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PERSPECTIVE

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Private planes and director independence

By Marc Boiron

In *Sandys v. Pincus*, the Delaware Supreme Court reversed the Delaware Court of Chancery's dismissal of a derivative suit against Zynga Inc.'s directors and officers related to an offering of Zynga's stock. On Dec. 5, in a 4-1 decision, the Supreme Court held that a director's co-ownership of a private airplane with the company's CEO and controlling stockholder, or sharing of a venture capital network with other directors, raises a reasonable doubt as to the director's independence.

Zynga completed an initial public offering priced at $10 per share, which was followed by a secondary offering priced at $12 per share. Before the IPO, all of Zynga's directors, officers and employees, and most of the other investors at the time, had agreed to lockup restrictions, which prohibited the sale of any of their shares of Zynga's stock before May 2012.

In March 2012, Zynga's board of directors approved modifications to the lockup restrictions on most of Zynga's shares of stock to stagger the end date of the lockup restrictions. The lockup restrictions on the sale of Zynga's stock (i) were waived (together with Zynga's blackout policy on the sale of stock around quarterly earnings) for certain investors, including four of Zynga's eight directors, on approximately 20 percent of their shares subject to the restrictions; (ii) were waived for all non-executive employees, but the blackout policy remained in place; (iii) were unmodified for shares held by former employees of Zynga and certain institution investors; and (iv) were extended for all stockholders that could participate in the secondary offering on approximately 80 percent of their shares subject to the restrictions. Only the first group of stockholders were able to participate in the secondary offering of Zynga's stock, which allegedly resulted in a benefit of approximately $100 million to those stockholders because they sold their shares before a steep decline in the value of Zynga's stock.

New York Times

Mark Pincus, the founder and controlling stockholder of Zynga, at the company's headquarters in San Francisco, Oct. 11, 2011.

The plaintiff stockholder commenced an action against, among others, Zynga's directors at the time of the secondary offering for breach of their fiduciary duty of loyalty, resulting from their waiver of the lockup restrictions for the benefit of some of them at the detriment of other stockholders subject to lockup restrictions.

The Court of Chancery dismissed the action for failure to show that a demand on the Zynga's board of directors required to commence the action would have been futile. On appeal, the Supreme Court reversed the Court of Chancery's dismissal, holding that the plaintiff satisfied its burden to show a reasonable doubt as to the disinterestedness and independence of a majority of the board of directors.

The Supreme Court agreed with the Court of Chancery that two of Zynga's directors, Reid Hoffman and Mark Pincus (who was also Zynga's controlling stockholder), were interested in the transaction because they sold shares in the secondary offering, thereby benefiting from the board of directors' approval of the waiver of lockup restrictions.

Unlike the Court of Chancery, which did not consider the independence of Don Mattrick, the Supreme Court found that Mattrick could not, as Zynga's CEO, be independent from Pincus, as Zynga's controlling stockholder, who was interested in the transaction.

After having found three of Zynga's directors independent, the Supreme Court reviewed de novo the independence of the other directors. Although the Court of Chancery concluded that the plaintiff had not sufficiently pled that Ellen Siminoff was independent, the Supreme Court found that the plaintiff had made a sufficient pleading. Notably, she and her husband co-owned a private airplane with Pincus, which was not used for business travel. Co-ownership of the airplane was significant because it implied an "extremely close, personal bond between Pincus and Siminoff, and between their families" and a "close personal relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment."

Similarly, the Court of Chancery determined that the plaintiff had not raised a reasonable doubt that William Gordon and John Doerr, partners at Kleiner Perkins Caufield & Byers, which controlled approximately 9.2 percent of Zynga's stock, were independent, but the Supreme Court reached the opposite conclusion. The partners' relationships were intertwined with Pincus and Reid Hoffman (who received a waiver of the restrictions to sell stock in the secondary offering) because Kleiner Perkins invested in a company co-founded by Pincus' wife and Kleiner Perkins and Hoffman invested in another company of which he served on the board with another partner at Kleiner Perkins. The impact of the mutually beneficial relationship between a founder like Pincus and a financing source like Kleiner Perkins cannot be ignored when determining parties' ability to make decisions adverse to one another.

In addition, although NASDAQ

rules regarding director independence are not conclusive for purposes of director independence determinations under Delaware law, they are relevant when making those determinations. When Zynga's board of directors classified Gordon and Doerr as not being independent under NASDAQ rules, regardless of the reason therefor, it showed the board's opinion that the relationships of Gordon and Doerr would interfere with the exercise of their independent judgment in carrying out their responsibilities as directors.

With a majority of the directors at the time not being disinterested and independent, the Supreme Court held that the plaintiff's demand on Zynga's board of directors would have been futile. As a result, the plaintiff's failure to make the demand should not result in dismissal of her action.

The *Sandys* decision further defines the contours of the Delaware courts' analysis of director independence. Even though allegations of friendship and shared ownership of property have not generally been sufficient to create an inference that a director could not act impartially, the Supreme Court has clarified that ownership of certain property may create such an inference. The relationship that is implied by the shared ownership of property is central to the analysis. Undoubtedly, the greater the cost of the shared property the greater the likelihood that a relationship between the owners of that property is deemed to be strong. Similarly, if shared property requires significant involvement of, or frequent communication between, the owners, then a Delaware court is more likely to question the independence of the co-owners of that property.

Moreover, Delaware courts have historically focused, and continued to focus in *Sandys*, on the incentives that business relationships create when making decisions as a director. As the Supreme Court suggested, the relationships between entrepreneurs and venture capitalists and among venture capitalists is particularly strong because of the ongoing economic opportunities they create for each other. Those incentives are even greater among venture capitalists who have funded several of the same companies and share board seats and between serial entrepreneurs and venture capitalists who rely on each other time and time again to create significant economic value that benefits them. In the life of a venture-backed company there will often be the potential for highly scrutinized decisions, either in an effort to save a failing company or to exit a successful company. Directors designated by venture capital firms should expect that they lack independence under Delaware law when making decisions that impact the founders or other venture capitalists and make board decisions with that in mind.

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