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A DECLARATION OF INDEPENDENCE: COMMITTEES, CONFLICTS, AND THE COURTS

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INTRODUCTION

Thank you, Dean McKenzie, for that kind introduction and for inviting me to speak this evening. I am honored to be in the company of other luminaries of the Delaware judiciary who have offered remarks for this lecture—former Chancellor and Chief Justice Leo Strine, and former Chancellor Andy Bouchard. I want to talk about an area of corporate law that is a bread-and-butter issue for the Delaware Court of Chancery and the Delaware Supreme Court: independence and its special place in our law.

Why does independence matter? Consider some examples outside corporate law where we value independence. Take doctors for instance. Physicians care for patients but also have paid consulting and speaking arrangements.[1] Doctors

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1. *See, e.g.*, World Medical Association, *The WMA International Code of Medical Ethics* (Dec. 13, 2022) ("The physician must practise with conscience, honesty, integrity, and accountability, while always exercising independent professional judgement and maintaining the highest standards of profes-

conduct research studies to help develop new pharmaceuticals or medical devices, invest in biotechnology companies, or own testing facilities or treatment centers that provide healthcare services. While these activities are essential to advancing medical science and improving patient care, the financial benefits physicians receive from these arrangements raise potential conflicts of interest.[2] One need only look at opioids, financial incentives, and prescribing practices to realize that something was broken with how conflicts of interest were managed.[3] Without robust ethical guidelines and disclosure requirements, how can the public have confidence that when a physician prescribes a drug for a patient or implants a medical device, the physician is motivated by the patient's best interests and not by expensive trips to exotic locations paid for by a drug company or a medical device manufacturer?

We demand independence of our judiciary. The Delaware Judge's Code of Judicial Conduct ("the Code") defines independence as "a judge's freedom from influence or controls other than those established by law."[4] According to the Code, "[a]n independent and honorable judiciary is indispensable to justice in our society. A judge should participate in establishing, maintaining and enforcing high standards of conduct, and should personally observe those standards, so that the judiciary's integrity, independence, and impartiality may be preserved."[5]

We also require a degree of independence of attorneys. Although attorneys have a duty to represent their clients zealously,[6] they also have a duty to the Court, such as the duty of candor.[7] A lawyer may not lie for a client[8] and in certain cir-

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sional conduct."), https://www.wma.net/policies-post/wma-international-code-of-medical-ethics.

2. *See* INST. OF MED. OF THE NAT'L ACAD.'S, *Conflict of Interest and Medical Practice*, *in* CONFLICTS OF INTEREST IN MEDICAL RESEARCH, EDUCATION, AND PRACTICE 166, 166–67 (2009).

3. *See* Jonathan H. Marks, *Lessons from Corporate Influence in the Opioid Epidemic: Toward a Norm of Separation*, 17 J. BIOETHICAL INQUIRY 173, 175, 180 (2020).

4. DEL. JUDGES' CODE OF JUDICIAL CONDUCT, Terminology (2008).

5. DEL. JUDGES' CODE OF JUDICIAL CONDUCT R.1.2(B) (2008).

6. *See* DEL. LAWYERS' R. PROF'L CONDUCT pmbl. (2008).

7. *See* DEL. LAWYERS' R. PROF'L CONDUCT R.3.3.

8. *See id.* at R.3.3, R.4.1.

cumstances, must withdraw from representation.[9] A lawyer also has a singular duty to the client even if the fees are paid by another.[10]

While some degree of independence is essential to well-functioning professions, it is also important to acknowledge that lawyers and judges are human beings. It might come as a surprise to some, but judges socialize with lawyers. We appoint lawyers to committees, lawyers defend us when we are sued, and they draft our wills. In response to potential conflicts of interest, judges have engineered ways to address the appearance of impropriety.[11]

Although directors are not subject to professional regulation like judges and lawyers, they can be called upon to exercise independent judgment and to evaluate the strengths and weaknesses of legal claims that might be asserted by the corporation against board members and others. And, like judges, directors have relatives and friends. They own property, make financial investments, and have other business activities. They have acquaintances who may be classmates, professional associates, or business contacts. They also hold memberships in clubs and other organizations and have political affiliations. It is a fact of life that "business dealings seldom take place between complete strangers" and "it would be a strained and artificial rule which required a director to be unacquainted or uninvolved with fellow directors in order to be regarded as independent."[12]

Under Delaware law, when dealing with director independence questions, we start with a presumption that directors approach their duties with professionalism and integrity.[13] Directors are typically accomplished people. They might serve on more than one board and make decisions for some of the largest corporations in the world. And to serve as an independent director on a listed company board, they are subject to stock

9. *See id.* at R.1.16.

10. *See id.* at R.1.8(f).

11. *See generally* DEL. JUDGES' CODE JUDICIAL CONDUCT Canon 3 (2008).

12. *In re* Oracle Sec. Litig., 852 F. Supp. 1437, 1442 (N.D. Cal. 1994).

13. *See* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1048 (Del. 2004) ("[D]irectors are entitled to a presumption that they were faithful to their fiduciary duties.").

exchange independence requirements.[14] According to the NYSE requirements, an "Independent Director" is one whom the board "affirmatively determines" has no "materiality relationship" with the company "either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company."[15] For the NASDAQ, an "Independent Director" means one who is not an executive officer or employee of the company and who, in the board's opinion, has no relationship which would "interfere with the exercise of independent judgment" in carrying out director responsibilities.[16] In other words, for listed companies, an independent director cannot have a material relationship with a company, is not part of the executive team, and is not involved in its day-to-day operations.

The stock exchange listing requirements are a start, but they do not recognize situational conflicts that might affect a director's independence. Delaware courts have not given substantial weight to the stock exchange independence requirements when assessing a director's independence.[17] The lack of deference is unsurprising because the independence inquiry is not a one size fits all proposition. It is highly contextual. And the regulations fail to consider other personal and professional connections between directors that lie outside the company's day-to-day operations.

One of the most influential Delaware Supreme Court decisions addressing director independence is *Beam v. Stewart*.[18] In that 2004 case, a stockholder of Martha Stewart Living Omnimedia filed a derivative action against Martha Stewart

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14. *See* NYSE Listed Company Manual § 303A.02; *see also* NASDAQ, Inc. Marketplace Rule § 5605(a)(2).

15. NYSE Listed Company Manual § 303A.02.

16. NASDAQ, Inc., Marketplace Rule § 5605(a)(2).

17. *See, e.g.*, Teamsters Union 25 Health Servs. & Ins. Plan v. Baiera, 119 A.3d 44, 61 (Del. Ch. 2015) ("[A] board's determination of director independence under the NYSE Rules is qualitatively different from, and thus does not operate as a surrogate for, this Court's analysis of independence under Delaware law . . . ."); *see also In re* Ezcorp Inc. Consulting Agreement Derivative Litig., 2016 WL 301245, at *36 (Del. Ch. Jan. 25, 2016) ("The independence standards established by stock exchanges and the requirements of Delaware law, such that a finding of independence (or its absence) under one source of authority is not determinative for purposes of the other . . . .").

18. *Beam*, 845 A.2d at 1040.

and five board members.[19] The stockholder alleged that Stewart, who controlled over 94% of the vote, breached her fiduciary duties by illegally selling ImClone stock for her personal account based on inside information and thereby damaging the company's reputation.[20] Two days after Stewart sold all her ImClone stock holdings, news broke that the FDA would not review ImClone's application for its cancer drug, the leading drug in ImClone's pipeline.[21]

We know that Martha Stewart faced criminal prosecution for her actions at the time. Due to her prominent media profile, the criminal case received widespread attention.[22] Stewart was convicted for criminal conduct and ended up serving a 5-month prison sentence and 5 months of home confinement.[23] A stockholder filed a derivative suit and claimed that her criminal actions harmed the company bearing her name. Because it was a derivative action, meaning the stockholder sued on behalf of the corporation, the stockholder also alleged that he could pursue the litigation on behalf of the corporation without the board's involvement because a majority of the board was not independent of Stewart.[24] Not unexpectedly, personal and professional relationships abounded among the board members and Stewart. In hearing the case, the Delaware Supreme Court had to sort through the conflicts.

In addressing whether a pre-suit demand on the board was excused because the board members were not independent of Stewart, Chief Justice Veasey wrote that a "key principle" in the director independence inquiry is that "directors are entitled to a presumption that they were faithful to their fiduciary duties."[25] The Court also observed that a director is con-

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19. *See id.* at 1044.

20. *Id.*

21. *See* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 833A.2d 961, 968 (Del. Ch. 2003).

22. *See, e.g.*, Constance L. Hays, *Prosecuting Martha Stewart: The Overview; Martha Stewart Indicted by U.S. On Obstruction*, N.Y. TIMES (June 5, 2003), https://www.nytimes.com/2003/06/05/business/prosecuting-martha-stewart-overview-martha-stewart-indicted-us-obstruction.html.

23. *See* Constance L. Hays, *Prosecuting Martha Stewart: 5 Months in Jail, and Stewart Vows, 'I'll Be Back'*, N.Y. TIMES (July 17, 2004), https://www.nytimes.com/2004/07/17/business/martha-stewart-s-sentence-overview-5-months-jail-stewart-vows-ll-be-back.html.

24. *See Beam*, 845 A.2d at 1049.

25. *Id.* at 1048.

sidered independent when a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.[26] Because the independence inquiry is a highly contextual and fact-specific determination, the assessment, according to the Court, is made in the context of a particular transaction or event.[27]

The Delaware Supreme Court in *Beam v. Stewart* addressed head-on the personal and professional relationships that might affect a director's independence. First, it rejected a structural bias argument, meaning pre-existing professional and social relationships or ones that naturally develop among board members impeded independent decision-making and rendered the board as a whole lacking independence from Stewart.[28] The Court reasoned that, although structural bias is a concern, the Court of Chancery has broad discretion to review in a particular case the specific facts pointing to bias.[29] In each case the court can decide whether the structural bias rises to the level that a majority of the board is compromised in its decision-making.[30] In other words, rather than adopt a bright line rule, the Delaware Supreme Court, as it often does, empowered the Court of Chancery to take a holistic view of the independence question in the context of a particular case.[31]

Also, in observations about relationships between the defendants and decision-makers, the Court found the allegations that Stewart and the other directors moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as "friends," were insufficient, without more, to rebut the presumption of a majority of the board's faithfulness to its fiduciary duties.[32] While a personal friendship or "outside business relationships" are relevant to a demand futility inquiry, the Court held that a materiality standard must be satisfied by showing that the relationship is of a "bias-producing" nature.[33] In the Delaware Supreme Court's view, the personal and pro-

26. *See id.* at 1049.
27. *See id.*
28. *See id.* at 1050–51.
29. *Id.* (citing Aronson v. Lewis, 473 A.2d 805, 815 n.8 (Del. 1984)).
30. *See id.* at 1051.
31. *See id.* at 1050.
32. *See id.* at 1051.
33. *Id.* at 1050.

fessional relationships pled in the *Stewart* case were insufficient to infer that the directors considering a demand may have been beholden to Stewart.[34]

Finally, the Delaware Supreme Court noted that the stockholder could have requested books and records from the corporation before filing suit to bolster its bias allegations.[35] The stockholder could have explored the nomination process, personal and financial connections between the directors and Stewart, and other information relevant to independence.[36] Because the stockholder did not take advantage of the tools at hand, the thinness of the pleading doomed the complaint to dismissal.[37]

Stewart is the starting point for many independence inquiry decisions involving personal and professional relationships. The Delaware Supreme Court recognized that independence depends on context, personal and professional relationships standing alone were not disqualifying, and it is up to the court in each case to decide how close is too close. Ultimately, the court was willing to accept some degree of personal and professional connections in the director independence inquiry and the trend in recent cases is to scrutinize those personal and professional relationships more closely.

I.
Independence in Three Contexts

Next, we look at the independence question in recurring contexts under Delaware law: (1) the work of a board committee formed to negotiate and review a transaction with a controlling stockholder; (2) Court of Chancery Rule 23.1 and the demand review committee; and (3) the special litigation committee and its authority to dismiss derivative litigation brought by a stockholder.

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34. *See id.* at 1052–54 ("That is not to say that personal friendship is always irrelevant to the independence calculus. But, for presuit demand purposes, friendship must be accompanied by substantially more in the nature of serious allegations that would lead to a reasonable doubt as to a director's independence.").

35. *See id.* at 1056–57.

36. *See id.*

37. *See id.* at 1057.

A. *Controlling Stockholder Transactions*

Taking the transaction committee first, a transaction approved by a majority of independent and disinterested directors will typically get deferential business judgment review by the Court of Chancery.[38] But a transaction approved by a majority of interested or conflicted directors will merit entire fairness review, described as the most stringent form of review under Delaware law.[39] Although not outcome determinative, surviving entire fairness review is a steep hill to climb. When a transaction involves a controlling stockholder, the board independence inquiry is center stage.

To avoid automatic entire fairness review of a controller transaction and the inevitable litigation that follows such transactions, our Court in *Kahn v. M & F Worldwide Corp* ("*MFW*") gave transaction planners a path to business judgment review of the transaction.[40] The court would apply the business judgment standard of review if the negotiations replicated arm's-length bargaining by a board committee representing the minority's interests.[41]

We held that a controller in a squeeze-out transaction can secure business judgment review if the transaction meets the following requirements:

> (i) the controller conditions the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of

38. *See* Grobow v. Perot, 539 A.2d 180, 190 (Del. 1988), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) ("Approval of a transaction by a majority of independent, disinterested directors almost always bolsters a presumption that the business judgment rule attaches to transactions approved by a board of directors that are later attacked on grounds of lack of due care.").

39. *See In re* Trados Inc. S'holder Litig., 73 A.3d 17, 44 (Del. Ch. 2013).

40. *See* Kahn v. M & F Worldwide Corp., 88 A.3d 635, 645 (Del. 2014), *overruled on other grounds by* Flood v. Synutra Int'l, Inc., 195 A.3d 754 (Del. 2018).

41. *See id.* at 644.

> the minority is informed; and (vi) there is no coercion of the minority.[42]

Two recent decisions from the Court of Chancery dealt with the independence question in the context of a controlling stockholder transaction that the board claimed was subject to *MFW* protections. In the first decision, *City Pension Fund for Firefighters & Police Officers in City of Miami v. The Trade Desk, Inc.* ("*The Trade Desk*"), the court confronted a challenge to a certificate of incorporation amendment proposed by the controlling stockholder that extended the duration of its dual-class stock structure and therefore its controlling position.[43] The board appointed a special committee to negotiate and review the transaction.[44] After approval, minority stockholders filed suit and challenged the transaction as unfair.[45] The court granted the motion to dismiss the complaint after finding that the *MFW* conditions had been satisfied.[46] The court found dispositive that the stockholder challenged only the independence of the special committee chair, leaving two special committee members unscathed.[47] Because the court typically reviews the independence question on a director-by-director basis, a majority of the special committee was essentially conceded to be independent.[48]

Hoping to get around the challenging fact that a majority of the special committee was independent, the stockholder claimed that the special committee labored under a "controlled mindset," meaning that the committee members' board service was material to the members and by ingratiating themselves with the controller they would ensure their continued service.[49] This controlled mindset theory sounds like another way of describing the structural bias rejected in *Beam v. Stewart*.[50]

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42. *Id.* at 639.

43. City Pension Fund for Firefighters & Police Officers in City of Miami v. The Trade Desk, Inc., 2022 WL 3009959, at *1 (Del. Ch. July 29, 2022).

44. *See id.* at *4.

45. *See id.* at *8.

46. *See id.* at *23.

47. *See id.* at *11–12.

48. *Id.*

49. *Id.*

50. *Compare The Trade Desk*, 2022 WL 3009959, at *14–16 *with Beam*, 845 A.2d at 1050–51 ("The facts alleged by Beam regarding the relationships

According to the court, the theory was not enough by itself.[51] The complaint lacked allegations that the controller interfered or pressured the committee members.[52] The court also was unpersuaded by an "infection" theory, meaning that the director who lacked independence infected the special committee process.[53] Under either the controlled mindset or the infection theory, the court found that the stockholder merely disagreed with the committee's decision on the merits rather than meaningfully attacking the committee's independence.[54]

By contrast, the Court of Chancery in *In re Dell Technologies* found that the special committee set up to negotiate a share conversion right lacked independence from Michael Dell and the company's private equity owner.[55] The case involved a post-closing challenge to a negotiated redemption of its Class V shares by Dell Technologies Inc., a company controlled by Michael Dell and private equity firm Silver Lake.[56] Dell's board of directors established a two-member Special Committee to negotiate a redemption of the Class V shares.[57] The eventual redemption was approved by both a special committee and the minority stockholders.[58] After litigation was filed, the defendants sought the protections of *MFW*. At the pleading stage, the Court of Chancery found that *MFW* could not be used to obtain business judgment review of the transaction. Instead, the "entire fairness" standard of review would apply.[59]

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between Stewart and these other members of MSO's board of directors largely boil down to a 'structural bias' argument, which presupposes that the professional and social relationships that naturally develop among members of a board impede independent decisionmaking.").

51. *See Trade Desk*, 2022 WL 3009959, at *11.

52. *See id.* at *17.

53. *See id.* at *13–14.

54. *The Trade Desk, Inc.*, 2022 WL 3009959, at *14 ("Plaintiff has not pleaded sufficient facts alleging that Buyer's conduct dominated or subverted the Special Committee process so as render the entire committee defective, even if she was determined to be lacking in independence.").

55. *See In re* Dell Techs. Inc. Class V S'holders Litig., 2020 WL 3096748, at *35–38 (Del. Ch. June 11, 2020).

56. *See id.* at *1.

57. *See id.*

58. *See id.* at *2.

59. *See id.* at *44.

Regarding independence, the court viewed the company's committee members as potentially not independent due to extensive business co-investments and connections with Michael Dell and Silver Lake, as well as personal connections based on membership in the same exclusive golf clubs (which featured prominently in the decision).[60] In the case of one director, the court relied on a transitive view of a lack of independence, meaning that the business and personal connections with the best friend of the controller rather than the controller himself were relevant to the independence inquiry.[61] One committee member and the managing partner of Silver Lake were also "platinum" donors, donating over $25,000 per year to the University of Georgia.[62] These relationships, said the court, "taken as whole," made it reasonably conceivable that the committee members' ability "to engage in hard-nosed bargaining as a member of the Special Committee" was compromised.[63]

B. *Demand Review Committee*

Turning to the demand review committee, there are a wealth of cases addressing committee independence after *Beam v. Stewart*. A few recent cases stand out for showing different outcomes depending on the facts.

For context, Court of Chancery Rule 23.1(a) requires that a stockholder seeking to assert a claim on behalf of the corporation must first, before filing suit, make a demand on the board of directors that the board pursue the claim.[64] This is a product of Delaware statutory law and specifically §141 of the Delaware General Corporation Law that concentrates the power to manage the business and affairs of the corporation in the board of directors.[65] However, the demand requirement is excused when it would be futile to make a demand on the

60. *See id.* at *36–37.

61. *See id.* at *37–38 (referencing Green's relationships with Dell's best friend Joseph Tucci).

62. *See id.* at *36.

63. *See id.* at *43.

64. Ct. Ch. R. 23.1(a) ("[t]he complaint shall . . . allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort.").

65. DEL. CODE ANN. tit. 8, §141.

board because a majority of the board is either interested or lacks independence.[66] For brevity's sake, our focus will be on the issue of independence.

In *Sandys v. Pincus*, a Delaware Supreme Court case, the plaintiff alleged derivative claims that certain top managers and directors at Zynga, including its former CEO, Chairman, and controlling stockholder, were given an exemption to the company's standing rule preventing sales by insiders until three days after an earnings announcement.[67] According to the plaintiff, top Zynga insiders sold millions of shares of stock at $12 per share for $236.7 million as part of a secondary offering before Zynga's April 26, 2012 earnings announcement.[68] Immediately after the earnings announcement, the market price dropped 9.6% to $8.52 per share.[69] Three months later, following the release of additional negative information, which the plaintiff alleges was known by Zynga management and the board when it granted the exemption, Zynga's market price declined to $3.18 per share, a decrease of 73.5% from the $12.00 per share offering price.[70]

The plaintiff alleged that the insiders who participated in the sale breached their fiduciary duties by misusing confidential information when they sold their shares while in possession of adverse, material non-public information.[71] It was also alleged that demand on the board was futile because a majority of the board lacked independence from the defendants.[72]

Our Court in a split decision reversed the Court of Chancery's independence determination and found that certain directors of Zynga were not independent because of personal and professional connections to the company's controlling stockholder.[73] Along with other connections, we found that the co-ownership of an airplane by a director and the investigation target was so unusual in nature as to demonstrate actual bias since it "requires close cooperation in use, which is suggestive of detailed planning indicative of a continuing, close

66. *See* Zapata v. Maldonado, 430 A.2d 779, 787–89 (Del. 1981).
67. *See* Sandys v. Pincus, 152 A.3d 124, 126–27 (Del. 2016).
68. *Id.* at 127.
69. *Id.*
70. *Id.*
71. *Id.*
72. *See id.* at 126.
73. *See id.* at 134.

personal friendship."[74] This has come to be known in plaintiff circles as "the airplane rule," where if you co-own an airplane, you start out behind in the independence inquiry.[75] The *Sandys* decision has been viewed as part of a continuing shift by the Delaware judiciary to scrutinize personal and business relationships more closely.[76]

From airplanes, we move to ice cream. In *Marchand v. Barnhill*, the plaintiffs asserted a derivative claim against the directors for lack of oversight under the famous *Caremark*[77] decision by Chancellor Allen.[78] Blue Bell sold ice cream contaminated with listeria resulting in the sickness and death of consumers.[79] The plaintiffs filed suit and claimed a lack of board oversight of the corporation's essential operations because the Blue Bell board allegedly failed to implement any system to monitor Blue Bell's food safety performance or compliance.[80]

In response to the defendants' motion to dismiss for failure to make a demand on the board before filing suit, the Court of Chancery found that the Blue Bell board was independent by one director, a director that had previously worked for Blue Bell.[81]

We reversed and found that the director declared independent by the Court of Chancery could not impartially de-

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74. *See id.* at 130.

75. *See* Steven M. Haas, *Co-Owning an Airplane and Other Things that May Affect Director Independence*, HUNTON & WILLIAMS (Feb. 2017), https://www.huntonak.com/en/insights/co-owning-an-airplane-and-other-things-that-may-affect-director-independence.html.

76. *See, e.g.*, Timothy R. Dudderar & Tyson J Prisbrey, *Delaware Insider: Sandys v. Pincus: Personal Relationships and Director Independence*, BUS. L. TODAY, January 2017, at 1, 3 ("*Sandys* . . . provides some additional clarity regarding the types of unique personal relationships that can alone affect director independence."); Nathan P. Emeritz, *Independence Issues in the Entrepreneurial Ecosystem*, BUS. L. TODAY, May 2017, at 1, 6 (highlighting *Sandys* to note that "corporate practitioners should be cognizant of the Delaware judiciary's focus on [personal] connections"); DEBORAH A. DEMOTT, SHAREHOLDER DERIV. ACTIONS L. & PRAC. § 5:13 (2022–2023) (citing *Sandys* to highlight "the importance of considering all particularized facts alleged about [personal] relationships in their totality").

77. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

78. *See* Marchand v. Barnhill, 212 A.3d 805, 807–08 (Del. 2019).

79. *See id.* at 807.

80. *See id.*

81. *See id.* at 808.

cide whether to sue members of the Kruse family, who founded Blue Bell, because the family had been instrumental in this director's career success, which included 28 years at the company, becoming chief financial officer and being elected a director.[82] The Kruse family also led a campaign that resulted in over $450,000 being donated to a local college, which resulted in the naming of a building after the director.[83] The Court explained that Delaware law "cannot ignore the social nature of humans or that they are motivated by things other than money, such as love, friendship, and collegiality."[84]

By contrast, our Court in the 2021 decision *United Food & Commercial Works Union v. Zuckerberg* differentiated between "thin" as opposed to "thick" friendships or relationships.[85] A plaintiff filed suit claiming that the Facebook board of directors breached its fiduciary duties by approving a stock reclassification proposal that would have allowed Facebook founder Mark Zuckerberg to retain voting control of Facebook even after donating a significant portion of his shares to charitable causes.[86] The Court of Chancery dismissed the plaintiff's claim for failure to make a demand on the board before filing suit.[87]

The *Zuckerberg* decision is best known for a restatement of the demand futility test before bringing shareholder derivative claims.[88] Part of the test addresses the independence of the board that would review a demand.[89] The plaintiff alleged that a majority of the directors on the Demand Review Board lacked independence from Zuckerberg.[90] We affirmed the Court of Chancery.[91] As we noted in *Beam v. Stewart*, to show a lack of independence the plaintiff must satisfy a materiality standard.[92] The plaintiff must allege that "the director in question had ties to the person whose proposal or actions he or she

82. *Id.*
83. *Id.*
84. *Id.* at 818.
85. *See* United Food & Com. Works Union v. Zuckerberg, 262 A.3d 1034, 1061 (Del. 2021) (detailing how levels of friendship differ in the weight the court accords them).
86. *See id.* at 1046.
87. *See id.* at 1046–47.
88. *See id.* at 1059 (outlining the restatement of the demand futility test).
89. *See id.*
90. *See id.* at 1056.
91. *See id.* at 1064.
92. *See id.* at 1061; *see also Beam*, 845 A.2d at 1050.

is evaluating that are sufficiently substantial that he or she could not objectively discharge his or her fiduciary duties."[93] The relationship must be of a bias-producing nature.[94] Friendships and financial ties, without more, are not disqualifying.[95]

In addressing demand futility, we found that a majority of the directors were independent of Zuckerberg.[96] For one director, Peter Thiel, the plaintiff alleged that Thiel harbored a "sense of obligation" to Zuckerberg for not removing Thiel from the Facebook board in the face of public scandal.[97] The defendants countered that the plaintiffs failed to allege that remaining a Facebook director was "financially or personally material to Thiel."[98]

Our Court agreed with the Court of Chancery that, given Thiel's wealth and stature, "[t]he complaint does not support an inference that Thiel's service on the Board is financially material to him. Nor does the complaint sufficiently allege that serving as a Facebook director confers such cachet that Thiel's independence is compromised."[99] Finally, the Court also was not persuaded by a "founder bias" theory without more specific allegations to back it up.[100]

C. *Special Litigation Committee*

In the last category of cases, Special Litigation Committees (SLC), it is fair to say that independence is scrutinized with more rigor. The SLC springs from the Delaware Supreme Court's early decision in *Zapata v. Maldonado*.[101] In that case, the court allowed an SLC to gain dismissal of pending derivative litigation if certain conditions are met.[102]

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93. *See Zuckerberg*, 262 A.3d at 1061.
94. *See id.*
95. *See id.*
96. *See id.*
97. *Id.* at 1063.
98. *Id.* at 1063.
99. *Id.* (quoting United Food & Com. Workers Union v. Zuckerberg, 250 A.3d 862, 898 (Del. Ch. 2020)).
100. *See id.* at 1063 ("[A] director's good faith belief that founder controller maximizes value does not raise a reasonable doubt that the director lacks independence from a corporation's founder.").
101. *See* Zapata v. Maldonado, 430 A.2d 779, 785 (Del. 1981) ("[A]n independent committee possesses the corporate power to seek the termination of a derivative suit.").
102. *See id.* at 787.

Unlike a demand review committee, the SLC arises when demand is futile and is a final way for the board to retain control of a derivative suit.[103] In other words, even if a board is deemed to lack independence after derivative litigation has been filed on behalf of the corporation, the board can still take control of the litigation from the stockholder by appointing an SLC.

An SLC has the power to investigate and to evaluate whether the suit should be pursued on behalf of the corporation. That inquiry requires the SLC to consider not just the merits of the claims but also the costs to the corporation of pursuing the litigation and other factors.

In the *Zapata* decision, the Court approved of the conflicted board appointing the SLC members.[104] But the Court recognized that because a conflicted board appoints the SLC, and the SLC has the power to obtain dismissal of the litigation, more substantial guardrails were needed than in the demand review context.[105]

The heightened scrutiny in the context of an SLC includes a summary judgment standard that must be met by the SLC, meaning the SLC bears the burden to show that the committee was independent and had reasonable bases for its findings and recommendations.[106] For each SLC member, the court asks whether the SLC member would be more willing to risk her reputation than the personal or professional relationship with the director subject to investigation.[107] "If the court determines either that the committee is not independent or has not shown reasonable bases for its conclusions," the motion is denied and litigation control reverts to the stockholder.[108]

Next, we turn our focus on a recent decision in the SLC context that can be fairly characterized as a close call. Indeed, the Chancellor has used the words "close call" in several recent opinions, and one can understand why after reviewing the facts of many of these cases.

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103. *See id.* at 787–88.
104. *See id.* at 786.
105. *See id.* at 786–87.
106. *See id.* at 787–88.
107. *See id.*
108. *See id.* at 789.

In *Diep on behalf of El Pollo Loco Holdings, Inc. v. Trimaran Pollo Partners* ("*El Pollo Loco*"), after the Court of Chancery denied a motion to dismiss for failure to make a demand, meaning the litigation could proceed, the board appointed a three director SLC to review claims brought against the company for insider trading by board member-investors who sold stock at a substantial profit just before the release of a negative earnings outlook.[109] Not unexpectedly, two of the three SLC members had business and social relationships with the individual defendants and the other director's independence was not challenged.[110]

An important circumstance dominated the analysis. Two of the SLC members were on the board when a motion to dismiss was filed.[111] The motion filed by the defendants raised not just the failure to make a demand; it also moved to dismiss on the merits.[112] The plaintiff alleged that two of the three SLC members were not independent because they had prejudged the subject matter of the SLC investigation by approving a move to dismiss those claims for lack of merit.[113] In other words, when the company moved to dismiss the litigation, they staked out their position that the claims were without merit.

A majority of the Delaware Supreme Court rejected that contention, holding that the record did not show that the two SLC members had "approved or participated in a substantive way in the decision to file the motion to dismiss."[114] Noting that "independence is a fact-specific determination made in the context of a particular case," the majority recited what it considered to be the relevant facts.[115] At a board meeting, the directors, including the two SLC members, had received:

> "an update regarding 'pending litigation'" . . . . The minutes [of the meeting] d[id] not mention the motion to dismiss. . . . [T]he record is devoid of evidence that [one of the two SLC members] was in-

109. Diep *ex rel.* El Pollo Loco Holdings, Inc. v. Trimaran Pollo Partners, L.L.C., 280 A.3d 133, 136–37 (Del. 2022).
110. *See id.* at 146–147.
111. *See id.*
112. *See id.* at 146.
113. *See id.*
114. *Id.* at 153.
115. *Id.* at 152–53.

> volved in any discussion about, or approved the filing of, the motion to dismiss. [The other SLC member] . . . was "sure" there "would have" been a "litigation update" and "discussion" on the subject, but "did not recall the details of it." Although [that second SLC member] did not recall anyone objecting to the motion, he did not say he "approved of its filing."[116]

The majority concluded that "these facts do not raise a material question of fact about whether [the two SLC members] prejudged the merits of the suit because they were exposed to a litigation review that included a less than in-depth discussion of the motion to dismiss."[117]

The dissent took a contrary view. It viewed the record as "show[ing] more than just [the two SLC members'] mere presence on the Board when the 2016 Motion [to Dismiss] was filed."[118] According to the dissent:

> The motion [to dismiss] was discussed with the Board and that no director objected to its filing. [One SLC member] specifically stated that he did not object to its filing. The logical conclusion is that the Board, at least tacitly, approved and authorized filing the 2016 Motion after discussion. . . . The 2016 Motion was obviously authorized by someone. Given that a corporation acts through its board of directors, and given that the motion was the subject of a Board discussion, the record suggests that the Board authorized it.[119]

II.
Discussion

Ok, enough about cases. It is now the time when I am required to say something profound.

First, these are hard cases. They are highly situational and depend on the materiality of the financial entanglements and the number and depth of the business and personal connections between the independent directors and the defendants.

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116. *Id.* at 153.
117. *Id.* at 154.
118. *Id.* at 168 (Valihura, J., dissenting).
119. *Id.* at 168 (Valihura, J., dissenting).

They are also uncomfortable because we tend to think instinctively, like judges and lawyers, that conflicts are inherently bad.

Second, I think it is accurate to say that there has been a trend in the cases to place a greater emphasis on non-economic factors in the independence analysis. As one paper has summed it up, the Delaware courts are taking a closer look at factors such as "'length of service on a board or committee, levels and types of director compensation and the robustness of the nominating committee and its nominating process,'[120] philanthropic, professional, personal, familial and any other type of connections between directors that could create 'an unacceptable risk of bias.'"[121]

Third, the trend towards greater scrutiny in controller transactions might be traced to the significant cleansing powers given to independent committees evaluating conflicted transactions. Like an SLC, who can move to terminate litigation, the board can structure an independent special committee process to invoke *MFW* protections. As noted earlier, an effective independent committee process can shield a conflicted transaction from entire fairness review, effectively immunizing the transaction from court review.

Fourth, a demand review committee has a great deal of power in that it can also consider factors other than the merits of the claims to assess whether claims should be pursued. It is unclear whether time, expense, and distraction of the board and management should trump valid claims, but we have recognized that it is one factor to consider when evaluating a demand.[122]

And fifth, to my mind there has been a trend in litigated cases to test the limits of the court's willingness to allow conflicts. In other words, boards are appointing directors to independent committees with material business and personal conflicts to see if they can run the litigation gauntlet.

El Pollo Loco is a prime example of such limits-testing. Instead of seeing what can be gotten away with, it will be far

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120. Jeremy J. Kobeski, *In re Oracle Corporation Derivative Litigation: Has A New Species of Director Independence Been Uncovered?*, 29 DEL. J. CORP. L. 849, 849 (2004).

121. *Id.* at 867 (quoting Shearman & Sterling, LLP, *In re Oracle Corp. Derivative Litigation: Possible Implications for Director Independence*, Client Publication, July 2003, at http://www.shearman.com.).

122. *See Zuckerberg*, 262 A.3d at 1056.

more cost-effective and beneficial in the long run if boards and their legal advisors keep in mind that the goal is to have a committee of directors that can replicate arm's-length bargaining to protect minority stockholders and in the case of claims brought on behalf of the corporation against the board and others, have a committee that can dispassionately evaluate the claims and decide without outside influence whether the claims should be pursued.

What are some suggestions to address the independence question? In a recent paper, Professor Lucian A. Bebchuk proposed that, when it comes to controlled company transactions, to induce independent directors to perform their oversight role, some independent directors should be accountable directly to public investors.[123] Professor Bebchuk argues that "[t]his can be achieved by empowering investors to determine or at least substantially influence the election or retention of these directors."[124]

These "enhanced-independence" directors would play a key role in vetting "conflicted decisions," where the interests of the controller and public investors substantially diverge without possessing a special role concerning other corporate issues.[125] According to Professor Bebchuk, enhancing the independence of some directors would improve the protection of public investors without undermining the ability of the controller to set the firm's strategy.[126] This separate class of directors would (i) lack the incentives produced by the controller's influence over the directors' appointment and retention and (ii) have some incentives that flow from making the directors accountable to public investors.[127] The practicality of this approach is untested but it has been suggested.

Another idea is to have a pool of independent directors that could be appointed to a board for the limited purpose to address heightened independence problems. I know retired judges have been used in this capacity. It has also been suggested that when the special committee is at high risk of an unfavorable outcome on the demand review front, the board

123. Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271, 1272 (2017).
124. *Id.*
125. *See id.* at 1274.
126. *See id.*
127. *Id.* at 1296–97.

might skip the motion to dismiss for failure to make a demand and go straight to the appointment of a special litigation committee. One advantage of such a strategy is avoiding an unfavorable judicial decision with negative statements that must be taken as true for purposes of the motion to dismiss.

What does the Model Business Corporation Act (MBCA) say about director independence? Its definitions do not materially advance the debate. The MBCA speaks in terms of "qualified directors" depending on the action taken.[128] A qualified director, for independence purposes, does not have a material relationship with another involved director where material means a familial, financial, professional, employment, or other relationship that would be reasonably expected to impair the director's judgment.[129] It also lists circumstances that are not automatically disqualifying of nomination to the board such as service on another board with the target director or individual and status as a named defendant.[130]

These proposals are a means to achieve what the board can do through its own appointment process by selecting individuals with non-material financial and personal connections to serve on special committees or to have independent directors select the independent directors to serve on a committee. In such a scenario, it may be necessary to appoint new board members to fill this role. In addition to using common sense, here are some other measures that can be taken to increase the odds of an independence finding by a Delaware court:

1. Retain independent advisors such as bankers and lawyers; selecting and relying on independent advisors are common components of a reviewing court's assessment of the committee's conduct.
2. Disclose personal and business ties up front and address the independence issues head on and avoid situations where committee member conflicts do not surface until litigation is filed.
3. If the potential independent director is on the board when a demand is received, insulate that director from the litigation contesting the demand.

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128. MODEL BUS. CORP. ACT § 1.43.
129. *See id.*
130. *Id.*

4. Lastly, pass on a director who shares a jet with the controller or the target of the investigation.

Conclusion

It is worth emphasizing that:

> it is a contingent risk we are dealing with, that an interest conflict is not in itself a crime or a tort or necessarily injurious to others. Contrary to much popular usage, having a "conflict of interest" is not something one is "guilty of". It is simply a state of affairs. Indeed, in many situations, the corporation and the shareholders may secure major benefits from a transaction despite the presence of a director's conflicting interest.[131]

There is nothing evil about being a director with ties to other directors. That is how many directors are recruited. But when it comes to replicating arm's-length bargaining or reviewing a director's conduct for possible or pending litigation, the less conflicts, the better. How close is too close? We will let you know. Thank you for inviting me to speak tonight.

131. Model Bus. Corp. Act ch. 8(F), intro. cmt. 1 (1984) (Am. Bar. Ass'n, amended 2016).