

DELAWARE CHANCERY COURT EMPHASIZES SOCIAL AND INSTITUTIONAL CONNECTIONS IN THE MEANING OF DIRECTOR INDEPENDENCE

Introduction

On June 13, 2003, the Delaware Chancery Court issued an important ruling addressing the factors to be considered in determining director independence in the context of an internal investigation of corporate directors and officers by a special litigation committee (“SLC”). The Court found that the SLC, formed to investigate allegations of insider trading against certain directors and officers of Oracle Corporation (“Oracle”), failed to meet its burden of proving that no material issue of fact existed regarding the SLC’s independence due to the substantial social and institutional interrelationships among the SLC members, Stanford University and the Oracle directors and officers being investigated. *In re Oracle Corp. Derivative Litig.*, C.A. No. 18751, 2003 WL 21396449 (Del. Ch. June 13, 2003).

Background

A shareholder derivative suit was brought against officers and directors of Oracle alleging, among other things, that certain of these directors and officers breached their fiduciary duties by engaging in insider trading (the “Trading Defendants”). An SLC, consisting of two Oracle directors, both of whom were tenured professors at Stanford University, was formed to investigate the validity of the insider trading allegations against the Trading Defendants.

The SLC engaged in an extensive investigation and review of the directors and officers accused of insider trading and ultimately concluded that the shareholders’ allegations were without merit. With regard to the SLC’s independence, the SLC’s report reasoned that its members were independent because of the following:

- no compensation was received from Oracle by either member other than as a director;
- neither of the SLC members was an Oracle director at the time of the alleged insider trading;
- the SLC members were willing to return their compensation as SLC members if necessary to preserve their status as independent; and
- there were no material ties between the SLC members and Oracle or any of the defendants.

Based on the results of its investigation, the SLC made a motion to terminate the pending shareholder derivative action. The issue before the Court was whether the substantial ties revealed during discovery “would be of a material concern to two distinguished, tenured faculty

members whose current jobs would not be threatened by whatever good faith decision they made as SLC members.”¹

The Chancery Court’s Decision and Director Independence

The standard for evaluating independence “turns on whether a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind.”² Furthermore, the SLC bore the burden of persuasion with respect to its independence.³ The key independence inquiry in this case was not whether there were financially material ties between the Trading Defendants and the SLC members, but rather whether other non-economic motivations of the SLC members would generate an unacceptable risk of bias.

The Court found that the SLC report failed to disclose several significant interrelationships among the SLC members, Oracle, the Trading Defendants and Stanford University. During discovery, substantial interrelationships were revealed including: (i) one of the defendants was a professor at Stanford University and taught one of the SLC members when the SLC member was a Ph.D candidate, and both the defendant and this SLC member were senior fellows and steering committee members at the Stanford Institute for Economic Policy Research (“SIEPR”); (ii) one of the defendants was a Stanford alumnus who had directed millions of dollars of contributions to Stanford during recent years, served as Chairman of the SIEPR Advisory Board, and had a SIEPR conference center named after him; and (iii) one of the defendants had made millions of dollars in donations to Stanford University through a personal foundation and large donations indirectly through Oracle, and was publicly considering making extremely large additional contributions to Stanford at approximately the time that the SLC members were added to the Oracle Board in October 2001.

The Court rejected the SLC’s argument that its members were independent because they were in no way under the “domination and control” of the defendant directors.⁴ In fact, the Court agreed with the SLC that its members were not dominated or controlled by any of the defendants, by Oracle, or by Stanford University. Instead, the Court emphasized the totality of the social and

¹ *In re Oracle Corp. Derivative Litig.*, C.A. No. 18751, 2003 WL 21396449, at 27 (Del. Ch. June 13, 2003) (citing *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981)).

² *Id.* at 47 (emphasis in original) (citing *Parfi Holding AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211, 1232 (Del. Ch. 2001), *rev’d in part on other grounds*, 817 A.2d 149 (Del. 2002), *cert. denied*, 123 S. Ct. 2076 (2003)).

³ *Id.* at 1.

⁴ *See In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 355 (Del. Ch. 1998) (deciding that the plaintiffs failed to create reasonable doubt as to a director’s independence where a corporation’s Chairman and CEO had donated over \$1 million to the university at which the director was the president and from which one of the CEO’s sons had graduated), *aff’d in part, rev’d in part sub nom. Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

institutional connections among the various parties in its finding that the SLC failed to meet its burden of proving its members' independence.

The Court denied the SLC's motion to terminate the derivative action because the SLC did not meet its burden to show that there was no material question of fact regarding its independence.

The interrelationships among the SLC members, Oracle, the Trading Defendants and Stanford University were found to be so substantial that they would weigh on the minds of the SLC members in making their decision on the validity of the insider trading allegations in a way that generated an unacceptable risk of bias. These interrelationships, the Court found, generated "a reasonable doubt about the SLC's impartiality because they suggest[ed] that material considerations other than the best interests of Oracle could have influenced the SLC's inquiry and judgments."⁵

Conclusion

This decision emphasizes the need to consider all potential aspects of a director's independence, including their non-economic social and philanthropic relationships, when forming a special litigation committee.

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This is an evolving area of the law and we recommend that clients having questions about director independence generally, or the *Oracle* decision specifically, should call the corporate partner with whom they regularly work.

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⁵ *In re Oracle*, 2003 WL 21396449, at 68.