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In re Oracle Corp. Derivative Litigation: Possible Implications for Director Independence

The recent decision of the Delaware Court of Chancery in *In re Oracle Corp. Derivative Litigation*[1] suggests that boards of directors may want to re-examine the independence of their directors in light of the expanding contexts in which independence has been successfully challenged by plaintiffs. While this decision focused on philanthropic ties between directors, it may suggest that courts may also scrutinize other connections between directors more rigorously.

Oracle formed a special litigation committee ("SLC") to investigate allegations in a derivative action of breach of fiduciary duty in connection with trading in its shares by four of its directors, including its Chairman and CEO, Larry Ellison. After a lengthy investigation, the SLC moved to dismiss the derivative suit. Under the applicable Delaware precedent,[2] the Chancery Court will grant such motions if it determines that (1) the SLC has met its burden to show that it was independent and showed reasonable bases for good faith findings and recommendations and (2) the SLC's determination accords with the court's own independent business judgment.

In *Oracle*, Vice Chancellor Strine found that the SLC had not met its burden to prove its independence, explaining that "[s]ummarized fairly, two Stanford professors were recruited to the Oracle board . . . to investigate a fellow professor and two benefactors of the University." After describing the details of "what academics might call the 'thickness' of the social and institutional connections among Oracle, the [director defendants], Stanford, and the SLC members," Vice Chancellor Strine concluded that such connections were "so substantial that they cause[d] reasonable doubt about the SLC's ability to impartially consider whether the [director defendants] should face suit." The motion to dismiss was denied.

The Facts of *Oracle*

The derivative complaint alleged insider trading during the third quarter of Fiscal Year 2001 by four Oracle directors—Larry Ellison, Jeffrey Henley, Donald Lucas and Michael Boskin. In response, Oracle's board formed an SLC to investigate the allegations and to determine whether Oracle should terminate, settle or proceed with the litigation. The board appointed two Oracle directors to the SLC, neither of whom were directors at the time of the alleged wrongdoing and both of whom are tenured professors at Stanford University. They were:

- Hector Garcia-Molina—Chairman of the Computer Science Department and Professor in the Electrical Engineering Department.
- Joseph Grundfest—Professor of Law and Business; director of two programs at Stanford Law School; former SEC Commissioner; graduate of Stanford Law School and graduate student in economics at Stanford; steering committee member and senior fellow of Stanford Institute for Economic Policy Research ("SIEPR").

The SLC retained counsel and conducted an investigation, which the court found was "by any objective measure, extensive." After reviewing "an enormous amount of paper and electronic records," directly or indirectly conducting the interviews of 70 witnesses and meeting extensively with its independent counsel, the SLC produced a 1,110 page report. The SLC concluded that the allegations against the director defendants were without merit and moved to dismiss the derivative litigation.

Despite the lengthy report, the court found that "disclosure of several significant ties between Oracle or the [director defendants] and Stanford" was "noticeably absent." The report had disclosed only that Boskin was also a Stanford professor, and that Lucas had made donations to Stanford. One such donation was in the amount of $50,000 to Stanford Law School after Grundfest delivered a speech to a venture capital fund at which Lucas's son is a partner, and half the donation was allocated for use by Grundfest for his research.

Vice Chancellor Strine expressed "shock" at the extent of other ties among Stanford, Oracle and the director defendants that emerged during discov-

[1] *In re Oracle Corp. Derivative Litig.*, 2003 WL 21396449 (Del. Ch. June 17, 2003).

[2] *E.g.*, *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

ery. The additional ties that appeared to influence the court included the following:

- Boskin is a Professor of Economics at Stanford; he taught Grundfest when Grundfest was a graduate student; although the two professors do not socialize, they have remained in contact over the years; both are senior fellows of SIEPR and steering committee members of SIEPR.
- Lucas received both his undergraduate and graduate degrees from Stanford; he is Chairman of a family foundation that has donated $11.7 million to Stanford, including funding of an MRI center at Stanford's Medical School; he has personally contributed $4.1 million to Stanford, including SIEPR and Stanford Law School; he is the Chair of the Advisory Board of SIEPR; the conference center at SIEPR is named the Donald L. Lucas Conference Center.
- Ellison is a "major figure in the community in which Stanford is located"; he is the sole director of the Ellison Medical Foundation, which has paid or pledged $10 million to Stanford; he has been CEO of Oracle while Oracle has donated over $300,000 to Stanford and endowed an educational foundation that named Stanford as "appointing authority" for a majority of its directors; he discussed with Stanford the creation of an Ellison Scholars Program, which was centered around SIEPR, with a budget of $170 million; he discussed donating his house, which is valued at over $100 million, to Stanford.

Prior Cases Concerning Director Independence

In prior cases concerning director independence, courts have focused primarily on economic ties between directors and whether directors were under the "dominion and control" of a defendant director. Vice Chancellor Strine conceded that it is "impossible . . . to rationalize [prior case law]" with the *Oracle* decision. Yet, while the decision is "in tension with the specific outcomes of certain other decisions," Vice Chancellor Strine disputed that the "result [he] reach[ed] applies a new definition of independence; rather, it recognizes the importance (*i.e.*, the materiality) of other bias-creating factors other than fear that acting a certain way will invite economic retribution by the interested directors."

The rule for director independence applied by Vice Chancellor Strine in *Oracle* was articulated in another decision by him in 2001, which concluded that "[a]t bottom, the question of 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. That is, the Supreme Court cases ultimately focus primarily on impartiality and objectivity".[3] The absence of a substantial personal economic interest is insufficient to establish independence.

The Decision

In *Oracle*, the members of the SLC moved to dismiss the derivative litigation. The court denied the motion to dismiss because the court found that the SLC failed to meet its burden of proof regarding its independence.

The court did not conclude that either Grundfest or Garcia-Molina consciously favored the director defendants. It found, however, that the independence inquiry has a different purpose. As Vice Chancellor Strine explained, "[t]hat inquiry recognizes that persons of integrity and reputation can be compromised in their ability to act without bias when they must make a decision adverse to others with whom they share material affiliations." The requirement for independence is "to ensure that stockholders do not have to rely upon special litigation committee members who must put aside personal considerations that are ordinarily influential in daily behavior in making the already difficult decision to accuse fellow directors of serious wrongdoing." To conclude that the members of the SLC were not independent is to conclude that the members "were not situated to act with the required degree of impartiality."

The court concluded that the connections described in the opinion "would weigh on the mind of a reasonable special litigation committee member" in making its decision. Whether or not the members of the SLC precisely knew of all the connections, "by any measure this was a social atmosphere painted in too much vivid Stanford Cardinal red for the SLC members to have reasonably ignored it." "Rather than form an SLC whose membership was free from bias-creating relationships, Oracle formed a committee fraught with them."

Implications

The requirement for independent directors arises in various contexts in addition to SLCs, including audit committees, compensation committees, nominating committees and committees to approve interested transactions, and different rules and standards to determine independence are developing in each context. For instance, regulatory bodies such as the Securities and Exchange Commission, the New York Stock Exchange and the National Association of Securities Dealers ("NASD") have promulgated rules and proposed rules that establish baseline stan-

[3] *Parfi Holding AB v. Mirror Image Internet, Inc*., 794 A.2d 1211 (Del. Ch. 2001) (emphasis in original).

dards for director independence in certain of the above contexts. The *Oracle* decision can be read to signal that courts, depending on the particular circumstances, expect boards of directors to establish a degree of independence that goes beyond these baseline requirements.

In *Oracle*, Vice Chancellor Strine explicitly adopted a "contextual approach" to the determination of director independence. Vice Chancellor Strine explained that "[t]his contextual approach is a strength of our law, as even the best minds have yet to devise across-the-board definitions that capture all the circumstances in which the independence of directors might reasonably be questioned. By taking into account all circumstances, the Delaware approach undoubtedly results in some level of indeterminacy, but with the compensating benefit that independence determinations are tailored to the precise situation at issue." This approach is consistent with comments that Vice Chancellor Strine made in an article in 2002 discussing the implications of the Enron case in which he wrote, "The question of whether a director can act independently is inherently situational."[4]

Vice Chancellor Strine employed this approach as a platform from which to depart from prior case law. First, he eschewed the emphasis on "dominion and control" employed by some courts as a test for independence, because it "would serve only to fetishize much-parroted language, at the cost of denuding the independence inquiry of its intellectual integrity." Next, Vice Chancellor Strine criticized the emphasis on personal material economic ties between directors also employed by some courts as a test for independence by admonishing that "[*h*]*omo sapiens* is not merely *homo economicus*," and "our law [should not] ignore the social nature of humans."

Thus, if other Delaware courts adopt Vice Chancellor Strine's approach, *Oracle* signals a directional change in how courts may view independence. It will no longer be sufficient (if it ever was) for boards of directors to focus primarily on issues of "dominion and control" or the existence of personal material economic interests when evaluating possible sources of impermissible bias. Instead, the independence inquiry will depend on whether a director is unable to make a decision with only the best interests of the corporation in mind for *any* substantial reason.

The breadth of this test for independence could mean that courts will consider possible sources of unacceptable risks of bias that have not previously been a focus of concern. For example, the contextual approach to independence may invite closer scrutiny of matters such as length of service on a board or a committee, levels and types of director compensation and the robustness of the nominating committee and its nominating process.

In addition to the broadened *scope* of possible sources of unacceptable risk of bias, the *Oracle* decision also signals that courts may view the *materiality* of certain sources of bias differently. Prior case law often focused on the materiality of certain benefits to a recipient. Similarly, the proposed NASD rules contain materiality thresholds that disqualify the independence of a director affiliated with an organization that received payments from the corporation. In *Oracle*, the members of the SLC argued that certain contributions to Stanford by the director defendants did not compromise their independence because, while seemingly large, such contributions amounted to a very small proportion of Stanford's endowment and annual donations. Vice Chancellor Strine rejected this argument, noting that "[e]ndowments and buildings grow one contribution at a time, and they do not grow by callous indifference to alumni." Thus, when corporations consider all facts and circumstances that may create impermissible bias, they may be prudent to consider materiality in relation to a broader social and community context rather than simply as a dollar threshold.

While the holding in *Oracle* could be construed narrowly to apply only in the context of philanthropic ties between directors, it is worth noting that the facts of the case provided an ideal platform for Vice Chancellor Strine to make more general statements about director independence. In *Oracle*, he found that "[n]othing in the record suggests to me that either Garcia-Molina or Grundfest [was] dominated and controlled by any of the [director defendants], by Oracle, or even by Stanford," and he found that the members of the SLC had no personal economically consequential connections with the director defendants because each was a tenured professor without fundraising responsibilities. Instead, the unacceptable risks of bias derived from notions of "collegiality and loyalty" and caring about the "well-being of the institution" the SLC members served. Moreover, Vice Chancellor Strine goes out of his way to assert that "[n]othing in this record leads me to conclude that either of the SLC members acted out of any conscious desire to favor the [director defendants] or to do anything other than discharge their duties with fidelity."

[4] Leo E. Strine, *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, August 2002.

As a consequence, corporate boards may wish to consider their composition in light of potentially shifting interpretations of the definition of director independence and view with a new lens the implications of philanthropic, professional, personal and any other types of connections between directors that may produce an unacceptable risk of bias.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

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