

Boards Should Be Mindful of Relationships in Assessing Director Independence



CLIENT ALERT | November 12, 2015

Joanna J. Cline | clinej@pepperlaw.com
Christopher B. Chuff | chuffc@pepperlaw.com
James H.S. Levine | levinejh@pepperlaw.com

A RECENT DECISION FROM THE DELAWARE SUPREME COURT CLARIFIES THE EXTENT TO WHICH A DIRECTOR'S PERSONAL RELATIONSHIP WITH AN INTERESTED PARTY CAN COMPROMISE THE DIRECTOR'S INDEPENDENCE FOR THE PURPOSES OF ANALYZING DEMAND FUTILITY.

Reprinted with permission from the November 4, 2015 edition of the Delaware Business Court Insider. © 2015 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. (ALMReprints.com, 877.257.3382).

THIS PUBLICATION MAY CONTAIN ATTORNEY ADVERTISING

The material in this publication was created as of the date set forth above and is based on laws, court decisions, administrative rulings and congressional materials that existed at that time, and should not be construed as legal advice or legal opinions on specific facts. The information in this publication is not intended to create, and the transmission and receipt of it does not constitute, a lawyer-client relationship. Please send address corrections to phinfo@pepperlaw.com.
© 2015 Pepper Hamilton LLP. All Rights Reserved.

A recent opinion (available at <http://courts.delaware.gov/opinions/download.aspx?ID=230540>) by the Delaware Supreme Court emphasizes the need for boards of directors to be aware of close interpersonal relationships between their directors and any party with a financial stake in a contemplated transaction. Indeed, the court in *Delaware County Employees Retirement Fund v. Sanchez*, No. 702, 2014 (Del. Oct. 2, 2015), held that a director's close, personal friendship with an interested party could have the effect of "compromising a director's independence." Based on that holding, the court found that the derivative stockholder plaintiffs adequately pleaded facts supporting a pleading-stage inference that a director lacked independence from an interested party because the director had been a close friend of the interested party for more than 50 years and was employed by an insurance company over which the interested party had substantial control.

Background

The derivative lawsuit in *Sanchez* arose out of a transaction between Sanchez Resources LLC, a private company wholly owned by A.R. Sanchez Jr. and certain of his family members, and Sanchez Energy Corp., a public corporation of which Sanchez and his family members, together, constituted the largest stockholder. As part of the transaction, Sanchez Energy agreed to pay Sanchez Resources \$78 million to, among other things, purchase a private equity investor's interest in Sanchez Resources, acquire an interest in certain properties with energy-producing potential, and facilitate the production of 80,000 acres of property. The stockholder plaintiffs brought suit derivatively on behalf of Sanchez Energy, alleging that the transaction unfairly benefited Sanchez Resources to the detriment of Sanchez Energy. The plaintiffs alleged they were not required to demand that the board of directors bring suit on behalf of Sanchez Energy because such a demand was futile, and therefore excused, because a majority of the board of directors was interested in the transaction or lacked independence.

Sanchez Energy's board of directors was composed of five members — two of whom were Sanchez and his son. It was undisputed that Sanchez and his son were interested in the transaction, but the parties disputed whether the remaining three directors were interested or lacked independence. The dispute as to the remaining three directors centered around the independence of director Alan Jackson. The stockholder plaintiffs alleged that Jackson lacked independence from Sanchez, one of the interested directors, because (1) Sanchez and Jackson have been close friends for more than 50 years and (2) Jackson and his brother are employed as executives of an insurance company that is wholly owned by a corporation of which Sanchez is a director and the largest stockholder.

On the defendants' motion to dismiss, the Court of Chancery held that the plaintiffs had failed to plead sufficient facts to overcome the presumption that Jackson was independent and dismissed the complaint for failure to plead demand futility. On appeal, the Delaware Supreme Court reversed, holding that Jackson's personal and business ties to Sanchez raised a reasonable doubt as to Jackson's independence, thereby excusing demand.

The Court's Analysis

For a derivative plaintiff to survive a motion to dismiss for failure to plead demand futility, the plaintiff must plead particularized facts creating a "reasonable doubt" that either "(1) the directors are disinterested and independent or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."

The court in *Sanchez* emphasized that, in analyzing a director's independence, a court must consider all of the ties, including personal and financial, between a director and an interested party together and "in their totality." The court stated that personal and financial or business ties should not be analyzed as "categorically distinct," but rather should be considered together in making the pleading-stage determination of independence.

The court explained that, in conducting that analysis, allegations of a close, personal friendship may support an inference that a director lacks independence. The court emphasized that, like the relationship between Jackson and Sanchez, a close, long-lasting friendship is "likely considered precious by many people" and that, "when a close relationship endures for [a long period of time], a pleading inference arises that it is important to the parties." For that reason, the court held that — unlike the "thin social-circle friendships" alleged in *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004) — "deeper human friendships," such as the one alleged in *Sanchez*, could have "the effect of compromising a director's independence."

In assessing Jackson's independence, the court found that the particularized allegations of Sanchez and Jackson's business relationships, together with the allegations of their close friendship, were sufficient to create a reasonable doubt as to Jackson's independence. The court explained the plaintiffs' allegations regarding Jackson's business relationship with Sanchez created a "pleading-stage inference that Jackson's economic positions derive in large measure from his 50-year close friendship" with Sanchez and that these economic positions "buttress [the plaintiffs'] contention that [Jackson and Sanchez] are confidantes and that there is a reasonable doubt that

Jackson can act impartially in a matter of economic importance to Sanchez personally.” For that reason, the court reversed the Court of Chancery’s dismissal of the plaintiffs’ complaint for failure to plead demand futility.

Key Takeaway

The Delaware Supreme Court’s decision in *Sanchez* clarifies the extent to which a director’s personal relationship with an interested party can compromise the director’s independence for the purposes of analyzing demand futility. Indeed, the court effectively created an exception to the general rule that merely alleging a personal friendship between a director and an interested party is insufficient to raise a reasonable doubt as to a director’s independence. Thus, as articulated by the court, assessing a director’s independence requires an analysis of all of the ties between a director and an interested party, including both financial and personal, together and “in their totality.” In analyzing personal ties between a director and an interested party as part of the independence assessment, courts will evaluate the nature, history and length of the personal relationship between a director and an interested party to determine whether the relationship is “close,” such as the 50-year relationship alleged in *Sanchez*, or merely “thin,” such as the relationship alleged in *Beam*, the former having the effect of compromising a director’s independence and the latter being insufficient to overcome the presumption of a director’s independence.

Boards of directors should conduct a similar analysis before voting to approve a proposed transaction or forming a special committee to negotiate, evaluate or approve such a transaction. Given the court’s decision in *Sanchez*, it is imperative for boards of directors to be aware of close interpersonal relationships between the board’s directors and any party that has a financial stake in a transaction that the board is considering in order to ensure that the board’s decision will be afforded the protections of the business judgment rule.