Delaware Supreme Court Rejects Piecemeal Approach to Analyzing Director Independence

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Considered together, a director's personal and business relationships with an interested director may be sufficient to sustain demand excusal under Aronson

I. INTRODUCTION

The ability of a Delaware board of directors to demonstrate that a majority of its members, or of a board committee to demonstrate that all of its members, are "independent" can have an important impact on the disposition of litigation brought to enjoin a transaction or to assess damages. For instance:

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- under *Kahn v. Lynch*,[1] the use of an independent board committee to approve a controlling stockholder-led buyout can shift the burden of proving a lack of fairness to the public stockholders;

- pursuant to *In re MFW Shareholders Litigation,*[2] such an independent board committee, when coupled with an informed vote of the holders of a majority of the shares owned by disinterested stockholders, can shift the standard of judicial review from entire fairness to the business judgment rule;

- in *Unitrin, Inc. v. American General Corp.*,[3] the Delaware Supreme Court noted that "the presence of a majority of outside independent directors will materially enhance . . . evidence" that a board meets the reasonableness test under *Unocal*; and

- under *Aronson v. Lewis*,[4] plaintiff stockholders who "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' " can establish demand excusal, a prerequisite for bringing a derivative claim against the board.

Delaware jurisprudence has no bright-line test for determining whether a particular director is "independent." Rather, the courts employ a deeply factual analysis, with plaintiff stockholders having, in the *Aronson v. Lewis* context, a rather high bar to clear. For instance, in *Beam v. Stewart*,[5] the Delaware Supreme Court ruled that allegations that directors "moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends' . . . are insufficient, without more, to rebut the presumption of independence."[6]

The question of board independence was recently front and center in *Delaware County Employees Retirement Fund v. A.R. Sanchez, Jr.*[7] In *Sanchez*, the Delaware Supreme Court clarified that it analyzes directors' independence for purposes of demand excusal by examining

1. 638 A.2d 1110 (Del. 1994).
2. 67 A.3d 496 (Del. Ch. 2013).
3. 651 A.2d 1361 (Del. 1995).
4. 473 A.2d 805 (Del. 1984).
5. 845 A.2d 1040 (Del. 2004).
6. *Id.* at 1051.
7. C.A. No. 9132-VCG (Del. Oct. 2, 2015).

the relevant facts *in their totality*. On this basis, the Court held that the personal and professional relationships between the board Chair and one of the directors, considered together, supported a pleading stage inference that this director could not act independently of the Chair.

II. BACKGROUND

The family of A.R. Sanchez, Jr. ("Chairman Sanchez") owns both all the equity of Sanchez Resources, LLC ("Private Company") and "the largest stockholder bloc" in publicly-traded Sanchez Energy Corporation ("Public Company").[8] In a "complicated transaction" between the two companies, Public Company paid $78 million to:

(i) help Private Company buy out one of its private equity investors;
(ii) acquire from Private Company certain properties with energy-producing potential;
(iii) facilitate the companies' joint production of 80,000 acres of property; and
(iv) fund a $14.4 million payment to Private Company.

Upon learning of this transaction, several Public Company stockholders filed a derivative action in the Delaware Court of Chancery against the board, alleging the transaction "unfairly benefited" Private Company while being "unfairly onerous" to Public Company. The stockholders pled demand excusal under *Aronson v Lewis,* alleging that a majority of Public Company's five directors "could not consider demand impartially." While it was agreed that two directors, Chairman Sanchez and his son Antonio, were clearly interested, the parties disputed the status of director Alan Jackson. The plaintiffs alleged that Jackson "cannot act independently of Chairman Sanchez" because, *first*, they "have been close friends for more than five decades" and, *second*, "Jackson's personal wealth is largely attributable to business interests over which Chairman Sanchez has substantial influence."

The Court of Chancery analyzed the personal and business relationships between Jackson and Chairman Sanchez separately, holding that neither "on its own was enough to compromise Jackson's independence for purposes of demand excusal." Therefore, because the Court of Chancery also found the second *Aronson v Lewis* prong was not

8. Private Company provides all the management services for Public Company. The Sanchez family owns 16% of Public Company.

satisfied, it granted defendant directors' motion to dismiss. On appeal, the Delaware Supreme Court focused on one "outcome-determinative" issue: "whether the plaintiffs had pled particularized facts raising a pleading-stage doubt about the independence of" director Jackson.

III. THE SUPREME COURT'S ANALYSIS

A. Pleading Demand Excusal

Initially, the Supreme Court recited the two-prong standard for pleading demand excusal under *Aronson v. Lewis*. In this connection, the Supreme Court noted that, despite the "heightened burden" faced by plaintiffs "to plead particularized facts" creating a "reasonable doubt" as to whether the board satisfied either prong, "all reasonable inferences from the pled facts must nonetheless be drawn in favor of the plaintiff. . . ."

Additionally, the Supreme Court noted that "our law requires that all pled facts regarding a director's relationship to the interested party be considered in full context in making the, admittedly imprecise, pleading stage determination of independence." This was not the approach taken by the Court of Chancery when it dismissed plaintiffs' derivative action. Rather, the Court of Chancery "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." According to the Supreme Court, the Court of Chancery erred when it treated these two aspects of the relationship as "categorically distinct."

B. Relationships Between Jackson and Chairman Sanchez

Thus, the Supreme Court's holding would turn on whether the personal and business relationships between the two men, *considered together*, indicated a pleading stage inference that Jackson lacked independence from Chairman Sanchez.

1. Personal Relationships.

The Supreme Court explained that personal friendships can create an inability to "act impartially on a matter important to the interested party." While the Supreme Court reaffirmed its holding in *Beam v. Stewart*, it noted that closer friendships than were present in

that case deserve greater attention.

Because "deeper human friendships" are not analogous to the "thin social-circle friendship" in *Beam*, the Supreme Court distinguished the relationship between Jackson and Chairman Sanchez. These two had remained "close friends for more than five decades" and, "when a close relationship endures for that long, a pleading stage inference arises that it is important to the parties."

2. Business Relationships.

The Supreme Court noted that plaintiffs pled facts beyond the personal relationship between the two men, indicating the importance of Jackson's business relationship with Chairman Sanchez:

- Jackson's "full-time job and primary source of income . . . as an executive at IBC Insurance Agency, Ltd" is intimately related to Chairman Sanchez. IBC Insurance is a "wholly owned subsidiary of . . . a company of which Chairman Sanchez is the largest stockholder and [a non-independent] director . . . under the NASDAQ Marketplace Rules."

- IBC Insurance also employs Jackson's brother, and the two brothers "service the work that IBC Insurance does" for the two Sanchez companies.

- Jackson's salary as a Public Company director constitutes "30-40% of [his] total income" for the year.

While the Supreme Court noted these economic ties "may be coincidental" to Jackson and Chairman Sanchez's close friendship, it nevertheless found "a pleading stage inference that Jackson's economic positions derive in large measure from this 50-year close friendship with Chairman Sanchez, and that he is in these positions because Sanchez trusts, cares for, and respects him." These facts "buttress" plaintiffs' position that the two men "are confidantes," creating "reasonable doubt that Jackson can act impartially in a matter of economic importance to Sanchez personally." On this basis, the Supreme Court reversed the Court of Chancery's dismissal, remanding the case so that "plaintiffs can prosecute this derivative action."[9]

9. While the Supreme Court noted that derivative plaintiffs generally are "admonished" to "use the books and record process to aid them in satisfying *Aronson*'s stringent pleading test," failure to do so is not outcome determinative when plaintiffs have sufficient facts (as here) to support their demand excusal pleading.

IV. CONCLUSION

While director independence remains an inherently factual question, *Sanchez* contributes two important reference points that are sure to be applied in future determinations. *First*, *Sanchez* illustrates that Delaware courts will consider all facts together when determining a director's independence from an interested director. A piecemeal approach is not called for. *Second,* the decision clarifies that friendships of significant duration are distinguishable from those pled in *Beam*. As such, a board of directors who ignores these factors when selecting new members or establishing an independent committee does so at its potential peril.