# DELAWARE INDEPENDENT DIRECTORS A JUDICIAL CONTEXTUAL EVOLUTION

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Over the last few decades, Delaware courts have emphasized the important role of independent directors in safeguarding the interests of shareholders by preserving the integrity of the corporate governance process. Delaware courts have focused on the independence of directors in determining whether demand is excused in a derivative action and whenever directors are required to exercise their judgment on behalf of the corporation in a related-party transaction or other conflict situation.

*Weinberger* is a 1983 decision about a corporation, Signal, which was the majority shareholder of a subsidiary, UOP. Signal eliminated UOP's minority shareholders by a cash-out merger.[1] In *Weinberger*, the Delaware Supreme Court held that "when the directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."[2] In footnote 7, the Delaware Supreme Court stated, "[a]lthough perfection is not possible, or expected, the results here could have been entirely different if UOP had appointed an independent negotiating committee of its outside

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1. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).
2. *Id.* at 710.

directors to deal with Signal at arm's length."[3]

The takeover era of the 1980s gave rise to another contextual example of the importance that Delaware courts assign to the role of independent directors. In *Unocal Corp. v. Mesa Petroleum*,[4] the Delaware Supreme Court held that when defensive measures are adopted the initial burden will be on the directors to establish two things. First, the "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed."[5] Directors "satisfy that burden 'by showing good faith and reasonable investigation.'"[6] Second, the directors must show that the defensive mechanism was "reasonable in relation to the threat posed."[7] The Delaware Supreme Court explained that proof is materially enhanced where a majority of the board favoring the proposal consisted of outside independent directors. Since *Unocal*, in a myriad of other contexts, Delaware courts have given significant weight and deference to decisions made by directors who are found to be independent.

Director independence under Delaware law was explained by the Delaware Supreme Court in the seminal case of *Aronson v. Lewis* as follows:

> Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences. While directors may confer, debate, and resolve their differences through compromise, or by reasonable reliance upon the expertise of their colleagues and other qualified persons, the end result, nonetheless, must be that each director has brought his or her own informed business judgment to bear with specificity upon the corporate merits of the issues without regard for or succumbing to influences which convert an otherwise valid business decision into a faithless act.[8]

Delaware law presumes that directors are independent. The burden is on a challenging party to overcome that presumption. The independence of a Delaware director is determined on an individual basis. In assessing director independence, Delaware courts apply a subjective "actual person" standard to determine whether a "given" director was likely to be affected in the same or similar circumstances.[9]

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3. *Id.* at 709 n.7.
4. Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).
5. *Id.* at 955.
6. *Id.*
7. *Id.*
8. Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984).
9. McMullin v. Beran, 765 A.2d 910, 923 (Del 2000); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995).

## INDEPENDENCE DISTINGUISHED FROM INTEREST

It has frequently been noted that, although director interest and director independence are both methods of challenging a director's loyalty, the difference between interest and independence is significant.[10] A director is interested in a given transaction if she stands to gain monetarily from it in a way that other shareholders do not.[11]

The Delaware General Corporation Law statute does not refer to independent directors.[12] That statute addresses only the narrower concept of "interested directors." A director who is also a shareholder is interested in a particular transaction if she stands to gain monetarily from it in a way that other shareholders do not.[13] Financial self-dealing and material financial self-interests eliminate director independence.

The difference between interest and independence is significant. The characteristics of directorial independence are ascertained solely from judicial opinions. The Delaware courts have developed the concept of director independence to be more encompassing than mere financial interest. In Delaware, the judicial independence inquiry requires an examination of whether a director, although lacking in a financial self-interest, is somehow connected to an interested party, or whether her decisions are not based on the corporate merits, but rather are influenced by personal, business or any other extraneous considerations.[14]

In determining independence, Delaware courts broaden the inquiry into the more subjective types of relationships that can generate what has been called a sense of being "beholden" to an extraneous influence.[15] In the Martha Stewart derivative litigation, the Delaware Supreme Court held that independence is a fact-specific determination and that Delaware courts must make that determination by answering two inquiries: "independent from whom and independent for what purpose?"[16]

Many of the seminal Delaware decisions involving director independence were written by former Chief Justice Strine when he was on

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10. Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675 (2009).

11. Aronson, 473 A.2d 805.

12. *See* Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 465 (2008) ("[I]t may be surprising to note that the Delaware General Corporation Law . . . does not contain a single reference to independent directors.").

13. *Id.*

14. *Aronson*, 473 A.2d 805.

15. Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040 (Del. 2004).

16. *Id.* at 1050.

the Delaware Supreme Court and the Court of Chancery.

CHANCELLOR AND VICE CHANCELLOR STRINE

*Biondi v. Scrushy* was a derivative action involving the HealthSouth Corporation scandals.[17] The HealthSouth board of directors' special litigation committee moved to dismiss the suit, which alleged that executives sold shares of HealthSouth's stock while they were in possession of material non-public information and thereby injured the company.[18] The special litigation committee initially consisted of two directors who were closely tied to the CEO Richard M. Scrushy, the target of many of the allegations made in the complaint.[19]

HealthSouth Director Jon Hanson was the Chairman of the National Football Foundation and College Hall of Fame, Inc. ("NFFCHF") and Director Larry D. Striplin was on NFFCHF's board.[20] Scrushy was also on the NFFCHF board.[21] HealthSouth had been an important donor to the NFFCHF while Hanson was its chair.[22] In addition, Striplin and Scrushy had longstanding personal ties to each other and to college football in Alabama, where one college has a Scrushy-Striplin field.[23] The alleged independence of the HealthSouth board's special litigation committee did not survive judicial scrutiny by Vice Chancellor Strine in light of the relationship the committee members had with the insiders who allegedly engaged in wrongdoing.[24]

Later that same year, Vice Chancellor Strine declined to accept the recommendation of a special litigation committee in the Oracle Corp. derivative litigation.[25] In *Oracle*, Vice Chancellor Strine did not question whether the members of the special litigation committee had acted in good faith and diligently conducted their investigation.[26] He recognized that the independence inquiry asks a different question. He summarized the Delaware Supreme Court's teachings on independence as follows: "At bottom, the question of independence turns on whether a director is, for any substantial reason, incapable of making a decision with only the best interests

17. Biondi v. Scrushy, 820 A.2d 1148, 1149 (Del. Ch. 2003).
18. *Id.*
19. *Id.* at 1156–57.
20. *Id.* at 1157.
21. *Id.*
22. *Id*.
23. *Id.*
24. *Id.* at 1166.
25. *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003).
26. *Id.*

of the corporation in mind. That is, the Supreme Court cases ultimately focus on impartiality and objectivity."[27]

In *Oracle*, Vice Chancellor Strine rejected the argument that the emphasis of an independence inquiry should be on "domination and control" because, in his view, such a focus would be "at the cost of denuding the independence inquiry of its intellectual integrity."[28] He stated that "Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement."[29] He concluded that a judicial inquiry into director independence should not be limited to motives like greed or avarice but should instead take into consideration the full "array of other motivations . . . that influence human behavior such as love, friendship and collegiality."[30] In doing so, he acknowledged that Delaware law requires courts to consider the independence of directors in the context of the facts known to the court about each director specifically, the subjective "actual person standard."[31]

Vice Chancellor Strine held that the Oracle special litigation committee failed to satisfy the test for independence. The committee consisted of only two members, both of whom were professors at Stanford University. The derivative action was brought against another Stanford professor with professional ties to one of the committee members, a Stanford alumnus who had directed millions of dollars in contributions to Stanford and served on a Stanford advisory board with one of the committee members, and Larry Ellison, the CEO, who had donated millions of dollars to Stanford.[32] In *Oracle*, Vice Chancellor Strine wrote:

> It is no easy task to decide whether to accuse a fellow director of insider trading. For Oracle to compound that difficulty by requiring [special litigation committee] members to consider accusing a fellow professor and two large benefactors of their university of conduct that is rightly considered a violation of criminal law was unnecessary and inconsistent with the concept of independence recognized by our law. The possibility that these extraneous considerations biased the inquiry of the [special litigation committee] is too substantial for this court to ignore.[33]

27. *Id.* at 939.
28. *Id.* at 937.
29. *Id.* at 938.
30. *Id.*
31. *Id.* at 942 (quoting Cinerama, Inc., 663 A.2d at 1167).
32. *Id.* at 920–21.
33. *Id.* at 921.

In both *Biondi* and *Oracle*, Vice Chancellor Strine relied upon non-pecuniary considerations in finding a lack of independence and addressed the effects that relationships, both social and professional, can have on directors' decision-making processes.[34] Vice Chancellor Strine concluded that "by taking into account all circumstances, the Delaware approach undoubtedly results in some level of indeterminacy, but with the compensating benefit that independence determinations are tailored to the precise situation at issue."[35] The extent to which personal relationships and other non-pecuniary considerations can compromise a director's independence is an important issue that he continued to develop in his future opinions on the Court of Chancery and the Delaware Supreme Court.

In *MFW*, Chancellor Strine reviewed the Delaware inquiry of director independence in the context of a squeeze-out merger by a controller.[36] The case involved a publicly traded company. More than half of the publicly traded companies in the United States are incorporated in Delaware.[37] Chancellor Strine noted:

> [T]hat [stock exchange] rules governing director independence were influenced by experience in Delaware and other states and were the subject of intensive study by expert parties. They cover many of the key factors that tend to bear on independence . . . and they are a useful source for this court to consider when assessing an argument that a director lacks independence.[38]

He began his analysis by acknowledging that under Delaware law there is a presumption that directors are independent, and the plaintiff bears the burden of rebutting that presumption.

He recognized that mere allegations that directors are friendly with, travel in the same social circles, or have past business relationships with the proponent of a transaction or the person they are investigating are not enough to rebut the presumption of independence. He noted that:

> [I]f a 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 thick as blood relations, that context would be different

34. Paula J. Dalley, *The Business Judgment Rule: What You Thought You Knew*, 60 CONSUMER FIN. L.Q. REP. 24, 28 (2006).

35. *Oracle*, 824 A. 2d 941.

36. *In re* MFW S'holder's Litig., 67 A.3d 496 (Del. Ch. 2013), *aff'd sub nom.* Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014).

37. Randy J. Holland, *Delaware Business Courts: Litigation Leadership*, 34 J. CORP. L. 771, 772 (2009).

38. MFW 67 A.3d at 510.

> from parties who occasionally had dinner over the years, go to some of the same parties and gatherings annually, and call themselves "friends."[39]

Instead, the plaintiff must demonstrate to the court that the director being challenged has sufficient material ties to the person she is evaluating that she cannot objectively fulfill her fiduciary duties. Chancellor Strine then applied those precepts to the plaintiffs' allegations and concluded that each of the challenged directors was independent under Delaware's well-established jurisprudence.[40]

## CHIEF JUSTICE STRINE

In *Sanchez*, Chief Justice Strine wrote an opinion for a unanimous court addressing whether the plaintiffs had pled particularized facts raising a reasonable doubt about one of the Sanchez Public Company directors, Alan Jackson.[41] The complaint challenged Jackson's independence on two grounds: first, that Chairman Sanchez and Jackson had been close friends for more than five decades; and second, that Jackson's personal wealth was attributable to business interests over which Chairman Sanchez has substantial influence.[42] The Court of Chancery concluded that the plaintiffs had not pled sufficient facts to overcome the presumption that Jackson was independent.[43]

The Supreme Court's opinion in *Sanchez* by Chief Justice Strine reversed the Court of Chancery's decision for the reason that its

> analysis seemed to consider the facts the plaintiffs pled about Jackson's personal friendship with Sanchez and the facts they pled regarding his business relationships as entirely separate issues. Having parsed them as categorically distinct, the Court of Chancery appears to have concluded that neither category of facts on its own was enough to compromise Jackson's independence for purposes of demand excusal.[44]

Chief Justice Strine explained "the problem with that approach is that our law requires that all the pled facts regarding a director's relationship to the interested party be considered in full context in making the admittedly

39. *Id*. at 509 n.37.
40. *Id*. at 518.
41. Del. Cnty. Emps. Ret. Fund v. Sanchez, 124 A.3d 1017 (Del. 2015).
42. *Id.* at 1020.
43. *Id.* at 1021.
44. *Id.*

imprecise, pleading state determination of independence."[45] The Supreme Court's opinion in *Sanchez* concluded that the plaintiffs had pled particularized facts that created a reasonable doubt about Jackson's independence.[46]

In *Sandy's v Pincus,* Chief Justice Strine wrote an opinion for a majority of the Delaware Supreme Court.[47] The decision held that certain directors were not independent because of personal and professional relationships with the company's controlling stockholder.[48] With regard to one director, the opinion noted that co-ownership of an airplane was unusual and required "close cooperation in use, which is suggestive of detailed planning indicative of a continuing, close personal friendship."[49] The opinion held that owning an airplane with the interested party is indicative 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."[50]

In *Marchand*, Chief Justice Strine's opinion for a unanimous court embraced his independent director analysis from Oracle: "when it comes to life's more intimate relationships concerning friendship and family, our law cannot 'ignore the social nature of humans' or that they are motivated by things other than money, such as 'love, friendship, and collegiality'."[51] The *Marchand* opinion then applied the teachings of Sandy's and Sanchez:

> [A]lthough the fact that fellow directors are social acquaintances who occasionally have dinner or go to common events does not, in itself, raise a fair inference of non-independence, our law has recognized that deep and long-standing friendships are meaningful to human beings and then any realistic consideration of the question of independence must give way to these important relationships and their natural effect on the ability of the parties to act in partially toward each other.[52]

The *Marchand* opinion held that the important personal and business relationship between Director Rankin and the Kruse family supported a pleading stage inference that Rankin could not act independently.[53]

In *Cornerstone*, Chief Justice Strine wrote an opinion answering the question of whether "in an action for damages against corporate fiduciaries,

45. *Id.* at 1022.
46. *Id.* at 1024.
47. Sandys v. Pincus, 152 A.3d 124 (Del. 2016).
48. *Id.* at 128.
49. *Id.* at 130.
50. *Id.*
51. Marchand v. Barnhill, 212 A.3d 805, 818 (Del. 2019).
52. *Id.* at 820.
53. *Id.*

where the plaintive challenges an interested transaction that is presumptively subject to entire fairness review, must the plaintive plead a non-exculpated claim against the disinterested, independent directors to survive a motion to dismiss by those directors?"[54] The opinion answered that question in the affirmative.[55] The opinion pointed out that for more than a generation, Delaware "law has recognized that the negotiating efforts of independent directors can help to secure transactions with controlling stockholders that are favorable to the minority."[56]

The *Cornerstone* opinion declined "to adopt an approach that would create incentives for independent directors to avoid serving as special committee members, or to reject transactions solely because their role in negotiating on behalf of the stockholders will cause them to remain as defendants until the end of any litigation challenging the transaction."[57] Therefore, the *Cornerstone* opinion held that:

> [A] plaintiff seeking only monetary damages must plead non-exculpated claims against a director who is protected by an exculpatory charter provision to survive a motion to dismiss, regardless of the underlying standard of review for the boards conduct—be it *Revlon*, *Unocal*, the entire fairness standard, or the business judgment rule.[58]

In *Cornerstone*, the Delaware Supreme Court cited with approval Chancellor Strine's decision in *Southern Peru*.[59] In that case, after a trial, the controller and its affiliated directors were held liable for damages because the interested transaction at issue was not entirely fair to the minority stockholders.[60] Nevertheless, the independent directors had been properly dismissed on summary judgment by Chancellor Strine "because the plaintiff had failed to present evidence supporting a non-exculpated breach of their duty of loyalty."[61]

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54. *In re* Cornerstone Therapeutics, Inc. S'holder Litig., 115 A.3d 1173, 1175 (Del. 2015).

55. *Id.* at 1184.

56. *Id.* (quoting Weinberger, 457 A.2d at 709 n.7).

57. *Id.*

58. Cornerstone, 115 A.3d at 1176 (footnotes omitted) (citing Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del.1986); Unocal, 493 A.2d 946); *see also* Weinberger, 457 A.2d 701 (entire fairness standard); Aronson, 473 A.2d 805 (business judgement rule).

59. *In re* S. Peru Copper Corp. S'holder Derivative Litig., 52 A.3d 761, 785 (Del. Ch. 2011).

60. *Id.*

61. *Id.* at 785.

## CONCLUSION

Determinations of director independence by Delaware courts continues to evolve. Those judicial evaluations involve a contextual examination of the materiality of the entire panoply of human relationships that may compromise a person's objectivity. In doing so, the courts frequently apply the foundational first principles of director independence set forth in the opinions of former Chief Justice Strine.