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Delaware Court of Chancery Rulings Highlight the Importance of a Plaintiff's Subjective Intent in Books and Records Actions

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Two recent rulings of the Delaware Court of Chancery highlight the need to examine a stockholder plaintiff's objectives in seeking to inspect the corporation's books and records under Section 220 of the Delaware General Corporation Law (DGCL). As is well known, a stockholder seeking to compel an inspection of books and records under Section 220 must demonstrate a "proper purpose" for the inspection by a preponderance of the evidence.[1] In general, to meet its burden, the stockholder must establish a "credible basis" from which the court can infer there is "possible mismanagement that would warrant further investigation."[2] But, even if its stated purpose is facially proper, the stockholder may not be entitled to conduct the inspection if it can be shown that the stated purpose is not the stockholder's actual primary objective.[3] The Court's recent rulings demonstrate that the stockholder's subjective intent, and not any unrelated objective of its counsel, is the focus of the inquiry into whether the stockholder has articulated a proper purpose.

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Wilkinson v. A. Schulman, Inc.

In *Wilkinson v. A. Schulman, Inc.*, the Court drew a clear distinction between the stockholder's stated purpose and that of his counsel, and ultimately dismissed the stockholder's books and records action on the basis that the purported purpose belonged to the counsel, rather than the stockholder.[4] The stockholder's demand, as conveyed to the corporation, articulated a purpose involving an investigation into the board's decision to accelerate the vesting of the former CEO's restricted shares upon his retirement.[5]

The demand alleged that, under his employment agreement, the CEO was only entitled to *pro rata* vesting of his restricted shares over time.[6] The demand also alleged that the acceleration of the restricted shares violated A. Schulman's stockholder-approved equity compensation plan, resulting in a loss of favorable tax treatment.[7] Finally, the demand asserted that the acceleration led to the vesting of

107,775 shares that the former CEO would not otherwise have been entitled to receive—and that A. Schulman received no additional consideration for the accommodation.[8]

After A. Schulman rejected the stockholder's demand, the stockholder brought an action under Section 220 of the DGCL seeking to compel the inspection.[9] During the course of his deposition, the stockholder conceded that the purported purposes for the inspection stated in his demand letter were not his own but had instead been crafted by his counsel.[10] (The stockholder initially intended to seek books and records for an entirely different purpose, which he articulated as follows: " '[t]hey [A. Schulman] lost $365 million, which is a pretty good reason [to demand an inspection of books and records pursuant to Section 220 of the DGCL], don't you think?' " Regardless of whether the alleged financial loss provided a good reason for the inspection, it was ultimately determined not to supply a "proper purpose" in this case.[11]) While his counsel had decided to pursue the demand on the basis of the board's decision to accelerate the vesting of the former CEO's restricted shares, the stockholder testified that he not aware of any facts suggesting any wrongdoing in connection with that decision.[12]

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Although the Court found the allegations of wrongdoing set forth in the demand to be credible, the actual stockholder's admissions proved fatal.[13] After trial, the Court determined that the stockholder's purported purposes were not his own but were those of his counsel.[14] As the Court found that the stockholder did not have a proper purpose, it ruled that he was not entitled to inspect the corporation's books and records.[15]

In its ruling, the Court made clear that it was not intending to limit the input of counsel in assisting their clients. To the contrary, the Court indicated that stockholders seeking to inspect books and records under Section 220 would be well-advised to engage counsel to assist with the endeavor.[16] *Wilkinson*, however, did not involve the typical "situation in which the stockholder client initiate[s] the process," following which "counsel draft[s] a demand,"[17] but a more troubling fact pattern. As the Court explained,

> a stockholder seeking an inspection and retaining counsel to carry out the stockholder's wishes is fundamentally different than having an entrepreneurial law firm initiate the process, draft a demand to investigate different issues than what motivated the stockholder to respond to the law firm's solicitation, and then pursue the inspection and litigate with only minor and nonsubstantive involvement from the ostensible stockholder principal.[18]

Guido v. Cynosure, Inc.

In a transcript ruling in *Guido v. Cynosure, Inc.*, a Master in Chancery recommended against quashing a subpoena requiring a stockholder plaintiff in a Section 220 action to appear at trial.[19] Based on the facts and circumstances of the case, the Master determined that the defendant corporation was entitled to have a full opportunity to examine the stockholder and determine whether the purpose stated in his demand and complaint, which were drafted by his counsel, represented his true objectives.[20]

Cynosure involved a demand seeking to inspect the corporate books and records of Cynosure, Inc. following the announcement of its impending acquisition by Hologic, Inc.[21] Specifically, the stockholder sought the inspection to

> determine whether wrongdoing or mismanagement ha[d] taken place such that

> it would be appropriate to file claims for breach of fiduciary duty, and to investigate the independence and disinterestedness of the Company's directors generally and with respect to the company's proposed acquisition by Hologic, Inc.[22]

Disputing the genuineness of the stated purpose, Cynosure served the stockholder with a subpoena, requiring him to appear at a trial for purposes of determining his entitlement to inspection. Although it presented no readily identifiable alternate purpose, Cynosure claimed that the plaintiff's deposition testimony indicated that he believed that he had sufficient information to file a breach of fiduciary duty claim.[23] This fact, in Cynosure's view, was inconsistent with the plaintiff's purported purpose "to determine whether it was appropriate to pursue litigation."[24] When Cynosure's counsel attempted to question the stockholder on this discrepancy during his deposition, the stockholder's counsel instructed him not to answer on grounds of attorney-client privilege. Cynosure viewed the objection as inappropriate.[25] Moreover, the stockholder's deposition testimony indicated that he may not have read the demand letter before it was sent to Cynosure and that he may not have read the initial verified complaint before it was filed with the Court. This gave Cynosure further reason to suspect that the purpose stated in the demand was merely formulated by his counsel but was not his actual personal objective.[26]

The plaintiff moved to quash the subpoena, arguing that there is no rule requiring stockholder plaintiffs in Section 220 actions to appear at the summary proceeding.[27] Additionally, counsel for the plaintiff argued that the information already before the Court was sufficient and, to the extent any additional information was required, offered to stipulate to various facts and make the stockholder available for a brief telephonic deposition.[28] In opposition, Cynosure asserted that the plaintiff, who bore the burden of proof in establishing a proper purpose, should be required "to come to trial to articulate exactly what his purpose is, be subject to cross-examination, and allow the Court to weigh the evidence and to assess his credibility."[29]

Following argument, the Master issued a final report recommending the denial of the plaintiff's motion for a protective order quashing the trial subpoena.[30] While Section 220 actions are commonly resolved on a paper record, the Master ruled that a plaintiff "does not have a right to such a streamlined presentation of evidence."[31] Rather,

> the defendant has the right to build a defense that a stated proper purpose is not bona fide or the shareholder's primary purpose, or to show that plaintiff has failed to meet his burden of a credible basis to infer mismanagement.[32]

Although noting that a plaintiff could rely on counsel to draft demand letters and complaints, in this instance, the Master declined to "foreclose the defendant from pursuing these defenses and force the defendant to accept stipulations in lieu of live testimony to which the defendant is entitled."[33]

Conclusion

In books and records actions brought under Section 220, stockholder plaintiffs bear the burden of establishing a proper purpose for their inspection. That purpose, however, must ultimately belong to the stockholder, and not solely the stockholder's counsel. If a discrepancy exists between a stockholder's improper purpose and its counsel's facially proper purpose, the defendant corporation may be able to take measures to dispense with the action.

Notes

1. 8 *Del. C.* § 220(b); *Seinfeld v. Verizon Commc'ns, Inc.*, 909 A.2d 117, 121 (Del. 2006).
2. *Seinfeld*, 909 A.2d at 123.
3. *Pershing Square, L.P. v. Ceridian Corp.*, 923 810, 817 (Del. Ch. May 11, 2007).

4. 2017 WL 5289553 (Del. Ch. Nov. 13, 2017).
5. *Id.*
6. *Id.* at *1.
7. *Id.* at *1–2.
8. *Id.*
9. *Id.* at *2.
10. *Id.*
11. *Id.* Depending on the facts and circumstances, a corporation's failure to meet its financial expectations may provide credible evidence of mismanagement sufficient for a stockholder to state a proper purpose for inspection of books and records under Section 220. *See Shamrock Activist Value Fund, L.P. v. iPass Inc.*, 2006 WL 3824882, at *2 (Del. Ch. Dec. 15, 2006).
12. *Wilkinson*, 2017 WL 5289553, at *3.
13. *Id.* at *1–2.
14. *Id.* at *3.
15. *Id.* at *4
16. *Id.* at *3.
17. *Id.*
18. *Id.*
19. C.A. No. 2017-0209-MTZ (Del. Ch. June 28, 2017) (TRANSCRIPT).
20. *Id.* at 16.
21. *Id.* at 13
22. *Id.*
23. *Id.* at 9.
24. *Id.* In certain circumstances, the Court has found stockholder plaintiffs in Section 220 actions to lack a proper purpose where they already possess sufficient information and have filed a complaint challenging the alleged wrongdoing. *See, e.g.*, *Bizzari v. Suburban Waste Servs., Inc.*, 2016 WL 4540292, at *6 (Del. Ch. Aug. 30, 2016).
25. *Cynosure*, C.A. No. 2017-0209-MTZ at 9–10.
26. Defs.' Reply Br. at 10, *Cynosure*, C.A. No. 2017-0209-MTZ.
27. *Cynosure*, C.A. No. 2017-0209-MTZ at 4.
28. *Id.* at 12, 15.
29. *Id.* at 9–10.
30. *Id.* at 13.
31. *Id.* at 15.
32. *Id.* at 16.
33. *Id.*