

# Client Alert

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## Co-Owning an Airplane and Other Things That May Affect Director Independence

Twice in 14 months, the Delaware Supreme Court has reversed findings that outside directors were independent. In the most recent opinion of *Sandys v. Pincus*, the court said that an outside director's co-ownership of an airplane with an interested party sufficiently questioned that director's independence because it was "suggestive of an extremely intimate personal friendship." The court also held that the plaintiff sufficiently pled that two other directors lacked independence where their affiliated venture capital fund had interlocking business relationships with interested parties.

### The *Pincus* Opinion

*Sandys v. Pincus* involved a derivative complaint challenging the sale of Zynga, Inc.'s common stock in a secondary offering.<sup>1</sup> The plaintiff alleged that Zynga's controlling stockholder and certain other insiders sold the stock while in possession of material nonpublic information and that the board of directors breached its fiduciary duties in granting waivers under lock-up agreements to permit the sales. The issue before the court was whether a majority of Zynga's board of directors was capable of considering a stockholder demand to initiate litigation against the interested parties. Under *Rales v. Blasband*,<sup>2</sup> the plaintiff had to allege particularized factual allegations creating a reasonable doubt that, when the complaint was filed, the board could have properly exercised its independent and disinterested business judgment in responding to the demand.

The Court of Chancery held that the plaintiff had not met this burden and dismissed the complaint. In doing so, the Court of Chancery noted that the plaintiff did not heed prior admonitions of the Delaware courts to conduct a books and records inspection prior to commencing litigation. The Delaware Supreme Court, however, reversed the Court of Chancery, finding that the complaint sufficiently questioned whether a majority of the directors were capable of considering the demand.

### *Co-Ownership of an Airplane*

The Delaware Supreme Court focused first on an outside director who, according to Zynga's proxy statement, co-owned a private airplane with the controlling stockholder. Chief Justice Leo E. Strine, Jr., writing for the majority, explained that:

owning an airplane together is not a common thing, and suggests that the [controller's and the outside director's respective] families are extremely close to each other and are among each other's most important and intimate friends. 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. In fact, it is suggestive of the type of very close personal relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment.

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<sup>1</sup> No. 157,2016 (Del. Dec. 5, 2016).

<sup>2</sup> 634 A.2d 927 (Del. 1993).

The court held that, for pleading purposes, the alleged co-ownership of an airplane was an “unusual fact” suggestive of an “extremely intimate personal friendship” that could prevent the director from independently assessing the derivative demand.

#### *Interlocking Business Relationships*

Next, the court turned to two other outside directors, both of whom were affiliated with a venture capital fund that owned 9.2% of Zynga’s stock. The complaint alleged that the venture capital fund (1) also had invested in a company that the controller’s wife had co-founded and (2) had invested in another company along with one of the other interested directors (and that the interested director was also a director of that other company). The court explained that venture capital funds “compete with others to finance talented entrepreneurs like [the controller], and networks arise of repeat players who cut each other into beneficial roles in various situations.” It continued that, in some circumstances, interlocking business relationships can be significant and “give rise to human motivations comprising the participants’ ability to act impartially toward each other on a matter of material importance.”

#### *Lack of Independence Under Nasdaq Listing Rules*

The plaintiff also alleged that, as disclosed in Zynga’s proxy statement, the two outside directors affiliated with the venture capital fund were not determined by the board to be “independent” under Nasdaq Listing Rules. Zynga’s public disclosures did not explain why those directors were not considered independent. Nevertheless, the Delaware Supreme Court said that “the criteria NASDAQ has articulated as bearing on independence are relevant under Delaware law and likely influenced by our law.” The court concluded that, in the case of a controlled company like Zynga, “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.”

#### **A Dissenting View**

The Delaware Supreme Court’s decision was 4-1, with Justice Karen L. Valihura issuing a dissenting opinion which criticized the lack of specificity in the plaintiff’s complaint. Although viewing the issue as a “close case,” Justice Valihura emphasized that, under Delaware law, the plaintiff has the burden to plead facts with particularity as to why the directors were not independent. She then explained why she believed the pleadings were deficient. She noted, for example, that:

- the plaintiff had not pled the type of airplane that was co-owned (i.e., whether it was “a \$40,000 Piper Cub or a \$40 million Gulfstream jet”), and thus had not addressed the economic significance of that relationship;
- the complaint did not specifically claim the outside director was a “close personal friend” of the controller, and instead alleged there was a business relationship but without any particularized facts as to why it was material;
- the plaintiff failed to plead any facts about the size, profits, or materiality to the venture capital fund’s board representatives of the interlocking business relationships; and
- the plaintiff never pled why the venture capital fund’s board representatives were not determined by the board to be independent under Nasdaq Listing Rules.

As to the latter point, Justice Valihura noted that the factors considered by Zynga’s board in assessing those directors’ independence might not be relevant to those directors’ ability to consider a demand to sue the controller or other interested parties.

## Remember the *Sanchez* Case

*Pincus* comes approximately 14 months after the Delaware Supreme Court's decision in *Delaware County Employees Retirement Fund v. Sanchez* ([Relationships Outside the Company Can Cause Conflicts of Interest in the Boardroom](#)). Like *Pincus*, the *Sanchez* court reversed the Court of Chancery's determination that a majority of directors were independent for purposes of considering a derivative demand. In *Sanchez*, Chief Justice Strine said the Court of Chancery had improperly considered the various allegations made against the outside director "in isolation from each other" rather than in their "totality."

In reversing, *Sanchez* considered the following allegations made against an outside director in challenging his independence vis-à-vis the company's chairman:

- (1) he and the chairman were "close friends for more than five decades";
- (2) he had donated \$12,500 to the chairman's failed gubernatorial campaign;
- (3) both the outside director and his brother worked as executives of an entity where the chairman was both the "largest stockholder" and a non-independent director, and that the entity did business with the company; and
- (4) the director fees paid to the outside director constituted 30-40% of his total income.

## Conclusion

*Pincus* is another reminder that director independence can be highly contextual when a board is dealing with an interested party – such as responding to a derivative demand to sue a fellow director. While Delaware law provides great predictability on some issues, it can be difficult to draw bright lines around some potential conflicts of interest. Still, Delaware courts look for material and durational economic relationships as opposed to social relationships. In fact, *Sanchez* emphasized it was not changing the law under *Beam v. Stewart*, which rejected challenges to director independence based on "[m]ere allegations that [directors] move in the same business and social circles, or a characterization that they are close friends."

Courts can also be expected to scrutinize certain board decisions where outside directors are not deemed "independent" under applicable stock exchange rules. Although such status is not necessarily dispositive, Chief Justice Strine said it could create "cognitive dissonance" to treat a director as independent when that director's "own colleagues will not accord them the appellation of independence." Thus, boards should be cautious when a director who is not independent under applicable listing standards is called to act as an independent board member with respect to an interested transaction.

*Pincus* should also be studied by venture capital and private equity funds whose portfolio companies may give rise to interlocking relationships with interested parties. Chief Justice Strine expressed his view as follows: "Although it is true that entrepreneurs like the controller need access to venture capital, it is also true that venture capitalists compete to fund the best entrepreneurs and that these relationships can generate ongoing economic opportunities. There is nothing wrong with that, as that is how commerce often proceeds, but these relationships can give rise to human motivations compromising the participants' ability to act impartially toward each other on a matter of material importance."

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