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New Chancery Guidance On Books And Records Law

APRIL 19, 2019

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Section 220 of the Delaware General Corporation Law permits a stockholder of a Delaware corporation to obtain certain corporate books and records, provided the stockholder's demand for inspection is made for a "proper purpose" and meets other form and manner requirements. The most common "proper purpose" cited by stockholders is the desire to investigate potential corporate mismanagement, waste or other wrongdoing.

In order to gain access to corporate books and records for this purpose, however, a stockholder must demonstrate that a credible basis exists to infer actual mismanagement or wrongdoing. And, even when a stockholder can do so, he, she or it is entitled to only those books and records that are "essential and sufficient to the stockholder's stated purpose."

In the past few months, the Delaware courts have issued a number of important decisions further delineating the metes and bounds of this inspection right. In addition to a recent Delaware Supreme Court ruling addressing whether and to what extent Section 220 allows access to electronic communications,[1] the Delaware Court of Chancery has, so far in 2019, also issued a handful of decisions further clarifying the scope of the statute's inspection right. These decisions, and key takeaways therefrom, are discussed below.

Schnatter v. Papa John's: Reaffirming A Director's Right to Books and Records

In a Jan. 15, 2019, post-trial ruling, the Court of Chancery reaffirmed that Section 220 vests directors of Delaware corporations with "virtually unfettered rights to inspect [the company's] books and records." The case arose out of the well-publicized feud between Papa John's International Inc. and its founder, John Schnatter. After making racially insensitive comments, Schnatter agreed to resign as the company's chairman and CEO, but refused to give up his seat on the board of directors.

The board formed a special committee to investigate the company's remaining ties to, and agreements with, Schnatter, which it subsequently took steps to terminate. Schnatter, in his continuing capacity as a director, thereafter made a books and records demand under Section 220 for the stated purpose of investigating whether his fellow directors had breached their fiduciary duties in seeking to expel him from the company.

Although the parties resolved many of their disputes regarding the categories of requested documents, a one-day trial was held in October 2018 before Chancellor Andre G. Bouchard to address the remaining issues. The court found that Schnatter had demonstrated a proper purpose for the demand and, in so doing, highlighted important differences between Section 220 demands made by stockholders and those made by directors.

Whereas a stockholder has the burden to demonstrate a "credible basis" to infer mismanagement or other wrongdoing to support a Section 220 demand, the chancellor explained, a "director seeking inspection of books and records makes out a prima facie case when he shows that he is a director, he has demanded inspection and his demand has been refused. At that point, the defendant corporation bears the burden of proving that any such inspection is for an improper purpose," i.e., that the director's "motives are improper, or that they are in derogation of the interests of the corporation." Applying the director standard, the court found that Schnatter had made a prima facie case for inspection, which Papa John's had not adequately rebutted.

Other noteworthy aspects of the decision include the court's (a) ordering the production of relevant emails and text messages from the personal accounts—and/or on the personal devices—of the other Papa John's directors, and (b) rejection of the company's argument that Schnatter's filing of a related shareholder derivative suit against the Papa John's special committee members and his successor as CEO rendered his attempt to obtain documents via a Section 220 demand improper.

With respect to the former ruling, the court noted that "[a]lthough some methods of communication (e.g., text messages) present greater challenges for collection and review than others, and thus may impose more expense on the company to produce, the utility of Section 220 as a means of investigating mismanagement would be undermined if the court categorically were to rule out the need to produce communications in these formats." In addressing such requests to inspect information from personal accounts and devices, Bouchard emphasized the need for the court to "apply its discretion on a case-by-case basis to balance the need for the information sought against the burdens of production and the availability of the information from other sources."

With respect to the latter issue, the court found that the separate derivative action that Schnatter brought in his capacity as a stockholder did not provide a basis for denying the demand for inspection made in his capacity as a director. While noting that Delaware courts have held that "a stockholder who files a plenary action asserting claims of mismanagement undercuts his alleged need to obtain documents under Section 220 to investigate the same alleged acts of mismanagement," Bouchard stated that no authority had been brought to his attention in which "a director's right to access books and records under Section 220(d) has been denied based on his filing of a plenary claim as a stockholder."

The court also noted that Schnatter had represented that he would not use any documents produced in response to his Section 220 demand to support his derivative claims without first obtaining the company's consent to do so.

Hoeller v. Tempur Sealy: Failure to Establish "Credible Basis" of Wrongdoing in Connection with Challenge to "Business Decisions"

In another recent post-trial decision, the Delaware Court of Chancery denied a demand to inspect corporate books and records under Section 220 after finding that a stockholder failed to demonstrate a "credible basis" to infer wrongdoing to support the stated purpose of the demand. The case involved a Tempur Sealy stockholder's demand to inspect corporate books and records relating to the company's failure to retain one of its largest customers, Mattress Firm, which sourced mattresses and bedding products from Tempur Sealy.

Although Mattress Firm had been acquired in August 2016 by a European company that had its own mattress and bedding supply chain—thereby creating a risk that Mattress Firm would no longer need Tempur Sealy for its mattress supplies—Tempur Sealy's CEO continued to tell the market that he was "optimistic" about maintaining the relationship. In January 2017, Mattress Firm terminated its contract with Tempur Sealy.

A Tempur Sealy stockholder served a Section 220 demand on the company for the stated purpose of investigating "potential wrongdoing, distribution of false and misleading information, and/or breaches of fiduciary duties by the members of the Board, Tempur Sealy's current and/or former executive offices, and/or others" in connection with the company's failure to retain Mattress Firm's business. Tempur Sealy rejected the demand, and the stockholder filed a Section 220 action. The case was tried before Vice Chancellor Joseph R. Slights III, who rendered a decision on Feb. 12, 2019.

The court denied the stockholder's demand for inspection, finding that the stockholder had failed to demonstrate a "credible basis" for the assertion that Tempur Sealy and its officers and directors had "mismanaged" the negotiations with Mattress Firm, or otherwise engaged in wrongdoing in connection with its efforts to retain the business. Quoting prior precedent, Slights emphasized that "[s]tockholders cannot satisfy [the credible basis] burden merely by expressing disagreement with a business decision. When a business judgment forms the basis of a request for books and records, a stockholder must show a credible basis for an inference that management suffered from some self-interest or failed to exercise due care in a particular decision."

CHC Investments v. FirstSun Capital Bancorp: Pending Plenary Action Undermines Stockholder's Books and Records Request

Finding that a books and records demand made by a stockholder after it has already filed a plenary action was "inherently contradictory," the Delaware Court of Chancery also recently dismissed a stockholder's Section 220 action at the pleading stage. The case arose out of a 2014 investment by CHC Investments LLC in Strategic Growth Bancorp Inc., which claimed at the time to be developing its mortgage platform business.

According to CHC, it was unaware at the time of its investment that there were several lawsuits pending against SG Bancorp concerning residential mortgage-backed securities. Within a few months of CHC's investment, SG Bancorp announced that it would spin off the mortgage unit. In 2018, CHC first initiated a direct action against SG Bancorp alleging that disclosures made in connection with CHC's 2014 investment contained material misrepresentations and/or omissions about SG Bancorp's mortgage business.

Thereafter, CHC served a Section 220 demand on FirstSun, which had acquired SG Bancorp, indicating that the purpose of its inspection demand was to "investigate the facts behind SG Bancorp's incomplete disclosures, corporate mismanagement in association with the split-off of its operation into a separate Delaware limited liability company, and improprieties underlying the terms of the exchange offer." FirstSun denied the inspection demand, prompting CHC to file a Section 220 action in the Court of Chancery, which FirstSun promptly moved to dismiss.

In a decision dated Jan. 24, 2019, Vice Chancellor Kathaleen S. McCormick granted the motion to dismiss, concluding that the stated purpose for CHC's Section 220 demand—which CHC admitted was "designed to give Plaintiff the information necessary to investigate the claims asserted in the plenary action"—was improper. Specifically, the court chided CHC for what it characterized as a "sue first, ask questions later" approach.

The court explained that CHC's filing of the plenary action signaled that CHC already had enough information to support its allegations, which contradicted CHC's subsequent Section 220 demand seeking documents to support those very same claims and allegations. The court further observed that discovery rules—not Section 220—govern the exchange of information once an action has commenced. While observing that, in certain special circumstances, Delaware courts have enforced a stockholder's Section 220 demand even with the existence of a pending plenary action, the court concluded that none of these circumstances were present in this case.

Key Takeaways

The Court of Chancery's recent decisions in Schnatter, Tempur-Sealy, and CHC Investments provide key insights into the current state and direction of Delaware books and records litigation.

Stockholders of a Delaware corporation seeking to inspect company books and records under Section 220 bear the burden of demonstrating a "credible basis" to infer mismanagement or wrongdoing on the part of the company's fiduciaries. But directors of Delaware corporations enjoy "virtually unfettered rights to inspect [the company's] books and records." While the filing of a plenary action will, in most cases, foreclose a stockholder's ability to obtain related books and records via a Section 220 demand, the same is not necessarily true with respect to inspection demands made by directors—at least where the plenary action in question is a shareholder derivative action brought in the director's capacity as a stockholder, rather than in his or her capacity as a director.

Subject to a balancing test that weighs the need for the information against the burdens imposed and the availability of the information from other sources, the court will, in appropriate cases, order the production of information from personal accounts and devices in response to an otherwise proper Section 220 demand. But stockholders cannot satisfy the "credible basis" burden under Section 220 merely by expressing disagreement with a business decision. Rather, a stockholder must show a credible basis for an inference that management suffered from some self-interest or failed to exercise due care in a particular decision.

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[1] See https://www.law360.com/articles/1123415/del-justices-broaden-investor-email-right-in-doc-suits.

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