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"CREDIBLE BASIS" TO INVESTIGATE MISMANAGEMENT: DEVELOPMENTS IN § 220 BOOKS-AND-RECORDS INSPECTIONS

Under a Delaware statute, stockholders of Delaware corporations seeking to investigate corporate books and records must show a "proper purpose," usually involving a credible basis from which corporate wrongdoing may be inferred. In this article, the authors first discuss the general requirements of the statute, and then turn to a detailed discussion of recent applications by the Delaware courts of the credible-basis standard.

By Michael J. McConnell and Marjorie P. Duffy *

For years, the Delaware Supreme Court has been urging stockholder-plaintiffs to use the so-called "tools at hand" to advance a public policy in favor of well-researched complaints. One of the most important — and, now, often utilized — tools is the qualified right to inspect a corporation's books and records, as codified in Section 220 of Title 8 of the Delaware General Corporation Law.

Recently, Delaware courts have issued numerous opinions deciding stockholder inspection rights under Section 220. This increased frequency is attributable to several factors, including the curtailment of litigation options for stockholders challenging mergers before closing and the corresponding increase of post-closing challenges that depend on factual showings that stockholder votes were uninformed or that controlling stockholders were involved in the transaction. Section 220 provides a possible means for stockholder-plaintiffs to obtain facts necessary to try to make this showing. Likewise, stockholders also frequently turn to Section 220 to collect information relating to other alleged forms of actionable officer and director conduct, including director oversight claims under *Caremark*.[1] Those claims, like all derivative claims, are subject to heightened pleading standards, and stockholders use Section 220 to try to plead with the factual particularity required to survive a motion to dismiss.

Whether in the M&A or *Caremark* context, stockholders claiming wrongful conduct must show a "credible basis" of wrongdoing to proceed under Section 220. The cases discussed below illustrate the recent applications by the Delaware courts of that standard.

BACKGROUND

Stockholders who wish to inspect corporate books and records or other materials are not automatically

[1] *In re Caremark Int'l Inc. Derivative Litig*., 698 A.2d 959 (Del. Ch. 1996) ("Caremark").

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entitled to do so. Instead, they must submit inspection demands that strictly comply with certain statutory mandates.[2] Among those is the "proper purpose" requirement.[3] Section 220 specifies that a stockholder's purpose for the desired inspection must be one that is "reasonably related" to the stockholder's interest as a stockholder, and not only to a personal, individual, or other interest.[4] The propriety of the stockholder's purpose has been described by the Delaware Supreme Court as "[t]he paramount factor in determining whether a stockholder is entitled to inspection of corporate books and records."[5]

A purpose often identified by stockholders to justify the requested inspection of corporate books and records is the investigation of potential mismanagement, breaches of fiduciary duty, corporate waste, or other wrongdoing. But simply citing a desire to investigate potential wrongdoing is not enough; "indiscriminate fishing expeditions" are impermissible.[6] Instead, a stockholder must show, by a preponderance of the evidence, a credible basis from which wrongdoing may be inferred. The "credible basis" standard is the lowest possible burden of proof under Delaware law, but mere speculation, curiosity, and suspicions do not satisfy it. A combination of documents, logic, and testimony may, however, make a credible showing. Hearsay also may suffice, if sufficiently reliable, and government investigations and reports also may be enough.

In short, as illustrated by the cases discussed below, the application of the "credible basis" standard in any context turns on a nuanced, case-specific factual analysis and requires the stockholder to present at least "some evidence" of "legitimate issues . . . of wrongdoing" to warrant investigation.[7]

"Controlling" stockholders and *MFW*: *Kosinski v. GGP Inc.*[8] This case involved a non-majority stockholder that, under the credible basis standard, ultimately was deemed to be a "controlling" stockholder. GGP merged with its 34% stockholder in a transaction that was negotiated and recommended by a special committee of non-executive, non-affiliated directors. Though the special committee's negotiation efforts resulted in an increase in consideration to the stockholders, a stockholder nevertheless demanded books and records to investigate possible wrongdoing in connection with the merger, believing that the merger price was too low.

The court found a credible basis that the 34% stockholder was a "*de facto* controller" at the time of the merger, in light of its stock ownership, its ability to appoint one-third of the directors to GGP's board, and statements in GGP's 10-K about the stockholder's ability to exert "significant influence" over GGP in "any determinations with respect to mergers."[9] In addition, the court considered the absence of procedural protections under *MFW*.[10] Under *MFW*, a merger with a controlling stockholder is subject to business judgment review when it has been approved by an independent, disinterested, and properly empowered special committee, and the fully informed and uncoerced vote of a majority of the minority stockholders. The *GGP* court found that "where the procedural protections . . . under

[2] 8 *Del. C.* § 220(c) (stockholder making demand must establish that the stockholder "has complied with this section respecting the form and manner of making demand for inspection of such documents"); *Cent. Laborers Pension Fund v. News Corp.*, 45 A.3d 139, 143-45 (Del. 2012) ("Delaware courts require strict adherence to the section 220 inspection demand procedural requirements.").

[3] 8 *Del. C.* § 220(b) ("Any stockholder, in person or by attorney or other agent, shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose, and to make copies and extracts from [certain materials].").

[4] 8 *Del. C.* § 220(b).

[5] *Kosinski v. GGP Inc.*, 214 A.3d 944, 952 (Del. Ch. 2019) (quoting *CM & M Grp., Inc. v. Carroll*, 453 A.2d 788, 792 (Del. 1982)).

[6] *Seinfeld v. Verizon Commc'ns, Inc.*, 909 A.2d 117, 122 (Del. 2006) (quoting *Sec. First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 571 (Del. 1997)).

[7] *Seinfeld*, 909 A.2d at 118.

[8] 214 A.3d 944 (Del. Ch. 2019).

[9] *GGP*, 214 A.3d at 953.

[10] *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) ("MFW").

MFW are absent, it is *possible* that the transaction was not at arm's length, less than optimal, and potentially tainted by the undermining influence of a controller. There is no reason why these possibilities cannot contribute to a credible basis."[11] *GGP* thus demonstrates that, even while there is no requirement to follow the *MFW* pathway to business judgment review, a lack of *MFW* protections — even with a non-majority stockholder — may be enough to justify inspection of books and records under the credible basis standard.

"Controlling" stockholders and alleged conflicts: *Donnelly v. Keryx Biopharmaceuticals, Inc.*[12] This case, like *GGP*, involved a non-majority stockholder that the court found was possibly a de facto controller. A Keryx stockholder sought books and records to investigate alleged breaches of the duty of loyalty based on, among other things, the supposed influence by Keryx's largest stockholder in connection with Keryx's merger with Akebia Therapeutics, Inc.

Before the merger, Keryx's largest stockholder owned approximately 21.4% of Keryx, and also held convertible notes that, if converted, would increase its ownership stake to 39%. In its 10-K, Keryx identified this stockholder as one that "may have significant influence over matters submitted to [Keryx's] stockholders for approval."[13] The stockholder also had the right to appoint one director to Keryx's seven-member board. That director appointee oversaw a special committee that considered a merger with Akebia and ultimately suggested Keryx not go forward with Akebia. Shortly thereafter, Keryx reopened explorations and the board resumed discussions with Akebia, aided by the stockholder's own due diligence on Akebia. As part of those discussions (which the court inferred the stockholder had "revived"), Keryx, Akebia, and Keryx's largest stockholder agreed that the stockholder would receive approximately $20 million of additional shares of stock in exchange for early conversion of its notes.

The court acknowledged that "demonstrating actual control by a minority blockholder is 'not easy.'"[14] However, it concluded that, for purposes of the books-and-records demand, these allegations were sufficient to establish a credible basis that Keryx's largest stockholder was "in a control position."[15] *Keryx* underscores that a stockholder need not prove actual control by a non-majority stockholder to obtain books and records under the credible basis standard.

Exculpatory clauses and alleged conflicts of interest: *Paraflon Investments, Ltd. v. Linkable Networks, Inc.*[16] This case arose from an inspection demand by a stockholder to inspect possible mismanagement arising from the sale of Linkable for pennies on the dollar. Less than a year before the sale, Linkable entered into a term sheet with non-party Blue Chip Venture Capital for $2.5 million in financing. Days after signing the term sheet, however, Linkable rejected the final terms included in the investment agreement proposed by Blue Chip, which Linkable considered to be "onerous."[17] At the time of this rejection, an affiliate of Blue Chip was a member of the Linkable board. In its demand for books and records, the stockholder argued that Linkable failed to seek enforcement of the term sheet as a concession to this affiliated director. The court acknowledged that, in light of the fact that Linkable's charter contained an exculpatory provision under 8 *Del. C.* § 102(b)(7), "the stockholder's purpose must target non-exculpated wrongdoing."[18] Although observing that there were explanations for not seeking enforcement of the term sheet that did not involve mismanagement or wrongdoing, the court found the stockholder had presented sufficient evidence to meet the "credible basis" standard.

Linkable illustrates how "interest" allegations may side-step the hurdle presented by Section 102(b)(7). The stockholder does not appear to have presented any evidence showing the term sheet was legally enforceable, or that Linkable had sufficient financial resources to pursue enforcement. Nonetheless, the mere fact that one director affiliated with Blue Chip sat on the Linkable board, coupled with the existence of a liquidity crunch, was enough to establish a "credible basis" that the entire Linkable board may have engaged in non-exculpated conduct.

Failed contract negotiations: *Elow v. Express Scripts Holding Company*[19] **and *Hoeller v. Tempur***

[11] *GGP*, 214 A.3d at 954.

[12] No. 2018-0892-SG, 2019 WL 5446015 (Del. Ch. Oct. 24, 2019).

[13] *Keryx*, 2019 WL 5446015, at *1.

[14] *Keryx*, 2019 WL 5446015, at *5 (quoting *In re Rouse Props., Inc.*, 2018 WL 1226015, at *11 (Del. Ch. Mar. 9, 2018)).

[15] *Keryx*, 2019 WL 5446015, at *5.

[16] No. 2017-0611-JRS, 2020 WL 1655947 (Apr. 3, 2020).

[17] *Linkable*, 2020 WL 1655947, at *4.

[18] *Linkable*, 2020 WL 1655947, at *3.

[19] No. 12721-VCMR, No. 12734-VCMR, 2017 WL 2352151 (Del. Ch. May 31, 2017).

Sealy International, Inc.[20] As a general rule, "[s]tockholders cannot satisfy [the credible basis] burden merely by expressing disagreement with a business decision."[21] Nonetheless, the *Elow* decision illustrates that, under certain circumstances, a stockholder can show a credible basis to investigate failed contract negotiations.

That case arose from a 10-year contract obligating Express Scripts to provide pharmacy benefit management services to certain Anthem health plans. Express Scripts' revenues from the contract ranged from 12% to 17% over a roughly four-year period during the contract term. The parties agreed to negotiate pricing adjustments every three years. Although the parties successfully negotiated the first periodic price review, they ran into difficulties during the second review, which started in 2015. Throughout that year, Express Scripts' CEO made bullish statements regarding the strength of the company's relationship with Anthem, and claimed the relationship was well positioned for 2016. During 2015, however, Anthem had provided two breach notifications. After the second repricing discussions collapsed, Anthem filed suit in early 2016 claiming that Express Scripts negotiated in bad faith and failed to meet performance requirements. Express Scripts answered and filed a counterclaim and, in the interim, a federal securities action was filed against Express Scripts on behalf of a putative class of its stockholders. The action targeted, in part, the CEO's positive statements. In the Section 220 inspection action against Express Scripts, the stockholder argued that Express Scripts' pleadings in the Anthem litigation contradicted the CEO's statements. The court agreed, finding this contradiction, standing alone, showed a credible basis and justified the stockholder's investigation of possible mismanagement.

The allegations in *Hoeller* are very similar to those in *Elow*. *Hoeller* arose from a mattress supply contract between Tempur-Sealy and Mattress Firm. Mattress Firm accounted for 24% of Tempur-Sealy's net sales and, during the contract term in 2016, Mattress Firm was acquired. In 2016, Tempur Sealy made several filings with the Securities and Exchange Commission warning of its vulnerability to losing certain customer contracts, and possible declining revenue due to the acquisition of Mattress Firm. As late as October 2016, however, Tempur Sealy's CEO said he was "wildly optimistic about the future for both the Mattress Firm team and Tempur Sealy."[22] After Tempur-Sealy declined to renegotiate the terms of the contract as requested by Mattress Firm, Mattress Firm terminated the contract in January 2017. After Tempur Sealy publicly disclosed the termination, its stock declined by 32%. Subsequently, the parties filed competing lawsuits related to the terminated agreement in state and federal court and, similar to *Elow*, a federal securities class action was filed against Tempur Sealy alleging it falsely represented the strength of its relationship with Mattress Firm.

Even though the *Hoeller* court acknowledged that its facts were "quite similar" to those presented in *Elow*, it concluded that the *Hoeller* stockholder had failed to establish a credible basis from which mismanagement could be inferred. The court held the failed negotiations did not support a *Caremark* claim, nor was there any evidence of self-interest motivations to support a breach of loyalty claim. Further, it held that the stockholder had failed to show a credible basis that Tempur Sealy's directors were grossly negligent to support a duty of care claim (which may have been exculpated under Section 102(b)(7) in any event). The court distinguished the pleadings filed in the Tempur Sealy/Mattress Firm litigation and the pleadings filed in the Express Scripts/Anthem litigation. The court held Tempur Sealy's pleadings did not contradict its public statements, unlike Express Scripts. In rejecting the inspection demand, the court concluded that "[t]he credible basis standard would be turned on its head if a stockholder was afforded inspection rights every time a company in which he owned stock lost a major customer or was sued for breach of contract."[23]

Caremark* oversight liability — *Lebanon County Employees' Retirement Fund v. Amerisourcebergen Corp.[24] Both the plaintiffs' and defense bars are closely watching developments in this case, where the Delaware Supreme Court is poised to provide guidance regarding several aspects of Section 220 demands.

Stockholders sought books and records to investigate possible wrongdoing in connection with the company's distribution of opioids and to evaluate the board's independence and disinterestedness. The company rejected the demand, largely on the basis that the stockholders sought to investigate a *Caremark* claim and

[20] No. 2018-0336-JRS, 2019 WL 551318 (Del. Ch. Feb. 12, 2019).

[21] *Marathon Partners, L.P. v. M & F Worldwide Corp.*, No. 018-N, 2004 WL 1728604, at *4 (Del. Ch. July 30, 2004).

[22] *Hoeller*, 2019 WL 551318, at *4.

[23] *Hoeller*, 2019 WL 551318, at *12.

[24] No. 2019-0527-JTL, 2020 WL 132752 (Del. Ch. Jan. 13, 2020).

had failed to show a credible basis to suspect actionable wrongdoing by the board. After trial, the Court of Chancery ordered the company to produce certain books and records and authorized the stockholders to take a Rule 30(b)(6) deposition. The court ruled that the stockholders were not required both to state a proper purpose for the inspection and to identify a viable end to which the materials could be used, such as filing a lawsuit. The court also found that the stockholders were not required to show a credible basis from which an *actionable claim* could be inferred, and instead had to establish only a credible basis from which *wrongdoing* could be inferred. Thus, the court concluded, it was no defense to the stockholders' inspection demand that the company's certificate of incorporation included a Section 102(b)(7) exculpating the directors for monetary liability for breaches of the duty of care, nor was it a defense that the claims that the stockholders might assert based on their inspection would be time-barred.

The Delaware Supreme Court accepted interlocutory appeal, finding that the Court of Chancery had decided "substantial issues of material importance," including those relating to the "proper purpose" requirement and the stockholders' burden to demonstrate wrongdoing when seeking books and records for the purpose of investigating mismanagement.

CONCLUSION

As Section 220 demands continue to increase in frequency and scope, including in the M&A and *Caremark* contexts, companies responding to such demands will have to continue to wrestle with determining on a case-by-case basis whether or not a stockholder has established a credible basis to justify its investigations. The Delaware Supreme Court's decision in *Amerisourcebergen* may aid that determination and, in the meantime, both companies and courts will strive to strike the proper balance between stockholder rights to inspect books and records, and the best interests of the corporations and their stockholders. ■