



## Judicial Deference on Executive Compensation Decisions and Section 220 Demands

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**Editor’s note:** David Berger and Brad Sorrels are partners and Lori Will is of counsel at Wilson Sonsini Goodrich & Rosati. This post is based on a WSGR memorandum by Mr. Berger, Mr. Sorrell, Ms. Will, Katherine Henderson, Amy Simmerman, and Ryan Greecher. This post is part of the [Delaware law series](#); links to other posts in the series are available [here](#).

The Delaware Court of Chancery recently denied two books and records demands made by stockholders of Facebook, Inc. that sought to investigate alleged wrongdoing surrounding Facebook’s executive compensation practices at a time when its advertising revenues were declining. In *Southeastern Pennsylvania Transportation Authority v. Facebook, Inc.*, Vice Chancellor Joseph R. Sights III found that the stockholder plaintiffs lacked a proper purpose for the demands because they could not demonstrate a “credible basis” to suspect any disloyal conduct by the board. The court also found that—even if the plaintiffs had stated a proper purpose—Facebook had already turned over all “necessary and essential” information. The decision is instructive for companies faced with books and records demands seeking to investigate potential board misconduct. The case is also a useful reminder that decisions about executive compensation are—absent a board conflict, a controlling stockholder conflict, or waste—a classic business judgment to which the courts will defer.

The lawsuit arose after two institutional investors sent Facebook books and records demands under Section 220 of the Delaware General Corporation Law. Plaintiffs sought to investigate whether the board breached its fiduciary duties by overcompensating executives during a time when the company’s revenue growth rate was declining as a result, in part, from Facebook’s disclosures about errors in its advertising metrics. In addition to seeking to investigate Facebook’s executive compensation decisions, the stockholders also claimed that their demands were made in order to obtain information that would help them to inform themselves regarding a say-on-pay vote, to communicate with directors and other stockholders about the compensation issues, and to assess director independence. Facebook voluntarily produced some board materials in response to the demand. Facebook also stipulated that the board did not consider the errors in advertising metrics when setting executive compensation.

After a trial on a paper record, the court found that—notwithstanding their other stated purposes—the stockholder plaintiffs’ primary purpose was to investigate mismanagement. As to that primary purpose, the court concluded that the plaintiffs failed to satisfy the credible basis standard—the lowest burden of proof under Delaware law—to introduce “some evidence of possible mismanagement.” Vice Chancellor Sights explained that because duty of care claims

were barred by Facebook’s customary exculpatory charter provision, the plaintiffs had to demonstrate a credible basis to infer a potential breach of the board’s duty of loyalty. The plaintiffs did not claim the directors were conflicted or lacked independence, and therefore they had to argue bad faith: that Facebook’s executive compensation decisions were so “inexplicable... that bad faith—a motive other than the interest of the Company—*must* be at work.”

As explained by the court, there was no credible evidence that Facebook’s executives were overcompensated or that Facebook’s 2018 stock drop was related to advertising metric errors reported two years earlier. Even if there had been a connection between the errors and stock drop, the court found the allegations that the board failed to consider the ad-related errors when setting executive compensation—to which Facebook stipulated—did not raise an inference of bad faith, particularly where the directors had reviewed peer data and received expert guidance. Without credible allegations of waste or clearly “egregious” pay, the court explained it is not “a proper purpose for a stockholder to second-guess an exculpated, non-conflicted board’s executive compensation judgment.”

The court also found that, even if the plaintiffs had stated a proper purpose to investigate mismanagement, Facebook had already produced all “necessary and essential” records to fulfill that purpose. Before the lawsuit, Facebook had voluntarily produced certain board materials (minutes and presentations) relevant to the advertising metric errors, which showed that Facebook’s audit committee had discussed those errors and taken measures to address them. But Facebook otherwise stipulated that the directors did not consider the advertising metric errors when setting executive compensation. Vice Chancellor Slight concluded that the plaintiffs therefore had “the information they need[ed]” to decide whether to bring a duty of loyalty claim.

Finally, the court found that none of the plaintiffs’ secondary purposes for the demands was proper. The court rejected the stated purpose of contacting directors and stockholders about compensation decisions, explaining that “a conclusory statement that plaintiffs wish to discuss compensation issues with the board and/or stockholders is not a key to unlock more information than the company has already provided.” The purpose of deciding how to vote on “Say on Pay” was also improper because the 2019 vote had passed and it was unclear what issues would be relevant for future votes. On the plaintiffs’ request for director independence questionnaires to assess board independence, the court explained, “[b]ecause there is no credible basis to suspect wrongdoing, Plaintiffs are not entitled to determine whether the Board is independent for purposes of considering a demand to bring claims related to such wrongdoing.”

Stockholders continue to send Section 220 demands with increasing prevalence in an effort to prepare derivative complaints that are more likely to survive motions to dismiss. Although Delaware courts have endorsed such efforts, stockholders making books and records demands must still adhere to the requirements of Section 220—including stating a proper purpose and showing their need for specific documents. The court’s opinion is helpful precedent for companies seeking to proactively protect themselves from the burdens of Section 220 demands and for litigators responding to similar demands in the future. In particular, Facebook’s decision to produce a limited set of board materials and stipulate to the relevant issue made it difficult for the stockholders to show a credible basis to suspect wrongdoing or argue that additional documents were “necessary and essential” to their purposes. The decision also reaffirms the Delaware

courts' view that, absent a disabling conflict of interest or waste, executive compensation decisions should be protected by the business judgment rule.