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Facebook Decision Highlights Risks of Back-Channel Communications with a Controller

In *United Food v. Mark Zuckerberg and Facebook* (Oct. 26, 2020), a stockholder of Facebook, Inc. brought suit seeking damages, on behalf of the corporation, for losses Facebook incurred by pursuing and then abandoning a reclassification of its capital structure (the "Reclassification"). The Reclassification had been proposed by, and would have primarily benefitted, the company's controlling stockholder, Mark Zuckerberg. The Reclassification was later abandoned at Zuckerberg's request. The Delaware Court of Chancery dismissed the suit, holding that, because a majority of the directors were independent and disinterested with respect to the Reclassification, the plaintiff was not excused from first having made a demand on the board to bring the derivative litigation.

Although the suit was dismissed, and the focus of Vice Chancellor Laster's opinion is on the issue of "demand futility," the case nonetheless provides a reminder of the potential risks from flaws in a board process. These include the possibility of reputational damage, as well as the potential for personal liability for directors who (without disclosure to and supervision by the board) share information with a controlling stockholder about the board's process while the board is considering a transaction in which the controller is personally interested.

Key Points

- **Potential personal liability of directors for back-channel communications with a controlling stockholder.** It is well-established that, depending on the facts and circumstances, back-channel communications with a controller relating to the board's consideration and negotiation of a transaction in which the controller has a personal interest can render the board's process ineffective. Vice Chancellor Laster's opinion in this case underscores the problematic nature of such communications. The Vice Chancellor stated, without discussion, that he made the assumption, at the pleading stage, that the Facebook director who engaged in such communications with Zuckerberg had prevented the special committee from functioning effectively–and thus that he had breached his duty of loyalty and acted in bad faith (unexculpated violations for which he would be personally liable in a fiduciary suit).

- **Additional guidance on independence of directors.** The court's analysis of the independence of the Facebook directors is instructive in its rejection of a number of the plaintiff's arguments asserting non-independence. For example, the court confirmed that Facebook directors affiliated with venture capital firms should not be considered non-independent based on the venture capital firms' alleged reliance on Zuckerberg for "deal flow."

- **Some support for founders' efforts to retain control.** Some commentators have viewed the decision as supporting generally efforts of founders to retain even "permanent" control of their companies through a reclassification or other means. We would observe, however, that, on this topic, which the court addressed only in passing, the court simply stated that the Reclassification was not "so extreme or bizarre" that the board clearly should have rejected it out of hand.

- **New formulation of the test for "demand futility."** The Vice Chancellor argued, compellingly, based on the court's evolving jurisprudence, for an end to the use of the "*Aronson* test"–and the use instead of the "*Rales* test" in all cases–to determine if a stockholder-plaintiff is excused from making demand on a board before bringing derivative litigation.

Background. In 2010, Zuckerberg made the "Giving Pledge," which calls on wealthy business leaders to donate a majority of their wealth to philanthropic causes. Zuckerberg developed a plan to implement the Pledge by donating the bulk of his shares of Facebook stock. At the time, he owned 53.8% of the company's outstanding voting power, which, due to the company's dual-class capital structure, reflected economic ownership of only 14.8%. He proposed the Reclassification–which would shift two-thirds of the company's economic value to a new class of non-voting shares–so that he could make the planned donations of stock without giving up control. The Facebook board established a special Committee to consider the Reclassification, and the Committee engaged independent legal and financial advisors and negotiated the terms of the Reclassification with Zuckerberg over several months. The Committee recommended the Reclassification to the full board, and the board approved the Reclassification. Soon thereafter, Zuckerberg faced public criticism for his plan and Facebook shareholders filed suit to enjoin the Reclassification. At Facebook's annual meeting, although a majority of the shares (which included Zuckerberg's) approved the Reclassification, holders of more than 70% of the disinterested shares voted against it. Facebook agreed not to effect the Reclassification while the litigation seeking an injunction against it was ongoing. Just before trial was to begin, the board, at Zuckerberg's request, abandoned the Reclassification making the stockholder action moot. A Facebook stockholder then brought this suit, alleging that the directors breached their fiduciary duties by pursuing the Reclassification and then abandoning it. The plaintiff claimed that Facebook was entitled to recover from the directors damages for the expenses the company had incurred for advisors and attorneys in connection with pursuing the Reclassification (about $21.8 million), the fee award it had agreed to pay the plaintiffs' counsel in the litigation that sought to enjoin the Reclassification ($68.7 million), and losses from damage to Facebook's good will and reputation.

Discussion

The matter at issue in the case was not whether directors had breached their fiduciary duties but whether the plaintiff was excused from making demand on the board to bring derivative litigation. By way of background, under Delaware law, it is the board of directors that manages the affairs of a corporation, including determining whether, if the corporation is harmed, the corporation should pursue litigation to seek a remedy. In a derivative suit, "a stockholder seeks to displace the board…and assert the corporation's claim." A stockholder can only pursue a derivative suit (*i.e.*, a cause of action belonging to the corporation), however, if (i) the stockholder first demands that the directors pursue the claim and the directors wrongfully refuse to do so or (ii) demand on the board is "excused" because a majority of the directors are not independent and disinterested with respect to the demand (*i.e.*, they could not made an impartial decision on the demand and thus it would be "futile" for the plaintiff to make the demand). A critical part of the inquiry into a director's independence with respect to a litigation demand is whether the director faces "a substantial likelihood of liability" relating to the subject matter of the litigation (in this case, the Reclassification). As discussed below, the court found that the plaintiff's allegations about the Facebook board's process in general did not support a reasonable inference that the directors breached their fiduciary duties and therefore would face personal liability. The court found, however, that *one* of the directors, "M," was *not* independent, based on his alleged back-channel communications with Zuckerberg during the board's process. We note that the court could have ended the demand analysis after finding that a majority of the board was independent, but instead the court analyzed and discussed the independence of *each* of the directors, bringing attention to M's actions.

Potential personal liability for a director who engages in back-channel communications with a controlling stockholder while the board is evaluating and negotiating a transaction in which the controller has a personal interest. The plaintiff alleged that, throughout the Committee's process of evaluating and negotiating the Reclassification, M communicated information to Zuckerberg about the Committee's process and discussions. Nothing in the opinion suggests that any of the other directors (or the advisors) knew that the communications were occurring. The Vice Chancellor stated that, at the pleading stage, he was making the "pro-plaintiff assumption," that, "[b]ased on the back-channel communications," M breached his duty of loyalty and acted in bad faith–which are fiduciary violations for which exculpation under a company's charter is not available. The Vice Chancellor made the further "assumption" that, "[a]t a minimum, the back-channel communications with Zuckerberg prevented the Committee from functioning effectively."

The communications that the court viewed as problematic. The plaintiff alleged that, throughout the Committee's negotiations with Zuckerberg over the Reclassification, M "regularly engaged in back-channel communications with Zuckerberg about what the Committee was doing." M and Zuckerberg allegedly "exchanged text messages in which [M] described at least twelve different meetings during which the Committee deliberated over its negotiating positions." M allegedly shared with Zuckerberg "details about what the Committee focused on, what questions the Committee would ask, and how each member felt about different governance issues." For example, before one board meeting at which the Committee was going to update the board, M allegedly sent a series of text messages to Zuckerberg saying: "Between us–re special board session. 1. New share class will happen. 2. Everyone loves your plan [to make charitable donations and] your intent." Also, M allegedly wrote that the Committee was working "around the edges of the big things you want" and wants to "protect the company and you personally." M also allegedly texted that several senior managers thought that the Reclassification was "a big mistake" but "they don't want to challenge you." In addition, M allegedly "coached Zuckerberg before, during and after calls with the Committee." For example, during a call with the Committee on which Zuckerberg was advocating for his having the right to take an eight-year leave of absence, M allegedly sent him a text message saying that this "line of argument is not helping," and other texts telling him when his arguments *were* working. Before a call between Zuckerberg and one of the other Committee members, Zuckerberg asked M if he had "any context before I talk to [her]?," and M allegedly "provided a detailed preview of the call." The court wrote: "These communications are only examples. [M] [allegedly] engaged in similar communications with Zuckerberg throughout the negotiations."

The other flaws in the Committee's process: In the court's recitation of the background facts, the following allegations made by the plaintiff were noted:

- The Committee never prepared a formal charter delineating its duties and responsibilities.
- The Committee did not meet with its financial and legal advisors before hiring them.
- The Committee did not meet with its legal counsel before the counsel contacted Zuckerberg's legal counsel to discuss the terms of the Reclassification.

- The Committee appeared from the outset to "anticipate that a reclassification would take place," and "its deliberations focused less on whether to pursue a reclassification or propose an alternative and more on the details of the reclassification that Zuckerberg wanted." The Committee members told Zuckerberg they were "proud" of him for his planned philanthropy.
- Throughout the process, Zuckerberg acted as if the Reclassification would happen and that the Committee was just "locking things down" rather than broadly considering whether to do the Reclassification.
- The Committee's financial advisor noted that they were hired "in the second inning, after the transaction was well underway."
- The financial advisor engaged by Facebook had for a short time acted as the financial advisor to Zuckerberg personally–and, as a result, this financial advisor "knew about Zuckerberg's expectations for the reclassification" and used Zuckerberg's legal counsel's "work product when preparing its analyses of the reclassification."
- The Committee simply accepted Zuckerberg's refusal to consider certain concessions it requested of him–and thereafter did not "attempt to extract a cash payment or a greater number of Class C [non-vote] shares for the Class A [regular vote] stockholders," did not ask for any restrictions on his ability to sell stock, and did not propose that the Reclassification be conditioned on Class A stockholder approval.
- When the Committee's financial advisor advised the Committee that the Class A stockholders were unlikely to approve the Reclassification, the advisor provided no explanation and the Committee "did not ask why or otherwise explore the comment."
- "The final slate of governance provisions permitted Zuckerberg to retain voting control of Facebook even if he took years off to work for the government or redirected his focus to managing the charity that he and his wife had created."

The three non-independent directors. The court summarily concluded, as would be expected, that (i) Zuckerberg, as a controlling stockholder standing on both sides of the Reclassification, was not independent with respect to the Reclassification; and (ii) "S," due to her employment as the company's COO, was not independent of Zuckerberg (the CEO). As discussed above, the court also concluded that M, "[b]ased on his back-channel communications [with Zuckerberg] during the Committee process and [his] self-professed fealty to Zuckerberg, [was] not independent of Zuckerberg and…would face a substantial risk of liability on a claim challenging the Reclassification."

The five independent directors. The court concluded that at least five of the remaining six directors were independent with respect to the litigation demand. (One of the directors was a "close call" and the court did not analyze her situation given that the court had concluded that a majority of the directors were independent.) The court rejected the plaintiff's contention that the board's process with respect to the Reclassification was so flawed that all of the directors faced a substantial likelihood of liability for having breached their duty of loyalty and acted in bad faith. The plaintiff characterized the board's process leading to approval of the Reclassification as a "sham," with "glaring problems" that resulted in no material concessions "extracted" from Zuckerberg. The court stated, however, that the plaintiff's "disagreements" with the process were not sufficient to support an inference of bad faith by the board. "There is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties," the court wrote.

The court also rejected the other bases on which the plaintiff challenged the independence of these directors. The court's analysis reflects that, in determining the independence of directors, the court takes into account all of the facts and circumstances. The court confirmed that–unless there were additional, *specific* allegations supporting an inference that the director could not exercise independent judgment–a director would not be deemed non-independent because he or she:

- was recruited to the board by the CEO-controller;
- operates in a business which would benefit from "deal flow" from the CEO-controller (in this case, a director was affiliated with a venture capital firm and Zuckerberg is a "Silicon Valley superstar");
- has a business relationship with the company (in this case, a director was affiliated with Netflix, which purchases advertising from Facebook and had an "ongoing, supportive relationship" with Facebook such that it was accorded special data sharing benefits–but the court stated that there were no allegations relating to how Netflix relies on the relationship as part of its business model nor how valuable the relationship is to Netflix, thus no conclusion could be reached as to whether the relationship was "so important to Netflix as to compromise [the director]'s independence");
- has a "shared interest" with the CEO-controller (in this case, a possible bias toward, generally, believing that founders should retain control of their companies or engage in philanthropy);
- has been able to continue on the board due to the support of the CEO-controller in the face of negative publicity or other difficulties involving the director (unless continued service on the board is "financially material" to the director or provides "such cachet that [the director's] independence is compromised"); or
- has a relationship with a financial advisor that advised the company or the board with respect to the challenged decision (unless the director received a material personal benefit from the financial advisor's engagement).

Founders' efforts to retain control permanently. The plaintiff argued that the Reclassification was "so obviously unsound that the Board never should have considered it, much less approved it and defended it until the eve of trial" (and then abandoned it only at Zuckerberg's request). The court acknowledged that "doubtless there are proposals that are so extreme or bizarre that independent directors should reject them summarily," but, the court emphasized, generally a board has an obligation to consider corporate proposals and respond to them only after having become informed and duly deliberating. The court stated that "[t]he Reclassification was not so outlandish as to warrant rejecting it out of hand." The court noted that Google had recently implemented "a similar transaction" after a settlement that the court approved. The court wrote: "A director could believe in good faith that it is generally optimal for companies to be controlled by their founders and that [a] governance structure [facilitating this result] will maximize the long-term value of the corporation for the ultimate benefit of its residual claimants"–while others might believe the opposite. A director who has such a subjective belief, has a reasonable basis therefor, "and does not otherwise have any compromising interests," will not face liability for making a decision in favor of a transaction to accomplish that result, "even if a court later determines that the transaction was not entirely fair," the court wrote. In other words, a board conceivably could in good faith determine that a controller's efforts to retain "permanent" control would be in the best interests of the stockholders–*depending on the facts and circumstances*.

The Vice Chancellor's argument that the "*Rales* test" should be used in all cases to determine demand futility. The Delaware Supreme Court has established two tests for determining when directors would be incapable of making an impartial decision on a litigation demand–the "*Aronson* test" and the "*Rales* test." Vice Chancellor Laster stated that both tests "remain authoritative." However, in a very thorough analysis of the court's evolving jurisprudence relating to the tests, he concluded that the *Aronson* test is "no longer a functional test" and that the *Rales* test "encompasses *Aronson* and should be used as the general test." Under the *Rales* test, the Vice Chancellor explained, the court must determine, for each director, whether the director (i) received a material personal benefit from the alleged misconduct that is the subject of the litigation demand, (ii) would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand, or (iii) lacks independence from someone who did or would. The Vice Chancellor emphasized that, in determining whether a director faces a substantial likelihood of liability, the court not only must consider (as the *Aronson* test requires) the operative standard of review that would apply to the challenged decision (for example, if business judgment rule review were to apply, there would not be a substantial likelihood of liability), but also must consider the potential availability of exculpation (that is, even if a standard of review more stringent than the business judgment rule were to apply, there would not be a substantial likelihood of liability if the director's breach would be exculpated and thus the claims dismissed under *Cornerstone*).

Practice Points

- **A board should seek to ensure that it oversees all communications with a controller whose transaction is being considered by the board.** Any communications by a director with the controller during the board's process, if not directed and overseen by the board, should be promptly disclosed to the board. The board or special committee should then consider what action may need to be taken to counteract any negative impact on the process and to ensure oversight of any further communications. Counsel should ensure that directors understand the potential for personal liability for back-channel communications.

- **Directors should keep in mind that, even if flaws in a board process do not lead to legal liability, there is a risk of reputational damage.** As discussed, in *Facebook*, the court dismissed the case but nonetheless went through in detail the alleged flaws of the board's process.

- **Directors should understand that, with respect to any board or committee process:**

  - emails and text messages may become public;

  - the board should be proactive in evaluating whether relationships exist that give rise to a particular risk of back-channel communications;

  - a special committee should put in place a formal charter or other guidelines delineating its duties and responsibilities;

  - directors evaluating a transaction should not assume (or make statements that could be interpreted ads suggesting that they assume) that the transaction will occur and that their only role is to negotiate the details rather than to evaluate whether the transaction should occur;

- a board should not simply accept a controller's rejection of terms during negotiations (and should keep in mind the leverage arising from its ability to "just say no" to the proposed transaction);
- directors should meet with their proposed legal and financial advisors before engaging them;
- advisors should meet with the directors before beginning negotiations on their behalf; and
- advisors should explain the rationale behind their conclusions and advice, and directors should not simply accept advisors' conclusions and advice but should ask questions and understand their reasoning.

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Fried Frank M&A/PE Group:

Amber Banks (Meek)	David J. Greenwald	Steven G. Scheinfeld
Bret T. Chrisope	Erica Jaffe	Robert C. Schwenkel
Andrew J. Colosimo	Randi Lally	David L. Shaw
Warren S. de Wied	Mark H. Lucas	Peter L. Simmons
Steven Epstein	Scott B. Luftglass	Matthew V. Soran
Christopher Ewan	Brian T. Mangino	Steven J. Steinman
Arthur Fleischer, Jr.*	Shant P. Manoukian	Gail Weinstein*
Andrea Gede-Lange	Philip Richter	Maxwell Yim

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Contacts:

New York

Amber Banks (Meek)	+1.212.859.8522	amber.meek@friedfrank.com
Andrew J. Colosimo	+1.212.859.8868	andrew.colosimo@friedfrank.com
Warren S. de Wied	+1.212.859.8296	warren.dewied@friedfrank.com
Steven Epstein	+1.212.859.8964	steven.epstein@friedfrank.com
Christopher Ewan	+1.212.859.8875	christopher.ewan@friedfrank.com
Arthur Fleischer, Jr.*	+1.212.859.8120	arthur.fleischer@friedfrank.com
David J. Greenwald	+1.212.859.8209	david.greenwald@friedfrank.com
Erica Jaffe	+1.212.859.8442	erica.jaffe@friedfrank.com
Randi Lally	+1.212.859.8570	randi.lally@friedfrank.com
Mark H. Lucas	+1.212.859.8268	mark.lucas@friedfrank.com
Scott B. Luftglass	+1.212.859.8968	scott.luftglass@friedfrank.com
Shant P. Manoukian	+1.212.859.8617	shant.manoukian@friedfrank.com
Philip Richter	+1.212.859.8763	philip.richter@friedfrank.com
Steven G. Scheinfeld	+1.212.859.8475	steven.scheinfeld@friedfrank.com
Robert C. Schwenkel	+1.212.859.8167	robert.schwenkel@friedfrank.com
David L. Shaw	+1.212.859.8803	david.shaw@friedfrank.com
Peter L. Simmons	+1.212.859.8455	peter.simmons@friedfrank.com
Matthew V. Soran	+1.212.859.8462	matthew.soran@friedfrank.com
Steven J. Steinman	+1.212.859.8092	steven.steinman@friedfrank.com
Gail Weinstein*	+1.212.859.8031	gail.weinstein@friedfrank.com
Maxwell Yim	+1.212.859.8214	maxwell.yim@friedfrank.com

Washington, D.C.

Bret T. Chrisope	+1.202.639.7445	bret.chrisope@friedfrank.com
Andrea Gede-Lange	+1.212.859.8862	andrea.gede-lange@friedfrank.com
Brian T. Mangino	+1.202.639.7258	brian.mangino@friedfrank.com

*Senior Counsel