to the stock exchange's independence criteria, but rather engages in a context-specific analysis.[54] Nevertheless, the Supreme Court indicated that the Chancery Court placed undue weight on the presumptive independence of directors under Delaware law, stating 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."[55] The Supreme Court noted that, under the NASDAQ rules, "a director is not independent if she 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.' "[56] The Supreme Court presumed that Zynga's board did not make lightly its decision not to accord Gordon and Doerr independent director status.[57] It expressed skepticism that directors whose fellow directors could not affirm their independence would be independent for purposes of considering a demand.[58]

The Supreme Court indicated that the Zynga board, in making its independence determination regarding Gordon and Doerr, likely took into account the same facts that plaintiff pled in its complaint.[59] The Supreme Court continued, however, to note the "reality … that firms like Kleiner Perkins 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."[60] While noting that there is no inherent wrong in such arrangements, and that they are "crucial to commerce," the Supreme Court held that the "importance of a mutually beneficial ongoing business relationship" could reasonably be expected to influence the parties' ability to act impartially toward one another.[61]

## Conclusion

The Supreme Court's opinion in *Pincus* provides guidance as to the Delaware courts' views on personal and other relationships for determining whether a derivative plaintiff has sufficiently cast doubt on the independence of directors at the pleading stage for demand futility purposes. The opinion also highlights that, while they will not consider them dispositive, the Delaware courts will take into account independence criteria under the stock exchange listing rules for such purposes.

### Notes

1. — A.3d —, 2016 WL 7094027 (Del. Dec. 15, 2016).
2. *Id.* at *1.
3. *Sandys v. Pincus*, 2016 WL 769999, at *3 (Del. Ch. Feb. 29, 2016).
4. *Id.*
5. *Id.*
6. *Id.*
7. *Id.*
8. *Id.* at *4.
9. *Id.*
10. *Id.* at *5.
11. *Brophy v. Cities Serv. Co.*, 70 A.2d 5 (Del. Ch. 1949).
12. *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).
13. *Pincus*, 2016 WL 769999, at *5.
14. *Id.* at *3.
15. *Id.*
16. *Id.* at *5. The Court found that the *Brophy* and *Caremark* claims were derivative because any harm from the misuse of information or lack of oversight of disclosures would redound upon Zynga itself—and only indirectly to stockholders. *Id.* The Court also found that plaintiff's breach of fiduciary duty claim was derivative based on the relief being sought—namely, recovery stemming from the alleged reputational harm to Zynga and from liabilities in the federal securities law and other proceedings relating to the offering. *Id.*
17. *Id.* at *6. Delaware Court of Chancery Rule 23.1(a) provides that a derivative plaintiff must, in its complaint, "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Ct. Ch. R. 23.1(a). Thus, to avoid dismissal on Rule 23.1 grounds, the plaintiff must either make a demand on the board or demonstrate that making a demand would be futile.
18. *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984).
19. *Rales v. Blasband*, 634 A.2d 927, 933–34 (Del. 1993).
20. *Pincus*, 2016 WL 769999, at *6.
21. *Id.*
22. *Id.*, at *6 (emphasis added). As an example, the Court noted that *Rales*, rather than *Aronson*, would apply in

situations in which "a majority of the members that made the challenged decision have been replaced." *Id.*

23. *Id.* at *2.
24. *Id.*
25. *Id.* at *6.
26. *Id.* at *11.
27. *Id.*
28. The *Rales* court stated: "[A] court should not apply the *Aronson* test … where the board that would be considering the demand did not make a business decision which is being challenged. This situation would arise in three principal scenarios: (1) where a business decision was made by the board of a company, but a majority of the directors making the decision have been replaced, (2) where the subject matter of the derivative suit is not a business decision of the board, and (3) where … the decision being challenged was made by the board of a different corporation." *Rales*, 634 A.2d at 934.
29. *Pincus*, 2016 WL 769999, at *12. The Court expressed its view that "it makes no sense under these circumstances to focus any aspect of the demand futility inquiry on the board that approved the underlying transaction, as the second prong of *Aronson* contemplates." *Id.* Nevertheless, the Court noted that the "*Rales* test investigates the same sources of potential partiality that *Aronson* would examine" and "functionally covers the same ground" in assessing directors' impartiality. *Id.*
30. *Id.* at *6.
31. *Id.* at *7-8.
32. *Id.* at *8.
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.*
40. *Id.* at *9.
41. *Id.* at *9-10.
42. *Id.* at *9.
43. *Id.* at *10.
44. *Id.*
45. *Pincus*, 2016 WL 7094027, at *1. The Supreme Court noted, however, that plaintiff's decision to seek books and records relating only to the underlying transaction, and not the directors' independence more generally, had "compounded the already difficult task" of the Chancery Court in making close calls as to director independence at the pleading stage. The Supreme Court also indicated that, in addition to conducting a review of books and records under Section 220, prospective plaintiffs should use all the tools at hand, including Internet searches, to generate reliable sources of information (*e.g.*, articles in reputable publications) from which particularized facts regarding director independence could be adduced. *Id.* at *4.
46. *Id.* at *2.
47. *Id.* at *3.
48. *Id.*
49. *Id.* (citing *Del. Cty. Emps. Ret. Fund v. Sanchez*, 124 A.3d 1017, 1021 (Del. 2015)).
50. *Pincus*, 2016 WL 7094027, at *4.
51. *Id.*
52. *Id.*
53. 124 A.3d 1017, 1022 (Del. 2015).
54. *Pincus*, 2016 WL 7094027, at *5.
55. *Id.*
56. *Id.* at *6 (citing NASDAQ Marketplace Rule 5605(a)(2)).
57. *Pincus*, 2016 WL 7094027, at *6.
58. *Id.* The Supreme Court stated: "[A]lthough we do not know the exact reason the board made this determination, we do know this. In the case of a company like Zynga, which has a controlling stockholder, Pincus, who wields 61 percent of the voting power, if a director cannot be presumed capable of acting independently because the director derives material benefits from her relationship with the company that could weigh on her mind in considering an issue before the board, she necessarily cannot be presumed capable of acting independently of the company's controlling stockholder. That a director sits on a controlled company board is not, and cannot of course, be determinative of director independence at the pleading stage, as that would make the question of independence tautological. But, our courts cannot blind themselves to that reality when considering whether a director on a controlled company board has other ties to the controller beyond her relationship at the controlled company." *Id.* In her dissenting opinion, Justice Valihura

was less persuaded by plaintiff's bare allegation that such directors were not designated as independent under the NASDAQ rules, stating: "It is not difficult to come up with a scenario where a director might be deemed 'not independent' under the NASDAQ or NYSE rules, yet deemed independent for demand futility purposes." *Id.* at *8. Justice Valihura noted, for example, that there were no facts alleged to clarify whether such directors' "non-independent" designation was due to a relationship with Zynga, Pincus or another executive, and that plaintiff should have submitted a request for books and records under Section 220 on the matter.

59. *Id.* at *7.
60. *Id.* Specifically, the Supreme Court noted Kleiner Perkins' 9.2 percent equity ownership in Zynga, Kleiner Perkins' investment in the company Pincus' wife founded, and Kleiner Perkins' investment in a company in which Hoffman is also invested and on whose board he and another Kleiner Perkins partner sit. *Id.*
61. *Id.*