Think satisfying the director independence standards under Sarbanes-Oxley and stock exchange rules means that a director must be independent under Delaware law? Think again—and understand the potential litigation consequences of a lack of director independence under Delaware law.

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As readers are well-aware, Sarbanes-Oxley, the New York Stock Exchange ("NYSE") and NASDAQ have established standards for director independence. These are not the only director independence standards that can affect a corporation and its board. Director independence is also significant under Delaware law. Although similar, the standards for director independence under Sarbanes-Oxley, stock exchange rules and Delaware law differ. A director who is independent under Sarbanes-Oxley may not be independent under stock exchange rules or Delaware law and vice versa.

So why does it matter if a director is independent under Sarbanes-Oxley and/or stock exchange rules, but not Delaware law? If stockholders sue directors of a Delaware corporation (the majority of Fortune 500 companies and companies on the NYSE are incorporated in Delaware) for breach of fiduciary duties, it is likely that a court will apply Delaware law. A finding that a majority of directors is not independent under Delaware law can have serious consequences, including increased litigation expenses, in fiduciary duty litigation.

The Different Standards For Director Independence

Under the bright line standards of Sarbanes-Oxley, an Audit Committee member may not: (1) accept directly or indirectly any consulting, advisory or other compensatory fee from the issuer or any subsidiary (excluding, unless applicable listing criteria provide

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otherwise, receipt of fixed amounts of compensation under a retirement plan for prior service with the issuer, provided that such compensation is not contingent in any way on continued service); or (2) be an affiliated person of the issuer or any subsidiary thereof. Indirect acceptance includes acceptance of such a fee by the member's spouse, minor child or stepchild or a child or stepchild sharing a home with the member, or by an entity, in which such member is a partner, member or an officer and which provides accounting, consulting, legal, investment banking or financial advisory services to the company or any subsidiary.

Unlike Sarbanes-Oxley, there is no bright line test for director independence under Delaware law. Delaware courts have defined independence to mean "that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984). Although Delaware courts have noted that directors qualify as independent under the NYSE Rules, they still apply Delaware law to determine whether these directors are independent.

The NASDAQ and NYSE Rules fall somewhere between Sarbanes-Oxley and Delaware law, containing both general principles and bright line rules. Under the NYSE Rules a board of directors must determine that an independent director has no material relationship with the company and consider broadly all relevant facts and circumstances in making that determination. The NYSE Rules also establish categories of relationships that preclude a director from being considered independent, including: (1) a director who is or was in the past three years an employee of the company or has an immediate family member who is or was an executive officer of the company; (2) a director or an

immediate family member who has received more than $100,000 per year in any twelve month period in the last three years, other than director fees and pensions or other forms of deferred compensation; and (3) a director who is an employee, or whose immediate family member is an executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of the other company's consolidated gross revenues.

The NASDAQ Rules define an independent director as a person other than: (1) an executive officer; (2) an employee of the company; (3) or any other person having a relationship, which the company's board of director believes would interfere with the person's exercise of independent judgment in carrying out his or her responsibilities as a director. Like the NYSE Rules, the NASDAQ Rules establish categories of relationships that preclude a director from being independent. These categories include: (1) a director who is or was within the past three years, an employee of the company or any parent or subsidiary; (2) a director or family member who has received more than $60,000 in any consecutive twelve month period in the last three years, other than director fees, compensation to a non-executive family member or compensation pursuant to a retirement plan; (3) a director with a family member who is or was within the past three years an executive officer of the company; and (4) a director or family member who is a partner, controlling stockholder or executive officer of an organization to which the company made, or received, payments, property or services in the current year or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for the year or $200,000 whichever is greater.

Given these differing standards, it is possible for a director to be independent under Sarbanes-Oxley or NASDAQ and NYSE Rules, but not Delaware law. While Sarbanes-Oxley focuses on the present and the NASDAQ and NYSE Rules have a three year look-back, a court applying Delaware law could look back decades in determining whether a director is independent. In *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003), for example, the Court of Chancery took into account events more than twenty years earlier in concluding that members of a special litigation committee were not sufficiently independent. Additionally, Sarbanes-Oxley would not disqualify directors from the Audit Committee if they worked for non-profit organizations that received donations from the company. Under Delaware law, however, courts have found directors not independent where they solicited large non-profit donations from other directors.

Alternatively, a director might not qualify as independent under Sarbanes-Oxley or stock exchange rules, but be considered independent under Delaware law. For example, under Sarbanes-Oxley, a director is disqualified from the Audit Committee for receiving any consulting or advisory fee, no matter how small. Under Delaware law, however, courts have found directors who received immaterial consulting or advisory fees to be independent.

Potential Litigation Consequences

There can be serious litigation consequences for a company and its directors if the independence of directors is questionable under Delaware law. A court's determination of director independence under Delaware law can affect: (i) the standard of review applicable to a challenged transaction, (ii) its assessment of a special committee that was

formed to review the challenged transaction, (iii) whether a stockholder is entitled to pursue derivative litigation on behalf of a corporation against its directors, and (iv) whether the court will accept the recommendation of a special litigation committee to dismiss litigation brought on behalf of the company.

Outside of change of control transactions or where defensive measures are at issue, challenged transactions will be subject to the business judgment rule or the entire fairness standard of review. Pursuant to the business judgment rule, a court presumes that directors acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the corporation. Thus, if a court determines that a challenged transaction is subject to the business judgment rule, it will dismiss claims against directors and/or the corporation arising from the challenged transaction. A plaintiff may rebut the presumption that a challenged transaction is subject to the business judgment rule by showing that a majority of the directors approving the challenged transaction was either interested in the transaction or not independent of a person with an interest in the transaction. In that situation, the challenged transaction is subject to the entire fairness standard of review. Under the entire fairness standard of review, defendant directors and/or the corporation may be required to establish the challenged transaction was the result of fair dealing and fair price. If a court concludes that there is a possibility that the entire fairness standard of review will apply to the challenged transaction, dismissal of an action prior to trial is unlikely.

In a transaction with a controlling stockholder or where a majority of the directors is either interested or not independent of a director with an interest, a corporation may form a special committee of directors to negotiate and approve the transaction. If a

special committee of disinterested and independent directors negotiates and approves a transaction with a controlling stockholder, the standard of review is still entire fairness, but the burden shifts to the plaintiff to prove unfairness. Defendant directors and/or a corporation will not be able to obtain this burden shift if a majority of the special committee members are not independent.

A derivative plaintiff (a stockholder who institutes litigation on behalf of the company) is required to either demand that a corporation sue its directors and then, assuming the corporation refuses the demand, show why the demand was wrongfully refused, or allege that demand would be futile. When the board of directors that would be considering a demand made the challenged decision, a court will consider for demand futility purposes whether: (1) a majority of the directors are disinterested and independent; and (2) the challenged transaction was the product of a valid exercise of business judgment. If the board that would be considering a demand did not make the challenged decision or the subject of the derivative action is not a board decision, then the court must determine whether there is a reasonable doubt at the time the complaint is filed, that the board could have exercised its independent and disinterested business judgment in responding to a demand. A derivative plaintiff bears the burden of showing demand futility. If a court concludes that demand would have been futile, it will not dismiss a derivative complaint for lack of demand.

A director is not independent if the stockholder's complaint creates a reasonable doubt that a director is so beholden to an interested director that his or her judgment is compromised. Allegations of friendship or business relationships among directors, standing alone, are insufficient to raise a reasonable doubt about a director's

independence. A director's business ties with a corporation may render that director not independent if the relationship is material to the director and a conflicted or interested director controls that relationship.

Finally, independence is important in a Delaware court's determination of whether a special litigation committee may dismiss a derivative action. A board of directors may delegate its authority to respond to a demand or a derivative action to a special litigation committee. If a special litigation committee moves to dismiss a derivative action, the court must inquire into the independence and good faith of the committee members and review the reasonableness and good faith of the committee's investigation. Unlike in the demand futility context where the derivative plaintiff bears the burden of creating a reasonable doubt as to the independence of a majority of directors, a special litigation committee bears the burden of proving its independence. In *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003), the Court of Chancery concluded that the SLC had failed to establish there was no material factual question regarding its independence because of the strong ties the special litigation committee members and the directors accused of wrongdoing had to Stanford University.

What to Remember

While no Delaware court has specifically held that a director who qualified as independent under Sarbanes-Oxley or stock exchange rules was not independent under Delaware law, such a result is possible under the different standards for director independence. Boards should:

- Not assume that because a majority of their directors are independent under Sarbanes-Oxley or stock exchange rules, those directors are therefore independent under Delaware law.
- Keep Delaware law (or the law of the state of incorporation) in mind in evaluating director independence.
- Consider the context in which director independence arises. While a stockholder plaintiff in a derivative action bears the burden of alleging facts creating a reasonable doubt as to a majority of the board's independence, a special litigation committee bears the burden of proving its independence.
- In appointing directors to a special committee or special litigation committee, a board should re-evaluate the interest and independence of potential members in light of the transaction to be reviewed or the subject of the special litigation committee's investigation.

By considering Delaware standards for director independence, as well as Sarbanes-Oxley and stock exchange rules, a board could save itself significant litigation expenses down the road.