



INSIGHTS

The Corporate & Securities Law Advisor

VOLUME 31, NUMBER 6, JUNE 2017

IN THE COURTS

Guidance on “Credible Basis” Standard for Obtaining Books

By Joseph O. Larkin and Rupal Joshi

The Delaware Supreme Court has held that strict adherence to the procedural requirements of Section 220 of the Delaware General Corporation Law “protects the right of the corporation to receive and consider a demand in proper form before litigation is initiated.” For this reason, a stockholder making a books-and-records demand has the initial burden to show both that he or she has standing to make such a demand and that the production is necessary. To do so, a stockholder must provide documentary evidence of continuous beneficial or record ownership in the corporation from the time of the alleged wrong. The stockholder also must articulate a “proper purpose” for the request that is reasonably related to a legitimate interest as a shareholder and is not adverse to the corporation’s best interests. If the purpose is to investigate or prosecute alleged wrongdoing, the stockholder must demonstrate a credible basis (and

not mere speculation) of alleged mismanagement and also explain why each category of documents is “necessary and essential” to fulfill the demand’s stated purpose.

Background

Delaware courts consistently have held that the “credible basis” standard is intended to prevent stockholders from engaging in an “indiscriminate” fishing expedition. Accordingly, a generalized statement of possible mismanagement, without more, will not justify production. Rather, a stockholder must provide some evidence of possible mismanagement. Mere disagreement with a business decision, in the absence of evidence from which the court may infer a possible breach of fiduciary duty, does not satisfy the credible basis standard.¹ Several recent decisions indicate that the courts will examine carefully the “credible basis” standard when a stockholder seeks the production of books and records for investigating mismanagement.

New Guidance

Most recently, in *Haque v. Tesla Motors, Inc.*,² Vice Chancellor Joseph R. Slight III of the Court of Chancery issued an important opinion that provides additional guidance on books-and-records demands. Tesla Motors, a leading manufacturer of

Joseph O. Larkin is counsel, and Rupal Joshi is an associate at Skadden, Arps, Slate, Meagher & Flom LLP in Wilmington, DE.

luxury electric vehicles, provided guidance to the market in its quarterly reports that demand for its vehicles was high. At various times in 2014 and 2015, however, Tesla reported that it had missed its sales guidance. When its production or deliveries fell short of targets, Tesla consistently maintained that the shortfalls were driven by production issues (e.g., supply chain challenges), not a lack of consumer demand.

The plaintiff questioned whether Tesla's officers and directors had "fabricated" certain explanations for "sales misses" to cover up the fact that demand for Tesla vehicles was lower than reported. The plaintiff twice demanded to inspect Tesla's books and records pursuant to Section 220 "in order to investigate possible breaches of fiduciary duty and mismanagement" by Tesla's board and senior management. Tesla initially rejected both demands but ultimately agreed to make a limited production of documents to the plaintiff. The plaintiff was dissatisfied with the production and filed suit. By stipulation of the parties, the matter was tried by the Court of Chancery on a paper record without deposition or live testimony.

The court found that the plaintiff failed to demonstrate by a preponderance of the evidence a credible basis from which it could infer possible wrongdoing that would warrant further investigation. The court began its analysis by noting that the Delaware Supreme Court has held that "a stockholder's desire to investigate wrongdoing or mismanagement is a 'proper purpose'" under Section 220. The court stated that "at first glance," the plaintiff's desire to investigate whether or not Tesla publicly misled its shareholders stated such a purpose. However, "merely offering a suspicion of wrongdoing is not enough to justify a Section 220 demand," the court stated. Accordingly, the court held, a plaintiff seeking books and records must present "some evidence" to suggest a credible basis from which the court can infer that mismanagement, waste or wrongdoing may have occurred.

The court also noted that this evidentiary burden lies with the plaintiff and is not a mere formality. It may be satisfied by a "credible showing, through

documents, logic, testimony, or otherwise, that there are legitimate issues of wrongdoing." In a thorough analysis of each of the alleged misstatements at issue, the court held that it would not be credible to infer wrongdoing or mismanagement based solely on the fact that Tesla occasionally missed its vehicle delivery or production guidance. Indeed, Delaware law "requires more than a divergence between forward-looking statements and subsequent results" in order to provide a credible basis to infer mismanagement or wrongdoing. The court found that "when viewed in the aggregate," the plaintiff's evidence "amounts to nothing more than 'suspicion or curiosity,'" which is insufficient to satisfy the credible basis standard.

Another Decision

The court's recent decision in *Tesla Motors* is consistent with the Court of Chancery's decision in *Beatrice Corwin Living Irrevocable Trust v. Pfizer, Inc.*,³ in which Master Abigail M. LeGrow held after a full trial that there was no credible basis to infer a potential *Caremark* claim for breach of fiduciary duty for failure to exercise oversight. The action was brought by the trustees of a trust to inspect Pfizer's books and records for the purpose of valuing the trust's shares and investigating possible mismanagement. The plaintiffs asserted that the company violated accounting and disclosure laws by failing to calculate and disclose a particular deferred tax liability.

In *Pfizer*, the only mismanagement or wrongdoing the plaintiffs addressed was "possible breaches of fiduciary duties" by the Pfizer board of directors for "failing to assure compliance with applicable accounting rules" in relation to the deferred tax liability. None of the evidence the plaintiffs offered to support the credible basis standard, however, was focused on the board's compliance with its oversight duties under *Caremark*. As such, the court held that the plaintiffs failed to establish a credible basis from which the court could "infer that the board utterly failed to implement a reporting system or ignored red flags."

The court also found that an obvious defense to the purported claim—the board’s reliance on an audit firm for a complicated accounting issue—existed, and thus it denied inspection pursuant to the protections provided to directors under 8 Del. C. § 141(e). In making this conclusion, the court relied on *Southeastern Pennsylvania Transportation Authority v. AbbVie, Inc.*,⁴ Specifically, the court noted that under *AbbVie*, a stockholder did not have a credible basis to investigate mismanagement or wrongdoing where (1) the only identified use by the stockholder for the inspection was to help plead a later claim in litigation, (2) the only available relief the stockholder identified was monetary damages, and (3) the directors who were the potential subject of the suit were protected by an exculpatory charter provision under 8 Del. C. § 102(b)(7). In *AbbVie*, the Section 102(b)(7) exculpation for any potential duty-of-care claim prohibited a finding of actionable wrongdoing. Likewise, the plaintiffs in *Pfizer* focused solely on possible breaches of fiduciary duty by the board of directors for the purpose of evaluating potential shareholder or derivative litigation, and the board’s actions were ultimately “fully protected” by 8 Del. C. § 141(e). Thus, the court held that the plaintiffs failed to demonstrate a credible basis.

Like *Tesla*, importantly, the court in *Pfizer* noted that “a stockholder whose stated purpose is

investigating mismanagement must provide ‘some evidence’ to suggest a ‘credible basis’ from which th[e] Court may infer possible mismanagement, waste, or wrongdoing may have occurred” and that merely offering a suspicion of wrongdoing is insufficient to justify a Section 220 demand.

Key Takeaways

As the cases discussed above demonstrate, Delaware courts continue to strictly construe the “credible basis” standard against stockholders seeking the production of books and records. Although the “credible basis” standard “has been described as the ‘lowest possible burden of proof’ under Delaware law,” the burden is not insubstantial, and stockholders must present at least some evidence from which the court can infer possible mismanagement or wrongdoing to justify production.

Notes

1. *Seinfeld v. Verizon Commc’ns, Inc.*, 909 A.2d 117, 123, 125 (Del. 2006).
2. C.A. No. 12651-VCS (Del. Ch. Feb. 2, 2017).
3. C.A. No. 10425-JL (Del. Ch. Aug. 31, 2016).
4. C.A. No. 10408-VCG (Del. Ch. Apr. 15, 2015), *aff’d*, 132 A.3d 1 (Del. 2016) (TABLE).

Copyright © 2017 CCH Incorporated. All Rights Reserved.
 Reprinted from *Insights*, June 2017, Volume 31, Number 6, pages 26–28,
 with permission from Wolters Kluwer, a Wolters Kluwer business, New York, NY,
 1-800-638-8437, www.wklawbusiness.com.



Wolters Kluwer