Client Alert

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Relationships Outside the Company Can Cause Conflicts of Interest in the Boardroom

Directors and chief executive officers often operate in overlapping social and business networks. For that reason, directors should take note of the Delaware Supreme Court's recent decision in *Delaware County Employees Retirement Fund v. Sanchez*. The court concluded that an outside director's personal and business relationships with an insider created a reasonable doubt about the outside director's independence when approving a related-party transaction. As a result, the court reversed a lower court's ruling and thus allowed stockholders to proceed with a derivative lawsuit challenging the fairness of the transaction. The Delaware Supreme Court's opinion provides important insight into how judges will analyze personal and business relationships outside the boardroom. The opinion is also instructive on the scrutiny that Boards should apply in (1) determining the Board's composition; (2) recruiting, onboarding, and evaluating directors; and (3) assessing the process employed for approving transactions which may have the appearance of being compromised by the extent of a director's personal and business relationships with senior management of the company.

Background

The derivative suit was brought on behalf of Sanchez Energy Corporation (the "Company"). It challenged transactions between the Company and another entity that was owned by the Company's Chairman and his son, who was the Company's President. The Company's Board consisted of the Chairman, the President, and three outside directors.

To show that demand was excused, the plaintiffs had to show that a majority of the board was incapable of considering whether to bring the lawsuit. Because two of the five directors were insiders, this meant the plaintiffs had to show that at least one of the remaining three directors was not disinterested and independent. The plaintiffs focused most of their arguments on one outside director in particular, alleging:

(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 a company where the Chairman was the "largest stockholder" and a non-independent director and with which the Company did business; and

(4) the director fees paid to the outside director constituted 30-40% of his total income.

The Court of Chancery held that these allegations did not create a reasonable inference that the outside director was incapable of independently considering the derivative demand. As a result, it dismissed the lawsuit.

Delaware Supreme Court's Opinion: Outside Relationships Matter

Chief Justice Leo E. Strine Jr., writing for the court, held that the Court of Chancery improperly considered the various allegations made against the outside director "in isolation from each other" and not in their "totality." The court said that allegations challenging a director's independence must be "considered in full context" and that, while each allegation standing alone might have been insufficient, they collectively cast doubt on whether the outside director was independent of the Chairman and his son. In reaching this decision, the court focused on (i) "a close friendship of over half a century" between the outside director and the Chairman and (ii) the fact that the Chairman had "substantial influence" over the outside director's (and his brother's) employer.

Importantly, the supreme court contrasted this holding with its 2004 decision in *Beam v. Steward*, where it said that "[m]ere allegations that [directors] move in the same business and social circles, or a characterization that they are close friends, is not enough to negate independence." The court explained that the *Sanchez* plaintiffs' allegations rose above the "kind of thin social-circle friendship ... at issue in *Beam*." It further said that *Beam* did not foreclose a finding that "deeper human friendships" could have "the effect of compromising a director's independence."

The supreme court then reiterated that the plaintiffs had not focused solely on social relationships, but had also made allegations of business relationships – namely, that the outside director and his brother were employed at a company where the Chairman was a large stockholder and non-independent director. In their totality, the pleadings gave rise to an "inference that [the outside director's] economic positions derive in large measure from his 50-year close friendship with [the Chairman], and that he is in these positions because [the Chairman] trusts, cares for, and respects him."

Of particular note, the defendants argued that the Chairman, as a non-controlling stockholder and one of several board members at the outside director's current employer, did not have the power to terminate the outside director's employment. Consequently, they said the outside director was not beholden to the Chairman because, presumably, terminating his employment would require the approval of a majority of the directors of his employer. The supreme court said, however, that the power to hire and fire was not dispositive in determining whether the outside director was independent of the Chairman.

Observations and Recommendations

Business and Social Relationships: *Sanchez* reflects the very fact-dependent nature of personal and business relationships and the holistic review that Delaware courts may employ when analyzing director independence. Typically, social and business relationships have not stripped outside directors of their independence, and this opinion certainly does not stand for the proposition that directors and officers must be completely free of such outside relationships. In fact, such overlapping networks can be beneficial for the company. The supreme court clearly cautioned, however, that *Beam v. Stewart* does not foreclose stockholder lawsuits supported by well-pled arguments challenging the scope, depth, and duration of personal and business connections between a director and an interested party.

Small Boards are Most Vulnerable: In *Sanchez*, the Company had a five-member board in which two of the directors were father/son insiders. Because Delaware law generally defers to board decisions made by a majority of independent directors, plaintiffs only had to challenge the independence of one of the three outside directors. The result in this litigation could have been quite different had the board included more outside directors.

Board Composition: *Sanchez* deserves attention from nominating committees in reviewing potential director candidates and in assessing the composition of a board as a whole. It also deserves attention from boards in assessing the independence of directors even when they satisfy the "bright-line" independence tests under applicable stock exchange rules. Nothing in *Sanchez* or prior Delaware case law means that a director cannot have a preexisting relationship with the company, senior management,

or other directors. Indeed, directors are frequently selected because they are known to incumbent directors. But *Sanchez* shows that even if a director satisfies specific stock exchange independence requirements, a court may still find that the director lacks independence in the context of a particular transaction. Boards may also want to review their director questionnaires to determine whether they prompt the kinds of responses necessary to fully evaluate connections which may support subsequent challenges.

The Power to Hire/Fire: Governance issues created by interlocking boards are not new, particularly in the context of compensation committees where an insider can influence the compensation of a director at another company. Still, *Sanchez* clearly stated that "[a] lack of independence does not turn on whether the interested party can directly fire a director from his day job." Board interlocks thus need to be examined carefully to evaluate an insider's influence on an outside director and how it could affect his or her independence. It should be noted, however, that the Chairman appears to have owned 14% of the outside director's employer and that the employer was founded by the Chairman's father (even though, for procedural reasons, these allegations were not considered by the supreme court).

Books and Records Inspections: Delaware courts continue to admonish plaintiffs for not conducting books and records inspections prior to making demand futility arguments. In addition, the *Sanchez* court criticized the plaintiffs for making factual arguments on appeal that were not included in their complaint. At the same time, the court acknowledged that social and business relationships may not be uncovered by books and records inspections, perhaps suggesting some pleading sympathy for plaintiffs in this area.

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