

Client Alert

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DE Court Rejects Challenge to Related-Party Transaction Approved by Audit Committee

In *In re Sanchez Energy Deriv. Litig.*, Consol. C.A. No. 9132-VCG, memo. op. (Del. Ch. Nov. 25, 2014), the Delaware Court of Chancery dismissed a derivative complaint challenging a related-party transaction. The court held that the plaintiff failed to sufficiently allege that the three members of the company's audit committee who approved the transaction were not disinterested and independent. The decision reaffirms Delaware law, requiring plaintiffs to plead facts with particularity when challenging the decisions of outside directors in derivative litigation.

Background

Sanchez Energy Corporation had a five-member board consisting of two members of its founding family and three outside directors. The company entered into a transaction with an entity controlled by the founding family to purchase certain "working interests" in a shale project. The transaction was approved by the other three directors in their capacity as members of the board's audit committee.

Court's Decision

Under Delaware law, a derivative plaintiff must make a demand on the board of directors to initiate litigation or show why demand was excused. The plaintiff argued that demand would have been futile because two of the outside directors were not independent due to their relationships with the founders outside of the company. One of the founders was a director at another company which had a subsidiary that employed one of those directors. The court held, however, that the complaint did not sufficiently explain how the founder, as "one of nine directors on the board of a parent corporation... could exert power to remove an executive in a subsidiary corporation." The court also concluded that the fact that the director had contributed \$12,500 to one of the founders' political campaigns 11 years earlier did not support a lack of independence.

With respect to the other outside director, the plaintiff alleged that such director was a co-investor with the founding family in certain ventures and thus not independent. The court disagreed, stating that it was "not apparent from the allegations in the Complaint why [the founder's] minority interest in two companies in which [the outside director] owns a large equity interest would cause [that outside director] to abandon his fiduciary duties to favor [the founder]."

The court also found that the plaintiff failed to show that the founders, who had two of five board seats and collectively owned 21.5% of the equity of Sanchez Energy, should be treated as a controlling stockholder and thus warrant heightened scrutiny under the entire fairness standard. In addition, the court held that the plaintiff failed to allege the transaction was not otherwise the product of a valid exercise of business judgment. Among other things, the court found that the complaint lacked detail about how the transaction was negotiated, other than to indicate the transaction was approved by the audit committee and that the audit committee had engaged a financial advisor.

Conclusion

Sanchez Energy reaffirms Delaware’s pleading standards in derivative suits – conclusory allegations challenging a director’s independence will not suffice. To challenge a director’s independence, a plaintiff “must allege particularized facts manifesting ‘a direction of corporate conduct in such a way as to comport with the wishes or interests of the [person] doing the controlling.’” In addition, when a plaintiff attempts to do so based on a director’s external relationships with the interested party, *Sanchez* held that “the nature of that relationship must be of a kind that would support a reasonable inference that ‘*the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director*’ (emphasis added).

Still, boards of directors and in-house counsel should be vigilant in monitoring directors’ independence under a variety of standards or definitions, including Securities and Exchange Commission rules, stock exchange listing standards, corporate governance guidelines, committee charters, and common law. The court acknowledged that “[i]t is a fact of human nature that close personal relationships can influence decisionmaking, even, in certain circumstances, at the expense of moral and legal strictures such as fiduciary duties.” But under Delaware law, mere personal friendships and business relationships are not sufficient to strip a director of his or her independence. Directors and their advisors should remain attentive to this issue, however, because it is contextual based on the circumstances present.

It should also be noted that the plaintiff in *Sanchez Energy* failed to inspect the company’s books and records prior to filing the lawsuit. Delaware courts have repeatedly admonished plaintiffs for not conducting a books and record inspection, which can provide information that might allow a plaintiff to successfully plead demand futility. Thus, companies should continue to take seriously such inspection requests since they are precursors to stockholder litigation.

Contact

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