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Delaware Supreme Court Excuses Demand Based on Directors' Personal and Outside Business Relationships

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In its December 5, 2016 decision in *Sandys v. Pincus*, No. 157, 2016, the Delaware Supreme Court held that a stockholder of Zynga Inc. alleged sufficient facts regarding personal and business ties among Zynga's directors to survive a motion to dismiss for failure to make demand on the board before commencing suit. The decision acknowledges the longstanding principle that the courts should defer to the business judgment of independent and disinterested directors when assessing the merits of a business decision. But it cautions against being too deferential when evaluating the directors' independence and disinterestedness at the pleading stage, where "that determination can short circuit a merits determination of a fiduciary duty claim." While the decision does not alter the applicable legal standards, it may signal an increased willingness to find a lack of independence and disinterestedness based on close personal relationships or overlapping business relationships, particularly in the context of a controlled company.

Background

Sandys reverses the Court of Chancery's dismissal of derivative claims challenging stock sales made by certain directors and top managers of Zynga including its former CEO, Chairman, and controlling stockholder Mark Pincus. The plaintiff alleged that the Zynga board granted the sellers an exemption from Zynga's rule prohibiting insiders from selling stock until three days after an earnings announcement. After receiving the exemption, the insiders sold stock as part of a secondary offering shortly before an earnings announcement that led the stock price to drop 9.6%. Three months later, the stock price again dropped significantly, following an additional release of negative information. The plaintiff brought derivative claims alleging that the sellers breached their fiduciary duties by misusing confidential information when they sold their shares and that the directors breached their fiduciary duties by approving the sale.

The defendants moved to dismiss for plaintiff's failure to make pre-suit demand on the board or allege that demand was excused as futile. The Court of Chancery applied the standard for assessing demand futility set forth in *Rales v. Blasband*, 634 A.2d 927 (Del. 1993), which requires the court to determine whether a plaintiff's allegations create a reasonable doubt that a majority of the directors at the time the complaint is filed would be disinterested and independent in making a decision on a demand. The Court of Chancery determined that the two directors who participated in the sale, Mark Pincus and Reid Hoffman, were not disinterested. It determined that five of the other directors on the nine-member board were independent, and therefore concluded that demand was not excused. The court did not analyze the independence of the two remaining directors, including Don Mattrick, who had replaced Pincus as CEO by the time the complaint was filed.

Delaware Supreme Court's Decision

In a 4-1 decision, the Supreme Court reversed, concluding that the plaintiff's allegations raised a reasonable doubt that a majority of the nine directors were disinterested and independent. The court agreed with the Court of Chancery's determination that Pincus and Hoffman were not disinterested, and also held that Mattrick could not be considered independent of Pincus, Zynga's controlling stockholder. The Supreme Court disagreed with the Court of Chancery's determination with respect to the independence of three of Zynga's other directors.

First, the Supreme Court held that the plaintiff had sufficiently alleged that director Ellen Siminoff was not independent from Pincus because she and her husband co-owned a private airplane with him. The court noted that plaintiffs face an elevated burden of pleading that directors lack independence in the demand excusal context, but concluded that the allegations regarding the jointly owned airplane supported an inference that "the Pincus and Siminoff families are extremely close to each other and are among each other's most important and intimate friends," which was sufficient to create a reasonable doubt regarding Siminoff's independence.

Second, the court held that the plaintiff had sufficiently alleged that directors William Gordon and John Doerr lacked independence for demand excusal purposes. The plaintiff alleged that Gordon and Doerr were partners at a venture capital firm that controlled approximately 9.2% of Zynga's equity and had overlapping investments with Pincus, Hoffman, or their family members. The court stated that it was reasonable to conclude that such business relationships "might have a material effect on the parties' ability to act adversely toward each other." The plaintiff further alleged that Zynga's board had determined that Gordon and Doerr did not qualify as independent directors under the NASDAQ listing standards. The court noted that such standards are relevant to, though not dispositive of, the independence determination under Delaware law, and concluded that the board's determination that Gordon and Doerr were not independent under those standards, along with the other facts alleged by plaintiff, were sufficient to raise a reasonable doubt regarding Gordon's and Doerr's independence.

The Supreme Court admonished the plaintiff for his failure to use the "tools at hand" to diligently investigate the board's independence before bringing suit, which unfairly compromised the courts' ability to evaluate the directors' independence in this "close" case. Notably, the plaintiff had sought books and records regarding the transaction, but not regarding the directors' independence. The court also suggested that "one of the most obvious tools at hand" is use of an internet search. While noting that information obtained by such means must be reliable in order to be included in a complaint, the court stated that reliable internet sources can include "articles in reputable newspapers and journals, postings on official company websites, and information on university websites."

Justice Valihura dissented. She disagreed with the majority's determination regarding the independence of Gordon and Doerr, emphasizing the plaintiff's failure to seek books and records and to plead facts regarding the "size, profits, or materiality to Gordon and Doerr of these investments or interests" or the basis for the board's determination that they lacked independence under the NASDAQ rules. She concluded that without such facts, the relationships alleged were insufficient to raise a reasonable doubt about Gordon's and Doerr's independence. Justice Valihura also disagreed with the majority's decision regarding Siminoff's independence, opining that the complaint misstated or failed to allege numerous facts regarding the airplane and the nature of the Siminoff-Pincus relationship, and that some of the facts on which the majority based its decision were outside the pleadings.

Key Takeaways

The determination of director disinterestedness and independence has been, and remains, a fact-intensive inquiry. *Sandys* does not change the applicable standards, and is limited to its facts. But the case may signal an increased willingness to find a lack of independence and disinterestedness based on personal relationships, if a plaintiff pleads sufficiently specific facts indicating a close personal relationship. The decision also indicates that overlapping business relationships will be carefully evaluated, particularly in the context of a company with a controlling stockholder.

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