

SHAREHOLDER INSPECTION RIGHTS: DELAWARE SUPREME COURT PROVIDES GUIDANCE TO SHAREHOLDERS SEEKING CORPORATE BOOKS AND RECORDS TO INVESTIGATE SUITABILITY OF DIRECTORS TO SERVE

On August 11, 2010, the Delaware Supreme Court issued an important decision addressing the rights of shareholders to inspect corporate books and records for the purpose of challenging directorial conduct. *City of Westland Police & Fire Retirement System v. Axcelis Technologies, Inc.*, No. 594, 2009 (Del. Aug. 11, 2010). The decision is particularly noteworthy for Delaware corporations that have adopted the “plurality plus” form of majority voting for uncontested elections of directors.

In recent years, shareholders, especially activist ones, increasingly have taken advantage of inspection rights under Section 220 of the Delaware General Corporation Law. Under that provision, before a stockholder may inspect corporate books and records, it must demonstrate a “proper purpose” for the inspection. A “proper purpose” is one that is “reasonably related to such person’s interest as a stockholder.” With few exceptions, the Delaware courts have defined “proper purpose” broadly and flexibly, and have encouraged books and records demands prior to the filing of a lawsuit challenging directorial conduct.

Inspection to Uncover Corporate Wrongdoing or Mismanagement

Shareholders seeking access to corporate books and records in order to challenge directorial conduct most commonly state that their purpose is to expose suspected wrongdoing or mismanagement by corporate directors or officers. Although this purpose is recognized under Delaware law as a “proper purpose,” the inspection right is not automatic. Rather, a shareholder must present “some evidence” to suggest a “credible basis” from which a court may infer possible wrongdoing or mismanagement that would justify further investigation and entitle the shareholder to review a corporation’s internal books and records.

In *City of Westland*, Axcelis corporation had rejected an unsolicited joint acquisition proposal by Sumitomo Heavy Industries and private equity firm TPG Capital (collectively, “SHI”). Two months later, at its 2008 annual meeting of shareholders, the three Axcelis directors who were standing for reelection failed to receive an affirmative majority vote, thus triggering the company’s “plurality plus” governance policy. That policy — which had been adopted by board resolution — provided that any director who received more “withhold” votes than “for” votes in an uncontested election was required to tender his or her resignation; in such an event, the Axcelis Nominating and Governance Committee would recommend to the full board whether or not to accept the resignation. The three Axcelis directors who failed to receive majority votes duly tendered their resignations, but the board chose not to accept the resignations because Axcelis would then be left with only four of seven directors and the board would lose experienced directors and committee members.

In response, City of Westland Police & Fire Retirement System (“City of Westland”), a shareholder, filed an action seeking corporate books and records to investigate possible mismanagement and wrongdoing, namely, the board’s rejection of SHI’s unsolicited acquisition proposals and its refusal

to accept the three directors' resignations. Specifically, the shareholder alleged that by refusing to accept the resignations, the board intended to entrench the three directors (and the entire board) in office, thus violating well-established Delaware law that requires a "compelling justification" where a board acts "for the primary purpose of impeding the exercise of stockholder voting power." *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988). The Chancery Court dismissed the action, finding that the board's refusal to accept the director resignations was simply the exercise of discretion conferred by the "plurality plus" governance policy, rather than evidence that shareholder voting power was being impeded under the *Blasius* standard. The Chancery Court also held that the simple refusal to entertain an unsolicited acquisition proposal, without more, did not implicate fiduciary duties under the longstanding standards established by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

Delaware Supreme Court's Focus on "Director Suitability"

Although the Delaware Supreme Court affirmed the Chancery Court's decision, it decided to provide further guidance on books and records demands made for the purpose of determining whether directors are suitable to serve, rather than for the more common purpose of seeking to uncover wrongdoing or misconduct.

Relying on a 2007 Chancery Court decision, *Pershing Square, L.P. v. Ceridian Corp.*, the Delaware Supreme Court in *City of Westland* stated that the question of whether an individual is suitable to serve as a corporate director is a proper purpose for a shareholder inspection request. While *City of Westland* had not articulated "director suitability" as a purpose for its inspection request, the Delaware Supreme Court nevertheless explored why such a purpose might have been proper had it been articulated. According to the Court, there is a relationship between the shareholders' inspection right and a unilaterally adopted "plurality plus" policy whereby directors confer upon themselves, without shareholder approval, the discretion to reject resignations tendered by candidates who fail to receive a majority vote. In those circumstances, a board's rejection of directors' resignations puts into question "the integrity of the Board decision overriding the determination by a shareholder majority" that the director candidates were no longer suitable to serve as directors. The Court noted that:

Where, as here, the board confers upon itself the power to override an exercised shareholder voting right without prior shareholder approval (as would be required in the case of a shareholder-adopted by-law or a charter provision), the board should be accountable for its exercise of that unilaterally conferred power. In this specific context, that accountability should take the form of being subject to a shareholder's Section 220 right to seek inspection of any documents and other records upon which the board relied in deciding not to accept the tendered resignations.

However, despite establishing that a director's suitability to serve is a proper purpose under Section 220, the Delaware Supreme Court made clear that simply stating such a purpose would not automatically entitle the shareholder to relief. Rather, the Court recognized that a balance must be struck between the shareholders' entitlement to information and the directors' entitlement to make decisions free from abusive litigation. *City of Westland* thus expressly endorsed the following qualifications established by the Chancery Court in *Pershing Square*:

- (a) The corporation can defeat an inspection demand by proving that, while a proper purpose has been stated, the shareholder's true or primary purpose is improper;
- (b) A shareholder must present "some evidence" to establish a "credible basis" from which the Court of Chancery may infer that there are legitimate concerns about a director's suitability;
- (c) A shareholder must prove that the information sought is necessary and essential to assessing a director's suitability to stand for reelection; and
- (d) A shareholder's access to information may be limited by the need to protect confidential board communications.

Conclusion

City of Westland is yet another reminder that in disputes involving shareholder voting and elections of directors, the Delaware courts will review very carefully conduct that attempts to shield directorial action from shareholder scrutiny. While invoking "suitability of directors to serve" will not provide shareholders with automatic access to corporate records, shareholders may, depending on the circumstances, find it easier to demonstrate a "credible basis" for concerns about director suitability than for wrongdoing or mismanagement. After *City of Westland*, books and records demands are likely to be more frequent where boards reject resignations under *board-adopted* "plurality plus" majority voting provisions. It remains to be seen whether *City of Westland* will also open the door to more frequent challenges in the case of *shareholder-approved* "plurality plus" policies or in other cases, such as proxy contests, where shareholders seek to challenge directors' suitability to serve.

City of Westland also highlights the importance of ensuring that shareholder inspection demands under Section 220, and responses to them, are crafted with care and with the assistance of counsel. As suggested by the Delaware Supreme Court, had the shareholder relied on "director suitability" as a basis for seeking inspection, it might actually have succeeded.

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If you have any questions about this memorandum, about shareholder inspection requests or responses to them, or would like a copy of the *City of Westland* opinion, please call or email Tariq Mundiya (212-728-8565; tmundiya@willkie.com), Michael A. Schwartz (212-728-8267; mschwartz@willkie.com), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6009. Our telephone number is (212) 728-8000, and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

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