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DARRYL P. RAINS — "The Oracle and eBay decisions make it difficult for companies to know whether their directors are, or could ever be, truly independent."

Independence Gets Elusive

Companies face changing standards for directors regarding derivative litigation.

By Darryl P. Rains and Cynthia L. Lopez

Independent directors are the key players in derivative litigation. They can decide whether a lawsuit against their company's directors or officers should proceed or not. And they can seize control of a case from the plaintiffs who originally filed it.

But changing standards of director independence threaten the power independent directors traditionally exercised over derivative litigation. Some new standards — such as those created by the Sarbanes-Oxley Act and recent stock exchange rules — impose more stringent independence requirements but are, at least, clear and objective.

Two recent decisions by the Delaware Court of Chancery, however, created new independence hurdles of uncertain height. These decisions — *In re Oracle Corp. Derivative Litigation*, 824 A2d 917 (2003), and *In re eBay, Inc. Shareholders Litigation,* 2004 Del. Ch. LEXIS 4 — raise a troubling question: Can companies ever have truly independent directors?

Independent Directors in Derivative Actions

A derivative action is an unusual species of shareholder lawsuit. Its purpose is to enforce a company's cause of action against its own directors or officers. See *Rales v. Blasband*, 634 A2d 927,932-33 (Del. 1993).

Because a derivative action seeks to enforce a corporate claim, a plaintiff normally must, before suing, demand that the company's board of directors commence litigation against the alleged wrongdoers. See Del. Ch. Ct. R 23.1; Fed. R Civ. P 23.1; Cal. Corp. Code § 800. Demand on the board is excused only when it would be "futile" — usually because the company's directors are not disinterested or independent. *See Aronson v. Lewis*, 473 A2d 805 (1984).

A company's independent directors may, in response to a demand or after the commencement of litigation, investigate derivative allegations and decide whether it is in the company's business interests to pursue a corporate claim. If the directors are truly independent, and they perform a reasonable investigation, their decision to pursue a claim or to seek its dismissal is entitled to deference under the business judgment rule.

New Director Independence Rules

Congress, the New York Stock Exchange and NASDAQ all recently imposed heightened director independence requirements. These changes, made in response to revelations of corporate wrongdoing, generally provide that an independent director may not have certain financial or business relationships with his or her company. For example, Sarbanes-Oxley bars directors who serve on audit committees from providing accounting, consulting, legal, investment banking or financial advisory services to their companies.

The new NYSE and NASDAQ rules say, among other things, that a director is not independent if, within the last three years, he or she was employed by the listed company, received more than $60,000 (NASDAQ) or $100,000 (NYSE) a year from the listed company for services other than as a director, or his or her employer received payments from the listed company totaling more than $200,000 (NASDAQ) or $1 million (NYSE) a year.

These new rules make it harder for a director to qualify as independent. But at least the rules are clear. Any company that wants independent directors — in order to respond to derivative actions, for example — can apply these standards and know, with a great deal of confidence, whether its directors will pass muster.

The *Oracle* decision, by contrast, erected amorphous barriers to director independence. *Oracle* involved an attack on the independence of two outside board members who investigated derivative allegations of insider trading. The two board members — Hector Garcia-Molina and Joseph Grundfest, both prominent professors at Stanford University — conducted what the court conceded was an "extensive" investigation. Oracle, 824 A2d at 925. Assisted by independent counsel, they interviewed 70 witnesses, reviewed "an enormous amount of paper and electronic records," and produced a 1,110-page report (excluding exhibits) that exonerated the accused wrong doers and recommended dismissal of the action.

"Dominated and controlled"

Under prior Delaware law, Oracle's two board members would have qualified as independent unless they were "dominated and controlled" by the alleged wrongdoers. See, for example, *Aronson*, 473 A2d at 815-17. The *Oracle* court candidly admitted that "[n]othing in the record" suggested that the two Stanford professors were dominated or controlled by defendants. *Oracle*, 824 A2d at 937. But the court nonetheless rejected their investigation, concluding that the professors failed two new independence tests.

The court found that Oracle's two board members were not independent because of ties between the alleged wrongdoers and Stanford University. One of the alleged insider traders was also a Stanford professor, a second was a Stanford alumnus and significant donor, and a third was a major financial contributor. These ties, the court found, created "a social atmosphere painted in too much vivid Stanford Cardinal red."

By disqualifying directors on the basis of social and business connections, the *Oracle* court disregarded prior Delaware decisions that held director independence was not compromised by ties to "family, friends and business associates." See, for example. *In re Walt Disney Co. Derivative Litig.*, 731 A2d 342 (Del. Ch. 1998).

The court criticized these earlier decisions for "giv[ing] little weight to ties of friendship in the independence inquiry." The court argued that "motives like love, friendship, and collegiality" and "the social nature of humans" can undermine a director's independence in ways comparable to financial or business relationships.

Where does this test leave independent directors? Can't plaintiffs always argue that directors share some feelings of "friendship" and "collegiality?" After all, even directors who are complete strangers to other directors and officers at the beginning of their tenure might develop feelings of "friendship" and "collegiality" over time.

The *Oracle* court also found that the two board members' independence was compromised by a generalized social aversion to accusing one's peers. Here, too, the court disregarded prior Delaware decisions.

The *Oracle* court had no evidence of actual pressure being applied to the board members. But the court repeatedly emphasized how hard it would be for one director to accuse another of serious wrongdoing: "It is no easy task to decide whether to accuse a fellow director of insider trading." "Some things are just not done."' "[A]ccusing such a significant person in [the] community of such serious wrongdoing is no small thing."

These concerns, of course, arise virtually every time a director considers suing another director or officer. The Oracle decision offers no guidance regarding the proper scope or application of its new rule.

The *eBay* Decision

The eBay decision arose out of an attempt to recover profits earned by certain *eBay* officers and directors on the sale of "hot" IPO stocks allocated to them by an investment bank. The bank allegedly allocated the stocks to secure subsequent investment banking engagements. Plaintiffs claimed that demand on eBay's directors would be futile, and the court agreed — again for reasons not found in prior Delaware cases.

Most directors receive some form of compensation for their services. This fact has never been seen as compromising a director's independence. In *eBay*, the court found that eBay's directors had received "huge financial benefits," "potentially" worth "millions of dollars," mostly in the form of vested and unvested stock options. This high level of compensation, the court concluded, would make it impossible for a director to "objectively and impartially" consider bringing a claim against the accused wrongdoers.

What's the difference between regular director compensation and "huge" director compensation? Does the answer turn on the absolute value of the compensation? Does it depend on the amount of compensation in relation to each director's personal financial situation? Does it matter whether stock options are unvested or earned? What if the value of stock options has varied greatly over time? When should their value be measured? The *eBay* decision does not answer these questions. Accordingly, companies have no way of knowing whether their director compensation programs might inadvertently destroy director independence.

The *eBay* decision also breaks new ground in the area of "domination and control." Prior decisions acknowledged that many directors are "nominated by or elected at the behest of those controlling the outcome of a corporate election." *Aronson*, 473 A.2d at 816. These directors did not lose their independence simply because they "owed" their positions to others.

In *eBay*, the directors and officers accused of wrongdoing allegedly owned or controlled "about one-half of eBay's outstanding common stock." This gave the accused directors and officers "the ability to control ... the election of directors," and made any other director "beholden [to them] for his current and future position on eBay's board."

Of course, many companies (including several very prominent ones) have large blocks of shares concentrated in the hands of a few individuals — typically founders or early investors, many of whom serve as officers or directors. *eBay* seems to say that these companies can never have truly independent board members because the directors of such companies can always be removed by a few powerful shareholders.

The *Oracle* and *eBay* decisions make it difficult for companies to know whether their directors are, or could ever be, truly independent. These decisions create tremendous uncertainty and new opportunities for derivative action abuse.

Only one thing is clear — there is more to worry about now.

■ Darryl P. Rains is a Palo Alto-based partner, and Cynthia L. Lopez is a Palo Alto based associate, at Morrison & Foerster.