

KIRKLAND ALERT

September 2013

The Interplay Between Delaware Law and the Exchange Rules in Assessing Director Independence

The *MFW* decision that was issued earlier this year by the Chancellor of the Delaware Chancery Court has been the subject of much discussion with respect to transactions involving controlling shareholders.¹ But the decision also addressed another important topic: the interplay between the exchange rules and Delaware law with respect to director independence. *MFW* seemed to align the Delaware law test for director independence with the specific, detailed independence requirements in the exchange rules, but Delaware decisions since *MFW* continue to reflect highly fact-intensive inquiries that look beyond the bright-line exchange rules. Accordingly, it is important to consider both the exchange rules and the latest guidance from Delaware courts when assessing director independence.

As background, the NYSE and NASDAQ rules require (1) a majority of a listed corporation's board of directors to be independent; and (2) that only independent directors may serve on the audit, compensation, and corporate governance & nominating committees of a listed corporation. For a director to be independent under the NYSE rules, the board must "affirmatively determine" that the director has "no material relationship with the listed company." Though the board of directors must consider all relevant factors in making that determination, the NYSE rules provide guidance by enumerating specific and detailed relationships that preclude a finding of independence. The NASDAQ rules are similar.

There is a separate inquiry for assessing director independence under Delaware law. That inquiry is highly fact-specific and considers material financial and social relationships in assessing independence. Delaware law does not require directors to be independent, but having a board with a majority of directors who are independent under Delaware law can be beneficial in shareholder litigation. For example, approval of an interested transaction by a majority of directors who are considered independent under Delaware law could result in a deferential standard of review in any later shareholder challenge to that transaction. Likewise, if a majority of the corporation's directors are independent, then a shareholder is required to make a demand on the board prior to filing a derivative lawsuit. And once a demand has been made, the corporation's board is empowered to investigate the matter and determine whether to pursue a lawsuit.

In *MFW*, the Chancellor found that the NYSE independence rules were useful for determining independence under Delaware law in light of the fact that the NYSE rules "were influenced by experience in Delaware and other states"; "were the subject of intensive study by expert parties"; and "cover many of the key factors that tend to bear on independence, including whether things like consulting fees rise to

In *MFW*, the exchange rules with respect to independence were found "useful" for assessing independence under Delaware law.

a level where they compromise a director's independence." Accordingly, because in *MFW* it was uncontested that the directors met the "specific, detailed independence requirements of the NYSE," the directors were found to be independent as a matter of law.

Aligning the test for independence under Delaware law with the independence test under the exchange rules would provide clearer guidance regarding whether directors will be considered independent under Delaware law in subsequent litigation. But in Delaware, even after *MFW*, Delaware courts have continued to engage in highly case-specific inquiries that look beyond the NYSE or NASDAQ rules to determine independence (e.g., *Trados, Volgenau*).² For example, in *Trados*, the court determined that directors who were principals of venture capital firms invested in the company were interested (i.e., not independent) because, among other things: (1) VC funds supposedly focus on liquidating "even profitable ventures that fall short of their return hurdles"; and (2) the VC funds in *Trados* were to receive a liquidation preference that the common stockholders would not be receiving.

Given Delaware's continued reliance on a fact-sensitive approach, it is helpful to compare the test for assessing the independence of directors under Delaware law with the test under the exchange rules:

Current Employment. Current employment by an entity interested in the matter at issue is a basis for finding that a director lacks independence under Delaware law, especially when the employment is full time and constitutes the director's primary source of income. But a director may still be independent even if he or she is employed by the interested entity, if the compensation is a modest portion of the director's overall income or wealth. In contrast, the exchange rules flatly state that a director who is also an employee of the listed company is not independent.

Past Employment. The exchange rules provide that prior employment ceases to preclude independence after three years. Delaware courts have not created any such bright-line test. Instead, Delaware courts find that past employment by an interested party generally does not compromise independence under Delaware law, except where the former employment was particularly meaningful for that director, such as when the past employment was recent, lengthy, and/or lucrative.

Financial Ties. Both the exchange rules and Delaware courts examine other financial ties when assessing independence. For example, under the NYSE rules, directors lack independence if payments by the listed company to the director's employer in the last three fiscal years exceeded the greater of \$1 million or 2% of the employer's consolidated gross revenues, or if the director received more than \$120,000 in annual compensation from the listed company at any point during the previous three years (excluding compensation for board services). In certain instances, Delaware courts have focused on financial ties that do not meet these thresholds. For example, the courts in Delaware have found a director's independence lacking based on, among other things, a \$75,000 consulting contract, and have considered donations over two decades relevant in assessing independence.

Even after *MFW*, Delaware courts have continued to engage in highly case-specific inquiries that look beyond the NYSE or NASDAQ exchange rules when assessing independence.

Personal Relationships. The exchange rules' categorical independence standards do not set out strict guidelines with respect to personal relationships. Under Delaware law, directors may lack independence on account of social relationships with an interested person, though the relationship must be material. Mere friendliness or periodic contact with the interested party is insufficient to eliminate independence.

Nomination to the Board. Under Delaware law, nomination of a director to the board by an interested party is not sufficient, standing alone, to destroy independence. Delaware courts may, however, find nomination to be a relevant consideration in combination with other factors. The exchange rules do not specifically address nomination as a factor.

In sum, having a board that has a majority of directors who qualify as independent under Delaware law could meaningfully benefit a Delaware corporation in shareholder litigation. Yet, because of Delaware's flexible approach, it can be difficult to determine *ex ante* whether a Delaware court will view directors as independent in subsequent litigation. *MFW* represents a positive step towards reducing this uncertainty, due to its deference to the specific, detailed exchange rules. But because Delaware courts continue even after *MFW* to undertake fact-sensitive inquiries into independence, it is helpful to consider the latest guidance from the Delaware courts when assessing director independence.

Because Delaware courts continue to undertake fact-sensitive inquiries into independence, it is helpful to consider the latest guidance from the exchange rules **and** the Delaware courts when assessing director independence.

¹ *In re MFW S'holders Litig.*, 67 A.3d 496.

² *In re Trados Inc. S'holder Litig.*, C.A. No. 1512-VCL, 2013 WL 4511262 (Del. Ch. Aug. 16, 2013); *Southeastern Pennsylvania Transp. Auth. v. Volgenau et al.*, C.A. No. 6354-VCN, 2013 WL 4009193 (Del. Ch. Aug. 5, 2013).

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