

Delaware Stockholders Need Only Present Reasonable Inference of Managerial Wrongdoing for Inspection of Company's Records

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Section 220 of the Delaware General Corporation Law affords stockholders a qualified right to inspect a corporation's books and records. A Section 220 inspection is a powerful stockholder right, and indeed, the Delaware Supreme Court has repeatedly counseled that stockholders should exercise this right to better develop the factual predicate for a derivative lawsuit. Inspection under Section 220 is qualified so as to balance the stockholder's legitimate need to access corporate records with the company's right to be free from requests that are disruptive or sought with improper motive. Section 220, therefore, requires that the stockholder seeking inspection (1) be a stockholder of record, (2) comply with the form and manner requirements when making the demand and (3) state a proper purpose for the requested inspection.

Although the Section 220 requirements appear simple on their face to satisfy, practical application can be vexing, resulting in frequent disputes over the scope of an inspection. The Court of Chancery's recent decision in *Donnelly v. Keryx Biopharmaceuticals, Inc.* addresses one of the more common disputes in Section 220 actions – is there a proper purpose for the demand. Following a merger transaction, Donnelly, a stockholder of Keryx Biopharmaceuticals, served a written demand on the company under Section 220 seeking inspection of books and records to investigate possible breaches of loyalty based on the fairness of the merger price, potential influence by a significant stockholder, bonuses paid to management in connection with the merger, the independence and disinterestedness of the directors, and deficiencies in the disclosures made in support of the merger. There was no dispute that Donnelly was a stockholder of record or that his demand met the technical formatting requirements of Section 220.

Nevertheless, the company refused the Section 220 demand, and produced no records for Donnelly's inspection, because it disputed that his purpose for the inspection was proper or that there was a credible basis of wrongdoing warranting the inspection. Donnelly filed suit to compel the inspection and his deposition was taken in that litigation. At deposition, Donnelly testified that his purpose for the demand included the aforementioned reasons (all of which the court deemed proper for purposes of Section 220), except he needed prompting to recall that deficient disclosures was a concern. He further testified that even had he received adequate disclosures, he would have opposed the merger anyway. The company seized on this line of testimony to contend that Donnelly's stated purpose was not his true purpose. The company additionally highlighted that the demand followed a form template frequently used by the attorneys representing Donnelly to suggest that the purposes included therein were merely formulaic and not truly Donnelly's.

Delaware recognizes a defense to Section 220 demands where it can be demonstrated that the stockholder's stated purpose is not the actual purpose for the demand. This defense requires the company to prove false pretenses for the

demand, which is a fact-intensive showing that is often difficult to satisfy. A subspecies of the false pretenses defense is where the Section 220 litigation is entirely lawyer – and not client – driven. In this instance, the court disagreed with the company's assertion that Donnelly's request was entirely attorney driven. The court observed that decisions upholding this defense involved situations where the stockholder's testimony revealed a complete divergence of purpose from what was provided in an attorney-drafted demand. Although the demand followed a form previously used by Donnelly's attorneys, the court found no reason to conclude that Donnelly did not have material input into the population of the demand template. And so, the court confirmed that where the company cannot show that the demand was entirely attorney driven, this line of defense will not be successful.

A further consideration under the proper purpose element is whether the stockholder has offered a credible basis from which the court can infer possible mismanagement warranting the inspection. The company challenged that Donnelly had not offered a credible basis for his allegations because he did not demonstrate the existence of a controlling stockholder to trigger entire fairness review of the transaction. The court noted that a stockholder need not provide actual proof to state a credible basis. The point of the inspection is to gather the information to evaluate whether there was actual mismanagement. The stockholder therefore needs only to show by a preponderance of the evidence that there is a credible basis to infer mismanagement. Given the preference for stockholders to utilize Section 220 demands to investigate whether there is a basis to pursue derivative litigation, the court is cognizant not to set the credible basis bar for Section 220 demands too high out of concern that doing so would preclude the pursuit of meritorious derivative lawsuits.

The court found that Donnelly had satisfied what it described as a low threshold for credible basis to infer wrongdoing. A 40% stockholder pressed for the merger, had a board seat, a board observer role and financial leverage over the company. The 40% stockholder also benefited from a side deal worth \$20 million in connection with the merger. Incumbent management received bonuses predicated on the completion of the merger, and several of them continued in lucrative positions with the post-merger entity. A financial advisor who had originally opined against the merger was dismissed and the replacement financial advisor favored by the 40% stockholder supported the merger. Although the court noted that these allegations alone were not sufficient to conclude there was mismanagement, they suggested an inference of wrongdoing to support a credible basis for the inspection.

In conclusion, Section 220 demands require a fact-intensive analysis, and generic handling is ill-advised. To state a proper purpose for inspection under Section 220, stockholders must set forth sufficient information from which the court can reasonably infer that wrongdoing may have occurred. This requires more than formulaic recitation of generic purposes, but does not obligate the stockholder to prove actual wrongdoing. It is accordingly recommended that parties consult counsel familiar with the nuances of Section 220 demands before issuing or responding to a request for books and records.

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