

Corporate Governance Feature: Delaware Courts Weigh In On Books and Records Inspections

By Bob Reder, David Schwartz and Roxana Azizi

Over the past nine months, Delaware courts have been asked to resolve several disputes arising from books and records inspection requests. In each of these decisions, the court asserted the importance of the inspection right as a mechanism for equity holders to police the actions of company managers. The purpose of this article is to discuss one of these decisions, issued by the Delaware Supreme Court, in order to provide some insight into the manner in which aggrieved shareholders can gain access to books and records for purposes of investigating potential breaches of fiduciary duty.

DGCL §220—Corporate Books and Records Inspections

Delaware boards of directors generally are afforded significant discretion in the exercise of their duties and obligations through the broad reservation of powers provided to them by Section 141(a) of the Delaware General Corporation Law (“DGCL”). Moreover, with certain notable exceptions, Delaware courts typically defer to decisions and actions of boards of directors through application of the business judgment rule. In view of the limited rights allocated to shareholders by the DGCL (principally, electing directors, approving charter amendments, mergers and substantial asset sales, and adopting bylaws), Delaware courts zealously guard those rights that are granted to shareholders by applying higher standards of review when board actions touching upon these rights are challenged. For instance, in the line of cases beginning with *Blasius Industries, Inc. v. Atlas Corp.*, Delaware courts have applied a “compelling justification” standard to protect the right of shareholders to vote in director elections.

One other right specifically allocated to shareholders is the right granted by DGCL §220 to inspect corporate books and records for a “proper purpose.” A “proper purpose” is one “reasonably related to such person’s interest as a stockholder.” Last year, in *City of Westland Police & Fire Retirement System v. Axcelis Technologies, Inc.*, the Delaware Supreme Court sought to protect and give meaning to the right of shareholders to conduct books and records inspections.

City of Westland Police & Fire Retirement System v. Axcelis Technologies, Inc.

In *Axcelis*, the Delaware Supreme Court upheld a Court of Chancery ruling that denied a disgruntled Axcelis shareholder access to corporate books and records. The shareholder’s stated purpose in seeking access was to investigate potential wrongdoing in connection with the Axcelis board’s rejection of tendered resignations by three of its members pursuant to a “plurality plus” corporate governance policy. The Delaware Supreme Court agreed with the Court of Chancery that, although the shareholder stated a “proper purpose,” the fact that the board rejected the tendered resignations – without more – was not “credible evidence” of wrongdoing sufficient to support granting access. The Court of Chancery was particularly mindful of the negative impact that a contrary ruling could have on the willingness of boards of directors to adopt “plurality plus” policies.

While affirming the Court of Chancery’s ruling, the Delaware Supreme Court also took the opportunity to bless an alternate – and ultimately less rigorous – path for shareholders to gain access to corporate books and

records as a prelude to challenging decisions made pursuant to a board-adopted “plurality plus” policy. *First*, the Delaware Supreme Court indicated that investigation of the suitability of directors to continue in office is a “proper purpose” under DGCL §220. And, *second*, the Delaware Supreme Court stated that if enough shareholders withhold their votes from incumbent directors so as to trigger their resignations under a “plurality plus” policy, that fact alone can constitute sufficient “credible basis” of the directors’ unsuitability to warrant a books and records inspection. Ironically, this seemingly advisory aspect of the Delaware Supreme Court’s ruling may have precisely the negative impact on “plurality plus” policies that the Court of Chancery sought to avoid in denying access to Axcelis’ disgruntled shareholder.

Background

Axcelis Technologies, Inc., a Nasdaq-traded company specializing in the manufacture and sale of semiconductor equipment, was an equal partner with Sumitomo Heavy Industries, Ltd. in a joint venture called “SEN.” In early 2008, Axcelis twice rejected unsolicited takeover bids from Sumitomo on the basis that they “materially discounted Axcelis’ true net worth.” Axcelis did indicate to Sumitomo that it was willing to discuss privately a transaction involving SEN, but no such talks apparently were held at that time.

Subsequently, at Axcelis’ 2008 annual shareholders meeting, three members of Axcelis’ classified board of directors ran unopposed for re-election. Although the directors were re-elected by a plurality vote in accordance with Axcelis’ bylaws, a greater number of votes were “withheld” from their candidacies than were voted in their favor. Therefore, as required by Axcelis’ board-established “plurality plus” policy, the three directors submitted their resignations. The board, citing the advice of its independent Nominating and Governance Committee, as well as the experience and knowledge of the three directors, their service on key board committees and the importance of retaining the directors if negotiations with Sumitomo proceeded, decided not to accept the resignations.

Following the annual meeting, Axcelis began discussions of a potential buy-out transaction with Sumitomo.

In September, however, Sumitomo put these discussions on hold without submitting a revised bid. Following public announcement of this development, the trading price of Axcelis common stock dropped precipitously. Then, in February 2009, in order to finance the repayment of outstanding notes that had fallen into default, Axcelis sold its stake in SEN to Sumitomo at a price reflecting only a fraction of the valuation implicit in Sumitomo’s earlier offers. When this sale was announced, Axcelis’ share price again took a dramatic fall.

Disappointed with these developments, an Axcelis shareholder — the City of Westland Police & Fire Retirement System (“Westland”) — delivered a demand to inspect Axcelis’ books and records for the purpose of investigating “the Board members’ compliance with their fiduciary duties.” After Axcelis rejected this demand, Westland filed a complaint in the Court of Chancery under DGCL §220, contending that its desire to investigate potential wrongdoing on the part of the Axcelis board constituted a “proper purpose.” Specifically, Westland argued, the board’s failure to accept the resignations of the three directors following the triggering of Axcelis’ “plurality plus” policy was motivated by an improper desire to entrench the directors in office. Westland also cited the board’s rejection of Sumitomo’s earlier offers as further evidence of the directors’ desire to entrench themselves. In Westland’s view, these circumstances provided a “credible basis” from which to infer potential wrongdoing.

The Court of Chancery’s Analysis

The Court of Chancery rejected Westland’s claim, determining that although investigation of potential directorial wrongdoing is a proper purpose for a books and records claim, Westland failed to establish the other key element developed by the Delaware judiciary for shareholders to gain access to corporate books and records — “credible evidence” of the alleged wrongdoing. The Court of Chancery expressed particular concern that “[i]f mere acting in accordance with the terms of a [plurality plus] policy is to be found credible evidence of wrongdoing, then its death knell has been rung.” The Court of Chancery also deferred to the board’s handling of the Sumitomo offers, ruling that “[r]ejecting an acquisition offer, without more, is not

[a] ‘defensive action’ under *Unocal*” that triggers enhanced scrutiny of the board’s actions. Westland appealed this ruling to the Delaware Supreme Court.

The Delaware Supreme Court’s Analysis

The Delaware Supreme Court agreed with the Court of Chancery that, to support a books and records investigation, a plaintiff must present “some evidence” to “suggest a credible basis” from which a court can infer the existence of directorial wrongdoing or mismanagement. A relaxation of the “credible basis” standard, characterized by the Delaware Supreme Court as the “lowest possible burden of proof,” would “be tantamount to permitting inspection based on the plaintiff-stockholder’s mere suspicion of wrongdoing.” The Delaware Supreme Court also agreed with the Court of Chancery’s application of the facts, ruling that its denial of Westland’s claim “must stand, because the record provides no credible basis to infer that [the board’s actions] were other than good faith business decisions.”

However, because “this dispute arises in connection with a shareholder vote,” the Delaware Supreme Court was not content merely to affirm the Court of Chancery’s decision, but proceeded to “a further elaboration of the ‘proper purpose’ requirement” in the context of “plurality plus” policies. In this connection, the Delaware Supreme Court cited, with approval, the analytical framework articulated by the Court of Chancery in *Pershing Square, L.P. v. Ceridian Corp.*, noting that “to reconcile legitimate interests of shareholders with the ever-changing dynamics and technology of corporate governance,” an inquiry “to determine an individual’s suitability to serve as a director” constitutes a “proper purpose” under DGCL §220.

The Delaware Supreme Court next considered whether, had Westland asserted the “suitability” purpose, it could have been considered to have presented facts sufficient to satisfy the *Pershing Square* requirement that “a plaintiff who states a proper purpose must also present some evidence to establish a credible basis from which the Court of Chancery could infer there are legitimate concerns regarding a director’s suitability.” In addressing this issue, the Delaware Supreme Court emphasized that Axcelis’ “plurality plus” policy

“conferred upon the shareholders the right to elect directors by majority vote ... [b]ut ... conditioned that right upon the board’s discretionary power to accept (or reject) the resignations of those directors who were elected by a plurality, but not a majority, shareholder vote.” Because the Axcelis board-adopted “plurality plus” policy conferred upon the board, *without* shareholder approval, “the power to override an exercised shareholder voting right,” in the Delaware Supreme Court’s opinion, the board “should be *accountable* for its exercise of that unilaterally conferred power.” [emphasis added].

The Delaware Supreme Court then declared that, in this context, accountability means “being subject to a shareholder’s [DGCL §220] right to seek inspection of any documents and other records upon which the board relied in deciding not to accept the tendered resignations.” The goal of this inspection is to determine “whether the directors, as fiduciaries, made a disinterested, informed business judgment that the best interests of the corporation require the continued service of these directors, or whether the Board had some different, ulterior motivation.” Thus, “a showing that enough stockholders withheld their votes to trigger a corporation’s (board-adopted) ‘plurality plus’ policy satisfies the *Pershing Square* requirement that ‘a stockholder must establish a credible basis to infer that a director is unsuitable, thereby warranting further inspection.’” In contrast to the standard when the shareholder’s purpose is to investigate potential directorial wrongdoing, under the fact pattern presented in *Axcelis*, no other credible evidence is required beyond the board’s decision not to accept a director’s resignation.

The Delaware Supreme Court did note, however, that *Pershing Square* requires two other elements for establishing a DGCL §220 claim relating to director suitability – namely, that “a plaintiff must also prove that the information it seeks is necessary and essential to assessing whether a director is unsuitable to stand for reelection,” and the need to limit “access to board documents ... to protect confidential board communications.” In the Delaware Supreme Court’s view, these elements, together with the requirements to state a “proper purpose” and to present “credible evidence” thereof, “strikes the appropriate balance between the shareholders’ entitlement to information and the direc-

tors' entitlement to make decisions in the corporation's best interest free from abusive litigation."

Conclusion

The Delaware Supreme Court's decision in *Axcelis* to provide "sharper focus for future guidance" with respect to DGCL §220 creates a clear path for future plaintiffs to gain access to corporate books and records to investigate decisions made under a board-adopted "plurality plus" policy. The *Axcelis* decision should enhance the ability of shareholders who cite as their purpose investigation of director suitability (as opposed to investigation of potential wrongdoing or mismanagement) to gain access to corporate books and records when a board of directors rejects director resignations tendered pursuant to a "plurality plus" policy. Moreover, the Delaware Supreme Court's willingness in *Axcelis* to provide guidance to future plaintiffs in DGCL §220 disputes, even though not required in connection with the appeal before it, demonstrates the importance attributed by the Delaware Supreme Court to the DGCL §220 inspection right.

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1. 564 A.2d 651 (Del. Ch. 1988).
2. DEL. CODE ANN. tit. 8 § 220 (2011).
3. *Id.*
4. 1 A.3d 281 (Del. 2010).
5. *City of Westland Police & Fire Ret. Sys. v. Axcelis Techns, Inc.*, C.A. No. 4473-VCN (Del. Ch. Sept. 28, 2007) at 16.
6. *Id.* at 283.
7. Under plurality voting, in an uncontested election, those directors receiving any favorable votes are elected so long as a quorum is present, no matter how many votes are withheld from their election. Plurality voting is the default provision under the DGCL for corporations which do not specify the required vote for the election of directors in their charter documents.
8. Under *Axcelis*' policy, any board nominee who receives "a greater number of votes 'withheld' from his or her election than votes 'for' such election," although technically elected under the corporation's bylaws, must submit his or her resignation to an independent board committee. The committee must then, in its discretion, rec-

ommend to the board whether to accept or reject the resignation.

9. *Axcelis*, 564 A.2d at 285.
10. *Axcelis*, C.A. No. 4473-VCN at 16.
11. *Id.* at 17.
12. *Axcelis*, 564 A.2d at 287.
13. *Id.*
14. *Id.*
15. *Id.* at 287-88.
16. *Id.* at 288.
17. *Id.* at 289.
18. 923 A.2d 810 (Del. Ch. 2007).
19. *Axcelis*, 564 A.2d at 289.
20. *Id.* at 289-90.
21. Because Westland had not cited investigation of the directors' suitability as its purpose in seeking access to *Axcelis*' books and records, in the Delaware Supreme Court's own words, its analysis "does not change the outcome of this case." *Id.* at 290.
22. *Id.*
23. *Id.* at 290-91.
24. *Id.* at 291.
25. *Id.* Because the Delaware Supreme Court's analysis focuses on unilaterally-adopted "plurality plus" policies, the ruling leaves open the question whether a shareholder-adopted plurality plus policy granting directors the discretion to accept or reject tendered resignations would yield the same result.
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.* at 290.
30. *Id.*
31. *Id.* at 291.
32. *Id.* at 290.