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# DIRECTOR INDEPENDENCE AND THE IMPACT OF BUSINESS AND PERSONAL RELATIONSHIPS

*Robin Alexander\**

## I. INTRODUCTION

Corporate governance reform has often focused on the need for, and the role of, independent directors on the board. The rules of the New York Stock Exchange (NYSE) and Nasdaq Stock Market (Nasdaq) require that listed companies (1) include a majority of independent directors on the board<sup>2</sup> and (2) allow only independent directors to serve on the audit, compensation, and nominating committees.<sup>3</sup> Delaware law does not require the use of independent directors but does provide greater deference to decisions by boards that do.<sup>4</sup>

Under Delaware law,<sup>5</sup> directors typically lack independence when they receive a material financial income stream from the company.<sup>6</sup> Directors can also lose their status as independent as a result of business and personal relationships with management.<sup>7</sup> Nonetheless, the courts have evidenced impatience with challenges to independence on these

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2. N.Y.S.E. Listed. Co. Manual. § 303A.01 (2013); Nasdaq Listing Rules 5605(b)(1) (2009).

3. N.Y.S.E. Listed. Co. Manual §§ 303A.04(a), .05(a), .07(a) (2013); Nasdaq Listing Rules 5605(c)(2)(A) (2010); Nasdaq List. R. 5605(d)(2)(A) (2013); Nasdaq List. R. 5605(e)(1) (2013); Nasdaq List. R. 5605(e)(5) (2013).

4. *See infra* notes 9-10.

5. The stock exchanges use similar definitions of independence. Under N.Y.S.E. Listed Co. Manual § 303A.02 (2013), “no director qualifies as ‘independent’ unless the board of directors makes an affirmative determination that the director has no material relationship with the listed company.” In addition, directors lack independence under the listing standard if they fall within a number of categorical exclusions, including (1) serving as an employee of the company; (2) receiving over \$120,000 in direct compensation in any one year period over the last three years, excluding directors fees; (3) partnering or being employed by a firm that is the listed company’s internal or external auditor; (4) acting as an executive officer of another company where any of the listed company’s present executive officers at the same time serve on the company’s compensation committee; and (5) operating as an employee of a company that has made payments to, or received payments from, the company for property or services in an amount which, in any of the last three years, exceeds the greater of \$1 million, or 2% of such other company’s consolidated gross revenues. *Id.* Delaware, however, does not recognize these categorical rules. *In re MFW S’holders Litig.*, 67 A.3d 496, 510 (Del. Ch. 2013) *aff’d sub nom.*, Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014) (“Although the fact that directors qualify as independent under the NYSE rules does not mean that they are necessarily independent under our law in particular circumstances[.]”).

6. Independence in Delaware depends upon the identity of the interested director. *See* J. Robert Brown, Jr., *Disloyalty Without Limits: “Independent” Directors and the Elimination of the Duty of Loyalty*, 95 KY. L.J. 53, 72-73 (2007). In most cases, the CEO qualifies. *Id.* The ability of the CEO to terminate material income streams paid by the company will therefore raise reasonable doubt about the recipient’s independence. *Id.*

7. *See* Aronson v. Lewis, 473 A.2d 805, 811-12 (Del. 1984); Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).

grounds and have, therefore, provided little guidance on the types of personal relationships that disqualify directors.

A recent case, however, has deviated from this usual approach. In *In re Orchard Enterprises, Inc. Stockholder Litigation*,<sup>8</sup> the court suggested that long-lasting personal relationships involving close connections to the family of the controlling shareholder may deprive a director of independence. The decision, therefore, provided guidance on the types of relationships a board should examine in considering director independence. The case also illustrated some of the risks to boards that treat directors with close personal ties to management as independent. Finally, the case may influence a board's disclosure obligations under the federal securities laws.

This article contains six sections. Section II introduces the function of independent directors in conflict of interest transactions and derivative suits and the definition the Delaware courts use to evaluate independence. Section III explains the courts' unwillingness to find that personal and outside business relationships invalidate directors' independence. Section IV highlights that in a pair of recent cases, the Delaware courts, for the first time, provided some insight into the types of personal connections that could be disqualifying. Section V describes the potential impact of these decisions on Delaware law and their possible influence on the disclosure requirements under the federal securities laws. In addition, Section V provides empirical insight into how public companies are implementing the U.S. Securities and Exchange Commission (SEC) and stock exchange requirements regarding consideration and disclosure of personal and business relationships. Finally, Section VI concludes that increased disclosure of these relationships, under the federal securities laws, will provide shareholders with the necessary information to challenge board independence despite the usual absence of discovery in this context and may result in a reduction in the nomination of directors with personal and business relationships with management.

## II. DIRECTOR INDEPENDENCE UNDER DELAWARE LAW

### *a. The Benefits of Director Independence*

Delaware does not require the use of independent directors.<sup>9</sup> The courts, however, provide greater judicial deference to the decisions of boards that do.<sup>10</sup> First, the presence of independent directors can affect

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8. 88 A.3d 1 (Del. Ch. 2014).

9. See DEL. CODE ANN. tit. 8, § 141(b) (2014) ("The certificate of incorporation or bylaws may prescribe other qualifications for directors.").

10. See *Rales v. Blasband*, 634 A.2d 927, 937 (Del. 1993) ("[T]he appropriate inquiry is whether Blasband's amended complaint raises a reasonable doubt regarding the ability of a majority of the Board to exercise properly its business judgment in a decision on a demand had one been made at the time this action was filed.").

the standard of review for transactions arising under the duty of loyalty. Rather than apply entire fairness, boards with a majority of independent directors typically receive the benefit of the business judgment rule for conflicts involving a director<sup>11</sup> and a shift in the burden of showing fairness for conflicts involving a controlling shareholder.<sup>12</sup>

Secondly, courts are more willing to dismiss derivative suits against boards with a majority of independent directors. In filing a derivative suit, a shareholder generally must make a demand on the board.<sup>13</sup> Demand will, however, be excused where the board lacks a majority of independent directors.<sup>14</sup>

*b. Director Independence Defined*

Independence exists where “a director’s decision is based on the corporate merits of the subject . . . rather than extraneous considerations or influences.”<sup>15</sup> The director must make decisions “without regard for or succumbing to influences which convert an otherwise valid business decision into a faithless act.”<sup>16</sup> Because Delaware law presumes director independence,<sup>17</sup> shareholders must demonstrate “reasonable doubt” about their status.<sup>18</sup> To do so, the evidence must demonstrate that a director is

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11. The test can be outcome determinative. *See* Brown, *supra* note 6, at 103. *See also* Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) (“It is often of critical importance whether a particular decision is one to which the business judgment rule applies or the entire fairness rule applies. It is sometimes thought that the decision whether to apply the business judgment rule or the entire fairness test can be outcome-determinative.”).

12. *See* Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1242 (Del. 2012) (“[I]n order to encourage the use of procedural devices that foster fair pricing, such as special committees and minority stockholder approval conditions, this Court has provided transactional proponents with what has been described as a ‘modest procedural benefit—the shifting of the burden of persuasion on the ultimate issue of entire fairness to the plaintiffs—if the transaction proponents proved, in a factually intensive way, that the procedural devices had, in fact, operated with integrity.”); *In re Zhongpin Inc. Stockholders Litig.*, No. 7393-VCN, 2014 Del. Ch. LEXIS 252, at \*32 (Del. Ch. Nov. 26, 2014) (“If the Special Committee were independent, its approval of the Merger would shift the burden of proof on the issue of fairness to the Plaintiffs.”).

13. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 785 (Del. 1981).

14. *See* Blaustein v. Lord Balt. Capital Corp., 84 A.3d 954, 958 (Del. 2014) (to excuse demand, “a plaintiff must allege with particularity that a majority of the board lacks independence or is otherwise incapable of validly exercising its business judgment”); *Aronson v. Lewis*, 473 A.2d 805, 817 (Del. 1984).

15. *Aronson*, 473 A.2d at 816.

16. *Id.*

17. *Id.* at 815.

18. Reasonable doubt is the proper standard in the context of demand excusal. *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993). With respect to substantive review of transactions under the duty of loyalty, the party seeking to shift the standard of review has the burden of establishing the integrity of the process, including director independence. *See In re Cox Commc’ns, Inc. S’holders Litig.*, 879 A.2d 604, 617 (Del. Ch. 2005) (indicating that transactional proponent has the burden of showing that the use of the special committee “operated with integrity”). As a practical matter, the main difference may be the right to discovery that more often arises in the context of challenges to special committees. *See Kahn v. M & F Worldwide Corp.*, 88 A.3d at 645 (discovery appropriate where shareholder can

controlled by or “beholden to” an interested director or controlling shareholder.<sup>19</sup>

The broad test, notwithstanding, the Delaware courts analyze independence almost entirely in the context of financial leverage.<sup>20</sup> Allegations of control typically arise out of material income streams that an interested director or controlling shareholder can terminate.<sup>21</sup> As a result, directors serving as officers at the same company typically lack independence.<sup>22</sup> Similarly, directors receiving material compensation as consultants will not qualify.<sup>23</sup> Payments made to an entity can also trigger a loss of independence to the extent the payments result in a material benefit to the director.<sup>24</sup>

In determining materiality, courts rely on a subjective “actual person” standard.<sup>25</sup> Plaintiffs must, therefore, relate the importance of the payment to the director’s specific financial circumstances.<sup>26</sup> The burden of doing so can be particularly difficult for payments that indirectly benefit directors.<sup>27</sup>

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show a “reasonably conceivable set of facts” showing that the conditions for a special committee are not present).

19. *Rales v. Blasband*, 634 A.2d at 936 (citing *Aronson*, 473 A.2d at 815).

20. *See Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1168 (Del. 1995).

21. *Brown*, *supra* note 6, at 72.

22. *See Rales v. Blasband*, 634 A.2d at 937 (“Because of their alleged substantial financial interest in maintaining their employment positions, there is a reasonable doubt that these two directors are able to consider impartially an action that is contrary to the interests of the Rales brothers.”); *In re Ltd., Inc. S’holder Litig.*, 2002 WL 537692, at \*5 (Del. Ch. Mar. 27, 2002) (director who also served as corporation’s chief administrative officer lacked independence to evaluate demand against the chairman and CEO); *California Pub. Employees’ Ret. Sys. v. Coulter*, No. 19191, 2002 WL 31888343, at \*10 (Del. Ch. Dec. 18, 2002) (“Coulter’s position as White’s superior alone would be sufficiently material to give reason to doubt White’s independence from Coulter.”).

23. *Orman v. Cullman*, 794 A.2d 5, 30 (Del. Ch. 2002) (noting even though there is no bright-line dollar amount to which consulting fees received by a director become material the court may reasonably infer that \$75,000 would be material); *In re Ltd., Inc.*, No. 17148-NC, 2002 WL 537692, at \*6 (Del. Ch. Mar. 27, 2002) (finding annual consulting fees of \$150,000 material). *But see Orman v. Cullman*, 794 A.2d at 29–30 (Director Bernbach was a consultant of the company but also a large shareholder. The court suggested that sometimes a director might not lose his independence if his interests are aligned with shareholders.).

24. *Khanna v. McMinin*, No. 20545-NC, 2006 WL 1388744, at \*17 (Del. Ch. May 9, 2006) (stating the inquiry into independence turns on whether the business relationship with the vendor was material to the vendor or the director himself).

25. *See Kahn*, 88 A.3d at 649 (“The inquiry must be whether, applying a subjective standard, those ties were *material*, in the sense that the alleged ties could have affected the impartiality of the individual director.”).

26. *See Brown*, *supra* note 6, at 72.

27. When a company makes payments to another entity, plaintiffs must establish the materiality of the payments to the director, which is not easy to do. *See Brown*, *supra* note 6, at 76. Materiality may be inferred where the payments are considerable in relation to the size of the recipient company, and the director is a leader or owner. *See Zimmerman v. Braddock*, No. 18473-NC, 2005 WL 2266566, at \*10 (Del. Ch. Sept. 8, 2005) (stating Priceline was one of the company’s two largest clients with a five year contract involving minimum payments of \$5 million) *rev’d*, 906 A.2d 776 (Del. 2006). Frequently these cases also involve payments to law firms. *See In re Emerging Commc’ns, Inc. S’holder Litig.*, No. 16415, 2004 WL 1305745, at \*2 (Del. Ch. May 3, 2004) (“Vitelco represented the largest portion of ECM’s business and accounted for approximately 88% of its revenues.”). Alternatively, a plaintiff must demonstrate a connection between the payments and the

The Delaware courts have also recognized that some personal ties could result in a loss of independence. For the most part, however, they were limited to family relationships.<sup>28</sup> For example, in *Mizel v. Connelly*, the court found that a grandson of the chairman and CEO was not independent.<sup>29</sup> Likewise, in *Harbor Financial Partners v. Huizenga*, reasonable doubt existed about the independence of a brother-in-law.<sup>30</sup>

The courts have been less willing to find that other types of personal and outside business relationships disqualify directors as independent.<sup>31</sup> In *Brehm v. Eisner*, the Delaware Supreme Court reasoned that “long-standing personal and business ties” could not “overcome the presumption of independence that all directors . . . [were] afforded.”<sup>32</sup> Thereafter, lower courts were, with one anomalous exception,<sup>33</sup> unwilling to find

director’s compensation. *See In re CompuCom Sys., Inc. Stockholders Litig.*, No. 499-N, 2005 WL 2481325, at \*9 (Del. Ch. Sept. 29, 2005) (“The plaintiff does not allege what compensation Loewenberg and/or JDL Enterprises obtained for Loewenberg’s advisory services, nor does the complaint allege that such fees constituted such a large part of his or the firm’s income so as to be material to Loewenberg or JDL Enterprises. The plaintiff merely states conclusory allegations which do not support a reasonable inference that Loewenberg lacked independence.”).

28. *See In re Ltd., Inc.*, No. 17148-NC, 2002 WL 537692, at \*4 (Del. Ch. Mar. 27, 2002) (noting that wife stood to benefit from transaction that aided spouse); *Grimes v. Donald*, 673 A.2d 1207, 1216 (Del. 1996) (finding that familial interest is a basis for demand excusal), overruled in part by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

29. No. Civ. A. 16638, 1999 WL 550369, at \*4 (Del. Ch. July 22, 1999). Not all family relationships will result in a loss of independence. *See also Seibert v. Harper & Row, Publishers, Inc.*, No. Civ. A. 6639, 1984 WL 21874, at \*3 (Del. Ch. Dec. 5, 1984) (director was independent of cousin when considering demand against him).

30. *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 889 (Del. Ch. 1999). Nonetheless, the cases have not always been consistent. *See In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 939 (Del. Ch. 2003) (“Without backtracking from these general propositions, it would be less than candid if I did not admit that Delaware courts have applied these general standards in a manner that has been less than wholly consistent. Different decisions take a different view about the bias-producing potential of family relationships, not all of which can be explained by mere degrees of consanguinity.”).

31. *See Cal. Pub. Emps’ Ret. Sys. v. Coulter*, No. Civ. A. 19191, 2002 WL 31888343, at \*9 (Del. Ch. Dec. 18, 2002) (noting that an allegation of a lifelong friendship with an interested party is not alone sufficient to raise a reasonable doubt of a director’s disinterest or independence); *Kohls v. Duthie*, 765 A.2d 1274, 1284 (Del. Ch. 2000) (holding that a friendship between a member of a special committee of the board and an interested party to the challenged transaction, as well as the fact that the interested party had once given the director a summer job, were insufficient to challenge the director’s ability to exercise his independent judgment with respect to the transaction); *Benerofe v. Cha*, No. 14614, 1998 WL 83081, at \*3 (Del. Ch. Feb. 20, 1998) (providing that an allegation of a longtime friendship was not sufficient to raise a reasonable doubt about a director’s ability to exercise his judgment independently of his friend).

32. *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 355 (Del. Ch. 1998) *aff’d in part, rev’d in part sub nom. Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

33. The one exception occurred in *In re Oracle Corp. Derivative Litig.*, 824 A.2d at 917. Shareholders filed a derivative complaint alleging insider trading during the third quarter of fiscal year 2001 by four Oracle directors including the CEO. *Id.* at 920. Discovery uncovered a number of connections among the directors and management. *Id.* at 931–35. For example, Oracle’s CEO, as the head of a charitable foundation, donated \$10 million to Stanford. *Id.* at 932. In addition, around the time the special litigation committee members joined the board the CEO publicly discussed donating his \$100 million house as well as \$170 million for a scholarship program to the University. *Id.* at 933–35. The chancery court concluded that the connections described in the opinion “would weigh on the mind of a reasonable special litigation committee member deciding whether to level the serious charge of insider trading against the [t]rading [d]efendants.” *Id.* at 947. A subsequent deci-

that non-familial, personal relationships impaired independence,<sup>34</sup> although some acknowledged the possibility.<sup>35</sup>

### III. BEAM EX REL. MARTHA STEWART LIVING OMNIMEDIA, INC. V. STEWART

The Delaware Supreme Court revisited personal and outside business relationships in *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*.<sup>36</sup> There the court effectively reversed the analysis in *Brehm* and found that such relationships could in fact result in a loss of independence. In that case, Martha Stewart owned 94% of Omnimedia and served as the CEO.<sup>37</sup> Following charges that Stewart engaged in insider trading, shareholders filed a derivative action alleging that the board failed to adequately supervise her behavior.<sup>38</sup> In an effort to demonstrate demand excusal, shareholders contested the independence of some members of the board on the basis of outside business and personal relationships.<sup>39</sup>

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sion, however, suggested that the analysis should be read narrowly. *See Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1054–55 (Del. 2004).

34. *See Litt v. Wycoff*, No. Civ. A. 19083-NC, 2003 WL 1794724, at \*4 (Del. Ch. Mar. 28, 2003) (holding “mere personal friendship” does not raise reasonable doubt as to director independence); *In re Paxson Commc'n Corp. Shareholders Litig.*, No. Civ. A. 17568, 2001 WL 812028, at \*10 (Del. Ch. July 12, 2001) (holding generalized allegations of close personal ties do not negate director independence); *Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 979–80 (Del. Ch. 2000) (holding an allegation of fifteen-year professional and personal relation failed to adequately plead the facts necessary to survive a motion to dismiss); *Green v. Phillips*, No. Civ. A. 14436, 1996 WL 342093, at \*5 (Del. Ch. June 19, 1996) (holding suggestions of longstanding personal ties are insufficient to impair independence).

35. *See Telxon Corp. v. Meyerson*, 802 A.2d 257, 264 (Del. 2002) (“[a] controlled director is one who is dominated by another party, whether through close personal or familial relationship or through force of will”); *Orman*, 794 A.2d at 27 n.55 (citing *In re Ply Gem Indus., Inc. Shareholders Litig.*, 15779-NC, 2001 WL 755133, at \*4 (Del. Ch. June 26, 2001) (“[a]lthough mere recitation of the fact of past business or personal relationships will not make the Court automatically question the independence of a challenged director, it may be possible to plead additional facts concerning the length, nature or extent of those previous relationships that would put in issue that director's ability to objectively consider the challenged transaction.”); *In re New Valley Corp.*, No. Civ. A. 17649, 2001 WL 50212, at \*7 (Del. Ch. Jan. 11, 2001) (holding a majority of New Valley’s current Board is not independent because the facts alleged in the complaint show that all the members of the current Board have current or past business, personal, and employment relationships with each other and the entities involved); *Nagy v. Bistricher*, 770 A.2d 43, 49 n.2 (Del. Ch. 2000) (“a fiduciary may act disloyally for a variety of reasons other than personal pecuniary interest; and (2) that, regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes.”); *Chesapeake Corp. v. Shore*, 771 A.2d 293, 299 n.4 (Del. Ch. 2000) (“*Unitrin* defines an independent director as one who can base her judgments on the corporate merits without being influenced by extraneous influences, such as personal relationships the director has with management or a controlling stockholder, or other material financial relationships the director has with the corporation.”).

36. *Beam ex rel. Martha Stewart Living Omnimedia, Inc.*, 845 A.2d at 1040.

37. *Id.* at 1051.

38. Plaintiff also made allegations arising out of the sale of shares of Omnimedia and the “board’s decisions with regard to the provision of ‘split-dollar’ insurance for Stewart.” *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 968 (Del. Ch. 2003).

39. *Beam ex rel. Martha Stewart Living Omnimedia, Inc.*, 845 A.2d at 1051.

With respect to one director, Darla Moore, the plaintiffs alleged a number of personal connections with Stewart.<sup>40</sup> Moore allegedly attended a wedding reception with Stewart hosted by Stewart's personal lawyer.<sup>41</sup> Additionally, *Fortune* magazine published an article highlighting their close personal friendship.<sup>42</sup> Although describing the matter as a "close call," the chancery court found that the facts did not rebut the presumption of director independence.<sup>43</sup>

On appeal, the Delaware Supreme Court conceded that a variety of motivations could impair independence, but "mere personal friendship" was not enough.<sup>44</sup> The alleged relationship between Stewart and Moore arose out of "structural bias" which "presuppose[d] that the professional and social relationships that naturally develop[ed] among members of a board impede[d] independent decisionmaking."<sup>45</sup> Such allegations were inadequate to defeat a motion to dismiss.<sup>46</sup> Instead, a plaintiff had to allege facts that would support the inference that the "non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director."<sup>47</sup>

The decision gave no guidance on the application of the test. The court did not describe the types of personal or outside business relationships that would cause a director to risk his or her professional reputation. As a result, courts continued to routinely dismiss such allegations.<sup>48</sup> Thus, in *Benihana of Tokyo, Inc. v. Benihana, Inc.*, the plaintiffs challenged the independence of directors serving on a committee considering the sale of preferred stock issued by Benihana to BFC Financial Corporation.<sup>49</sup> Plaintiffs alleged that one director of Benihana was interested in

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40. *Id.* at 1047.

41. *Id.* at 1045.

42. *Id.*

43. The plaintiff also challenged the independence of another director, Martinez. *Id.* The plaintiff presented evidence that before he was a director at Omnimedia, Martinez served as chairman and CEO of Sears Roebuck and Co. ("Sears"). *Id.* While at Sears, Martinez established a relationship with Omnimedia, which marketed a significant volume of Omnimedia merchandise through Sears. *Id.* Additionally, a longtime mutual friend of Martinez and Stewart recruited him to the board. *Id.* Lastly, in an article featured in *Directors & Boards*, another director remarked that Martinez was an old friend of both Stewart and her. *Id.* The Delaware Supreme Court held the factual allegations regarding Stewart's friendship with Martinez were inadequate to raise a reasonable doubt of his independence. *Id.* at 1051.

44. *Id.* at 1050.

45. *Id.* at 1050–51.

46. *Id.* at 1051.

47. *Id.* at 1052.

48. See *Gatz v. Ponsoldt*, No. Civ.A 174-N, 2004 WL 3029868, at \*3 n.9 (Del. Ch. Nov. 5, 2004) (holding conclusory allegations that a director on a special litigation committee and an interested party had significant prior business dealings did not demonstrate the director had "an inability to consider impartially issues related to potential transgressions involving" the interested party); *In re BJ's Wholesale Club, Inc. S'holders Litig.*, C.A. No. 6623-VCN, 2013 WL 396202, at \*6 (Del. Ch. Jan. 31, 2013) (holding allegations that a director had a long-term personal relationship with the CEO was not the type of allegation that raised a reasonable doubt as to the director's independence under Delaware law).

49. *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 178–79 (Del. Ch. 2005) *aff'd*, 906 A.2d 114 (Del. 2006).



the BFC transaction.<sup>50</sup> In contending that another director lacked independence, plaintiffs asserted both had been close friends for forty to forty-five years and “met every ten to fourteen days.”<sup>51</sup> Applying *Beam*, the chancery court found that the evidence demonstrated only that the directors “had a longstanding friendship” and that such a relationship was not sufficient to show a “lack [of] independence[.]”<sup>52</sup>

Similarly, in *Khanna v. McMinn*, plaintiffs alleged two directors had a long-time friendship.<sup>53</sup> They owned “homes in the same neighborhood and had ‘neighboring wineries’” in St. Helena, Napa.<sup>54</sup> Employing the *Beam* test, the chancery court dismissed the complaint without discovery, holding the directors may be close, “but allegations of this nature do not allow a reasonable inference that the exercise of a director’s discretion and judgment is impaired.”<sup>55</sup>

#### IV. SETTING STANDARDS

Shareholders continued to contest director independence on the basis of personal and outside business relationships. In a pair of recent cases, the Delaware courts for the first time provided some insight into the types of connections that could result in a loss of independence.

##### a. *In re MFW Shareholders Litig.*

In *In re MFW Shareholders Litigation*, stockholders challenged a going-private merger between M & F Worldwide (MFW) and MacAndrews & Forbes, a controlling shareholder owned by Ronald Perelman.<sup>56</sup> The complaint alleged that one of the special litigation committee (SLC) members had a friendship and business relationship with Perelman since the 1990s,<sup>57</sup> and “[had] been to Perelman’s house.”<sup>58</sup>

The chancery court reiterated that “mere allegations of mere friendship” were not enough to show a lack of independence.<sup>59</sup> Instead, a plaintiff must allege facts showing that “the director in question’s material ties

50. *Id.* at 176.

51. *Id.* at 178–79.

52. *Id.* at 179.

53. *Khanna v. McMinn*, No. Civ.A 20545–NC, 2006 WL 1388744, at \*19 (Del. Ch. May 9, 2006).

54. *Id.*

55. *Id.*

56. *In re MFW S’holders Litig.*, 67 A.3d 496, 499 (Del. Ch. 2013).

57. *Id.* at 511.

58. Another MacAndrews & Forbes representative sat on the Board of Visitors of the Georgetown University Law Center, where one of the SLC members was a tenured professor. *Id.* at 511–13. That representative had requested that the professor “join the board of another Perelman corporation, Revlon, in 2012.” *Id.* at 512. Lastly, a different SLC member had “known Perelman since at least 1988, when Perelman invested in failed thrifts with the banker Gerald L. Ford,” where the SLC director was the “President and Chief Operating Officer of their investment vehicles.” *Id.* at 513. According to the plaintiffs, this director “and Perelman both made a ‘significant’ amount of money” when the thrifts “sold to Citigroup for \$5 billion in 2002.” *Id.*

59. *Id.* at 509 n.37.

to the person whose proposal or actions she is evaluating are sufficiently substantial that she cannot objectively fulfill her fiduciary duties.”<sup>60</sup> In dicta, the court described the type of facts necessary to meet the standard, stating:

the friendship was one where the parties had served as each other's maids of honor, had been each other's college roommates, shared a beach house with their families each summer for a decade, and are as thick as blood relations, that context would be different from parties who occasionally had dinner over the years, go to some of the same parties and gatherings annually, and call themselves “friends.”<sup>61</sup>

Plaintiffs, however, failed, “despite receiving the chance for extensive discovery,” to produce the facts necessary to rebut the presumption of independence.<sup>62</sup>

*b. In re Orchard Enterprises, Inc. Stockholder Litig.*

Although *In re MFW Shareholders Litigation* did not find a loss of independence, the court provided a framework for examining personal relationships. Relying on this analysis, the court in *In re Orchard Enterprises, Inc. Stockholder Litigation*,<sup>63</sup> found that shareholders had sufficiently alleged an issue of fact as to the loss of independence between a director and a controlling shareholder as a result, in part, of personal connections.<sup>64</sup>

Orchard Enterprises, Inc. (Orchard) distributed “music and video through digital stores and mobile carriers.”<sup>65</sup> Dimensional Associates, LLC (Dimensional), a private equity fund, had controlled the company since 2007<sup>66</sup> and designated a majority of the directors on the seven-person board.<sup>67</sup> Joseph Samberg founded the parent of Dimensional and served as a senior executive officer of Dimensional.<sup>68</sup>

In 2009, Dimensional delivered a formal proposal to Orchard to buy out the minority shareholders “for \$1.68 per share, a 25% premium to the then-current stock price.”<sup>69</sup> In response, the Orchard board formed a special committee and appointed Donahue, a director designated by Dimensional, to serve as Chair.<sup>70</sup> According to the court, Donahue “acted

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60. *Id.* at 509.

61. *Id.* at 509 n.37.

62. *Id.* at 510.

63. *In re Orchard Enters., Inc. Stockholder Litig.*, 88 A.3d 1, 9 (Del. Ch. 2014).

64. *Id.* at 21.

65. *Id.* at 8.

66. *Id.* (noting that Dimensional held “53.3% of Orchard’s outstanding voting power”).

67. *Id.*

68. According to the court, “Joseph Samberg . . . controls Dimensional.” *Id.* at 21.

69. *Id.* at 9.

70. *Id.* at 8–9.

as the point man for Orchard in negotiating with [Dimensional]”<sup>71</sup> and received greater compensation than other members for his role as Chair of the special committee and later, the CEO search committee.<sup>72</sup> The special committee ultimately approved an offer at \$2.05 a share, and the merger closed on July 29, 2010.<sup>73</sup>

Plaintiffs filed suit alleging a breach of fiduciary duties arising from this cash-out merger.<sup>74</sup> In doing so, the shareholders challenged the independence of the special committee.<sup>75</sup> After discovery, shareholders uncovered facts suggesting that Donahue had “long-standing ties to members of the Samberg family.”<sup>76</sup> As the court described:

Donahue and Jeff Samberg, who is Joseph's brother, have been business associates and personal friends for approximately twenty years. They attended the NCAA Final Four together every year from 1999 to 2008, and they have invested together in fifteen different companies, either directly or through Greylock Partners, a venture capital fund. Donahue and Arthur Samberg, Joseph and Jeff's father, are also long-time friends.<sup>77</sup>

The past business and social connections between Donahue and the Samberg family, coupled with the evidence concerning Donahue’s possible consulting work for Dimensional after the closing of the merger, and his prominent role in the negotiating process, created a “gray” issue for the court regarding independence.<sup>78</sup> Accordingly, the chancery court concluded that “the facts surrounding Donahue's relationships with the Samberg family and Dimensional should be determined at trial, rather than through summary judgment.”<sup>79</sup> The case, however, settled before the matter could definitively resolve the independence issue.<sup>80</sup>

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71. *Id.* at 26 (evidence indicated that Donahue “chaired the Special Committee, served as the Committee's principal negotiator, and acted as the central conduit for the flow of information to and from the Committee.”).

72. *Id.* (“Evidencing [Donahue’s] greater responsibilities, he received compensation of \$80,000 for serving as Chair of the Special Committee and the CEO search committee. Other directors who served as members of both committees received only \$15,000.”).

73. *Id.* at 13–15.

74. *Id.* at 7.

75. *Id.* at 24–26.

76. *Id.* at 9.

77. Additional evidence suggested that Donahue may have contacted Dimensional about serving as a consultant to Orchard following the transaction. *Id.* (“Discovery further revealed that during the negotiation of the merger, Donahue approached Dimensional about serving as a consultant to Orchard after the merger closed. He got the job and provided post-closing consulting services for annual compensation of approximately \$108,000.”).

78. *Id.* at 25–26.

79. *Id.* at 28.

80. *In re Orchard Enters., Inc. Stockholder Litig.*, No. 7840–VCL, 2014 WL 4181912, at \*1 (Del. Ch. Aug. 22, 2014) (“The case settled for a payment by the defendants of \$10,725,000 to the class.”).

V. IMPACT OF *IN RE ORCHARD ENTERPRISES, INC. STOCKHOLDER LITIG.**a. Delaware Law*

The case provided insight into the factors that may impair director independence on the basis of outside business and non-family personal relationships.<sup>81</sup> First, social interactions may raise concerns where they are regular and longstanding rather than occasional and infrequent. The alleged closeness of Donahue's personal relationship with Jeff Samberg involved a twenty-year friendship and shared vacations over a protracted period including attending the NCAA Final Four together for 10 consecutive years.

Second, the strength of the relationship matters. Donahue had a relationship with Arthur Samberg, the father, suggesting the Sambergs viewed Donahue as a close family friend. Finally, Donahue and Jeff Samberg allegedly invested in fifteen different companies together illustrating the substantiality of their relationship.

The court's decision also implied that independence has a temporal or circumstantial component.<sup>82</sup> Donahue's heightened compensation in comparison to other committee members insinuated that he played a more active role in the work of the special committee. Additionally, the chancery court emphasized Donahue's position as Chair of the special committee.<sup>83</sup>

Moreover, the case demonstrated the possible risks that could occur when directors fail to adequately weigh personal relationships when appointing members to a special committee. In part because of the issue over independence, the court found that the burden of persuasion with

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81. J. Robert Brown, Jr., *Director Independence, Personal Relationships, and the Beach House Standard: In re Orchard (Part 3)*, RACE TO THE BOTTOM (May 26, 2014, 6:00 AM), <http://www.theracetothetbottom.org/independent-directors>.

82. The plaintiffs' access to discovery regarding director independence in *In re Orchard Enterprises, Inc. Stockholder Litigation* influenced the court's decision to deny the motion for summary judgment. The original complaint revealed that the plaintiffs knew nothing about Donahue's past business and social connections with the Samberg family before discovery. See Complaint, *In re Orchard Enters., Inc. Stockholder Litig.*, 88 A.3d 1 (Del. Ch. 2014) (No. 7840). However, when a special committee moves to dismiss a derivative action, the court may order limited discovery to determine the independence of the committee and the bases supporting its conclusions. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788–89 (1981). Importantly, in *In re Orchard Enterprises, Inc. Stockholder Litigation* the plaintiffs were offered an opportunity for discovery related to independence. 88 A.3d at 9. This procedural distinction may be outcome-determinative, because it allows plaintiffs to plead particularized facts sufficient to overcome a motion to dismiss unlike a demand-excusal case where the shareholders have little chance to obtain the information needed to rebut the presumption of director independence. See *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1055 (2004) (en banc).

83. Donahue's position on the Special Committee arguably did not go to independence but to his influence in the negotiation process. Had Donahue played a less critical role in the committee, the court may have been less willing to conclude that the personal connections deprived the committee of the traditional deference. See *supra* note 71.

respect to entire fairness remained with the defendants.<sup>84</sup> As a result, the court did not apply the duty of care or the exculpatory clause from Orchard's certificate of incorporation.<sup>85</sup> The director defendants therefore confronted the risk of personal liability and the potential burden of a trial.<sup>86</sup>

*b. Disclosure Requirements under the Federal Securities Laws*

The standards set out in *In re Orchard Enterprises, Inc. Stockholder Litigation* may affect the disclosure obligations of public companies. Under Item 407 of Regulation S-K, a listed company must disclose the identity of each director or nominee determined to be independent under applicable stock exchange listing criteria.<sup>87</sup> In addition, disclosure must include, by specific category or type, any transaction, relationship, or arrangement with any of the company's independent directors considered by the board but ultimately disregarded in determining the independence of the director.<sup>88</sup>

In considering relationships that could deprive directors of independence, boards of listed companies have not always contemplated business and personal relationships between directors and management.<sup>89</sup>

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84. In addition to the issue of independence, shareholders raised other concerns over the process used by the special committee. See *In re Orchard*, 88 A.3d at 28 ("Leaving aside the question of Dimensional's intentions, the plaintiffs have pointed to evidence which raises litigable questions about the Special Committee's negotiation process.").

85. *Id.* at 37.

86. Commentators, generally, have not emphasized personal connections in their analysis of *In re Orchard Enterprises, Inc. Stockholder Litigation*. See Stephen B. Amdur et al., *Entire Fairness in Controlling Stockholder Transaction: In re Orchard Enterprises, Inc. Stockholder Litigation*, M&A CLIENT ALERT (Latham & Watkins LLP), Mar. 2014, available at <http://www.lw.com/thoughtLeadership/LW-in-re-orchard-enterprises>; see also David N. Shine, Delaware Decision Reinforces Need for Proper Procedure in Squeeze-Out Merger, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Mar. 20, 2014, 9:04 AM), <http://blogs.law.harvard.edu/corpgov/2014/03/20/delaware-decision-reinforces-need-for-proper-procedure-in-squeeze-out-merger/#more-61061> ("In Orchard, the lead director on the special committee had continuing social contacts with the controlling stockholder, and, most troubling to the Court, had arranged for a post-merger consulting agreement with the corporation.").

87. See 17 C.F.R. § 229.407(d)(2) (2014).

88. See 17 C.F.R. § 229.407(a)(3). Under the SEC's original proposal for Item 407, a company would have had to disclose the specific details of each such transaction, relationship or arrangement. Executive Compensation and Related Person Disclosure, Securities Act Release Nos. 33-8732A; 34-54302A, 2006 WL 6325877 (August 29, 2006). In response to commenters, the SEC revised the disclosure requirement in the final rule to permit the relationships of each director to be described by the specific category or type. *Id.* The rule requires the disclosure be made on a "director by director basis" and the description of the category or type "be sufficiently detailed so that the nature of the transactions, relationships or arrangements is readily apparent." *Id.*

89. The plain language of the NYSE listing standards, directs boards determining director independence to consider whether directors have a "material relationship with the listed company". NYSE, *supra* note 2, § 303A.02. In 2010, Black & Decker issued a press release in connection with a special meeting of stockholders held to approve its merger with The Stanley Works stating, "[p]ersonal business relationships between individuals (as opposed to relationships with the company) generally are not relevant to the independence tests under the New York Stock Exchange rules because they do not create a material relationship between a director and the company." Press Release, Black & Decker, Black & Decker Provides Additional Information in Connection With the Special Meetings of Stockholders to Consider the Stanley Transaction (Mar. 9, 2010) (on file with

The stock exchanges and the Commission, however, have clarified that a board does have an obligation to consider these types of relationships when determining director independence.<sup>90</sup>

In altering its listing standards, the NYSE recently added a new subsection affirmatively requiring that the board “consider all factors specifically relevant to determining whether a director has a relationship to the listed company which is material to the director’s ability to be independent from management in connection with the duties of a compensation committee member[.]”<sup>91</sup> In addition, the SEC noted that companies must consider business and personal relationships. As the SEC stated:

Although personal and business relationships, related party transactions, and other matters suggested by commenters are not specified either as bright-line disqualifications or explicit factors that must be considered in evaluating a director’s independence, the Commission believes that compliance with NYSE’s rules and the provision noted above would demand consideration of such factors with respect to compensation committee members, as well as to all Independent Directors on the board.<sup>92</sup>

The standards emphasized the need to consider personal relationships but did not provide guidance on the types of connections or ties that might result in a loss of independence. *In re Orchard Enterprises, Inc. Stockholder Litigation*, however, offers some guidance. First, a company should consider and possibly disclose frequent social interactions between directors or any member of their immediate family and members of the company’s senior management or their affiliates. Second, a company should consider the length of the relationships between directors and executives and whether the parties consider their relationships strong and family-like.

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author). The NYSE disapproved of Black & Decker’s explanation of its rule and required the company to issue the following statement: “the NYSE advised Black & Decker that, in interpreting its rules, the NYSE believes relationships between a director and a member of senior management that are material to either party should be considered by a board of directors in its evaluation of a director’s independence.” Press Release, Black & Decker, Black & Decker Issues Further Statement in Connection with the Special Meetings of Stockholders to Consider the Stanley Transaction (Mar. 10, 2010) (on file with author). In sum, the NYSE’s interpretation was unclear from the plain language of its listing standards.

90. See *infra* notes 91-92.

91. NYSE, *supra* note 2, § 303A.02(a)(ii). Similarly, under the Nasdaq Listing Rule 5602(a)(2), a director is considered independent if the director is not an officer or employee of the listed company, and the listed company’s board affirmatively determines that the director does not have any relationship which would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

92. Self-regulatory Organizations, Exchange Act Release No. 34-68639, 2013 WL 166322 (Jan. 11, 2013).

*c. Empirical Insight*

Given the guidance from the SEC and the requirements of the exchanges, some public companies have expressly recognized the need to consider personal relationships. For example, Compass Minerals International Inc.'s 2014 Proxy Statement stated that in determining director independence "the Board of Directors broadly considers the relevant facts and circumstances, including: the nature of any relationships with the Company, including personal and business relationships as well as any relationships with the director's employer or any company on whose board the director serves[.]"<sup>93</sup> Likewise, Worthington Industries Inc.'s 2014 Proxy Statement specified "[t]he Board has been advised of the nature and extent of any direct or indirect personal and business relationship between the Company (including its subsidiaries)" and each "Independent Director" or "any entities for which any Independent Director is a partner, officer, employee or shareholder."<sup>94</sup>

A review of the disclosures in 2014 by the companies in the S&P 100, however, reveals at best modest disclosure with respect to personal and business relationships between directors and officers. Some note the need to consider these types of factors. For example, Colgate-Palmolive Co.'s 2014 Proxy Statement stated that:

a director is not considered independent if the director has any relationship with Colgate or its senior management or with another director that in the Board's judgment may impair the director's ability to make independent judgments. Such relationships could include voting arrangements and personal, economic or professional ties between a director and an officer of Colgate or another Colgate director.<sup>95</sup>

Similarly, Walt Disney Company's 2014 Proxy Statement stated the board considered "whether there were any transactions or relationships between Directors or any member of their immediate family (or any entity of which a Director or an immediate family member is an executive officer, general partner or significant equity holder) and members of the Company's senior management or their affiliates."<sup>96</sup> A handful of companies in the S&P 100 described some outside affiliations between directors that the companies considered but deemed immaterial.<sup>97</sup> For example, Oracle's 2014 Proxy Statement revealed that Stanford University,

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93. Compass Minerals Int'l Inc., Proxy Statement (Schedule 14A) at 14 (Mar. 26, 2014).

94. Worthington Indus., Proxy Statement (Schedule 14A) at 10 (Aug. 14, 2014).

95. Colgate-Palmolive Co., Proxy Statement (Schedule 14A) at 6 (Mar. 26, 2014).

96. Walt Disney Co., Proxy Statement (Schedule 14A) at 13 (Jan. 24, 2014).

97. See Morgan Stanley, Proxy Statement (Schedule 14A) at 12 (Mar. 28, 2014) (stating "[a] relationship arising solely from a director's membership in the same professional, social, fraternal or religious association or organization, or attendance at the same educational institution, as an executive officer or director" is not material for purposes of director independence).

the employer of two of its directors, received donations from both Oracle and various board members.<sup>98</sup>

Nonetheless, many companies in the S&P 100 do not expressly state whether they have considered personal and business relationships between directors and management.<sup>99</sup> Nor has any company revealed the types of relationships at issue in *In re Orchard Enterprises, Inc. Stockholder Litigation*.<sup>100</sup> It may be that such relationships are not present. Alternatively, such relationships may be present but not considered by the board despite the requirements of the stock exchanges and the SEC.<sup>101</sup>

## VI. CONCLUSION

*In re Orchard Enterprises, Inc. Stockholder Litigation*, for the first time, identified a set of non-familial personal factors that could result in the loss of independence. The factors, however, only came to light as a result of discovery, something unavailable for most challenges to director independence.<sup>102</sup> The case, therefore, illustrates the importance of discovery in ascertaining director independence.

The case also provides a basis for increased disclosure of these types of relationships under the federal securities laws. Increased disclosure of personal connections between directors and management would likely cause shareholders to focus greater attention on these relationships.<sup>103</sup> Increased disclosure may also facilitate legal challenges to director independence.<sup>104</sup> As a result, increased disclosure could result in a reduction in the nomination of directors with personal and business relationships with management.<sup>105</sup>

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98. See Oracle Corp., Proxy Statement (Schedule 14A) at 23 (Sept. 23, 2014) (“Dr. Boskin and Mr. Garcia-Molina are both employed by Stanford University, which has received donations from both Oracle and various Board members.”).

99. Robin E. Alexander, *S&P 100 Proxy Spreadsheet 2014*, U. DENV. STURM C.L. CORP. GOVERNANCE, <http://www.law.du.edu/documents/corporate-governance/independent-director/S-%20P-100-Proxy-Spreadsheet-2014.xlsx> (last visited Jan. 15, 2015).

100. See *id.*

101. See 17 C.F.R. § 229.407 (2012).

102. Perhaps the most significant aspect of the in *In re Orchard Enterprises, Inc. Stockholder Litigation* decision was that the plaintiffs were offered an opportunity for discovery related to independence, which allowed plaintiffs to plead particularized facts sufficient to overcome a motion to dismiss. Given the usual absence of discovery regarding directors’ business and personal relationships, it seems reasonable to assume there are other directors with disqualifying relationships that boards incorrectly characterized as independent. See *supra* note 82.

103. Brown, *supra* note 81.

104. *Id.*

105. *Id.*