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## Zuckerberg isn't above corporate formalities, nor are you

By Marc Boiron

Last month in *Espinoza v. Zuckerberg*, the Delaware Court of Chancery addressed the formalities required under the General Corporation Law of the state of Delaware (DGCL) in connection with a controlling stockholder's action taken outside of a stockholders' meeting. The issue, a matter of first impression in Delaware, was whether a disinterested, controlling stockholder's ratification of a transaction approved by an interested board of directors could cause the standard of review to shift from entire fairness to the business judgment presumption where the ratification was expressed informally and without using a method provided for stockholder action in the DGCL. For policy reasons, the court concluded that stockholder ratification of a self-dealing transaction must be accomplished either by a vote at a meeting of stockholders or by written consent to shift the standard of review applicable to the transaction.

In August 2013, Facebook Inc.'s compensation committee considered changes to the compensation of Facebook's non-management directors. In September 2013, Facebook's board of directors approved a compensation plan that (i) increased the annual cash compensation paid to non-management directors from \$50,000 to \$70,000, (ii) increased the annual cash compensation paid to the chair of the audit committee from \$70,000 to \$100,000, and (iii) granted annually restricted stock units valued at \$300,000 to non-employee directors. Approval of the compensation plan permitted the non-management directors to receive, in 2013, grants of restricted stock units with a fair value of between \$387,874 and \$935,874 on the date of the grant.

The plaintiff filed a derivative action on behalf of Facebook against all of the members of Facebook's board of directors. The complaint alleged, among other things, that the directors breached their fiduciary duties by awarding to or receiving from the non-management directors excessive compensation.

On the same day as the defendants moved for summary judgment on the claim for breach of fiduciary duty, Mark Zuckerberg, Facebook's chief executive officer and controlling stockholder, filed an affidavit in support of the motion for summary judgment. The affidavit provided, in relevant part: "I approve of all 2013 equity awards to Facebook's Non-Executive Directors ... I would vote in favor of the 2013 equity awards to Facebook's Non-Executive Directors, as well as the Annual Compensation Program, and if presented with a stockholder written consent approving them, I would sign it." In addition, during Zuckerberg's deposition, he stated that the non-management directors would serve Facebook best and that the compensation plan approved by Facebook's board of directors attracts



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Mark Zuckerberg at a town hall event in Menlo Park in September.

and retains those directors over the long term. However, Zuckerberg did not execute a written consent approving the compensation plan.

The defendants argued that Zuckerberg, in his capacity as Facebook's controlling stockholder, ratified the compensation plan through the statements he made in the affidavit and the deposition.

With respect to the allegation of breach of fiduciary duties, the court noted that the DGCL provides only two methods for stockholders to approve a corporate matter: (i) by vote in person or by proxy at a meeting of stockholders or (ii) by written consent pursuant to Section 228 of the DGCL. The court explained that an action taken outside of a stockholders' meeting inherently involves the potential for mischief, which magnifies the importance that both the substantive and the ministerial formalities set forth in Section 228 be satisfied. In addition, the court noted that insistence on corporate formalities when seeking stockholder approval of a corporate action avoids ambiguity and misinterpretation while maintaining certainty and efficiency, which benefits the corporation and its stockholders.

The court relied on a number of policies underlying Section 228 in its analysis, which included: (i) ensuring that the required number of stockholder votes approving the action was obtained; (ii) creating transparency for all stockholders, including non-consenting stockholders; and (iii) defining the exact nature of the authorized action. Although ensuring that the required number of votes is obtained is not a concern when a controlling stockholder approves the ratification of a board action, the informal approval of an action by a controlling stockholder keeps the minority stockholders in the dark regarding the action and, in the case of an oral approval (such as Zuckerberg's deposition testimony), the nature of the action (such as the year of the compensation plan being approved) is not clear. The court also noted that the types of informal approvals could be limitless, questioning the wisdom of permitting approval by, for example, "Liking" a

Facebook post of a proposed corporate action."

The court rejected the defendants' argument that common law ratification applies in the corporate context. Instead, the decisions that the defendant cited in support of common law ratification demonstrated the need to be sensitive to particularities that arise when applying general ratification principles in the corporate context.

For the foregoing reasons, the court concluded that even if a controlling stockholder clearly intends to ratify a decision outside of a stockholders' meeting, the ratification will not be effective to shift the standard of review from entire fairness to the business judgment presumption unless the stockholder has complied with the formalities required under Section 228.

This decision reinforces the importance of corporate formalities under Delaware law. It is one of many decisions where the court has required strict compliance with corporate formalities for policy reasons. Other decisions have focused on specific formalities required under Section 228 or on different provisions of the DGCL requiring that corporate formalities be observed, including, among others: (i) the use of a written instrument to approve a stock issuance, (ii) that each stockholder individually date a written consent of stockholders, (iii) that prompt notice of an action taken by less than unanimous written consent of stockholders be given to non-consenting stockholders, (iv) the order of approval of an amendment to a corporation's certificate of incorporation (first by the board of directors then by the stockholders), (v) the election of one officer to record in the books of the corporation the proceedings of meetings of stockholders and directors of the corporation, and (vi) the holding of an annual meeting of stockholders within thirteen months of the prior annual meeting. In addition, there are many other provisions of the DGCL that have not been the subject of litigation but require compliance with corporate formalities.

Lastly, this decision makes clear that Section 228 is a means of efficiency and economic relief from the expense of holding a meeting of the stockholders. However, a desire to also avoid the expense of acting by written consent, including the cost of giving notice under Section 228(e), does not give a corporation or stockholder the right to act informally.



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