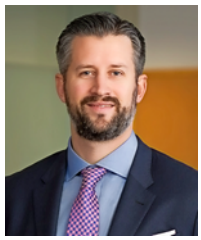
Bloomberg Law

Corporate Law & Accountability Report™

BOOKS AND RECORDS INSPECTIONS

Shareholders Seeking Books and Records Must Demonstrate Credible Basis to Infer Wrongdoing


By Michael Hefter, Ryan M. Philp and Adam J. Fine

Michael Hefter is a trial partner in Bracewell LLP's New York office and co-head of the firm's securities litigation group. Michael has experience as lead litigation and trial counsel for numerous clients in complex business matters in federal and state courts throughout the U.S. He has litigated both jury and non-jury trials in federal and state courts.

Ryan M. Philp is a partner in Bracewell's New York office and concentrates his practice on complex corporate and commercial disputes, including class action and derivative litigation, securities litigation and other business disputes arising under federal and state law. He has represented public companies, private investment firms, financial institutions, and officers and directors in all phases of civil litigation, including jury and bench trials.

Adam Fine is an associate in Bracewell's New York office and focuses his practice on representing clients in commercial litigation matters.

In recent months, the Delaware Court of Chancery has reaffirmed that shareholders seeking to inspect the books and records of Delaware corporations must provide ''some evidence'' to demonstrate a credible basis to infer corporate wrongdoing. In two recent decisions, the Court denied shareholders' books and records demands because the shareholders failed to raise their allegations above mere ''suspicion'' and ''curiosity.'' *Beatrice Corwin Living Irrevocable Trust v. Pfizer, Inc.*, C.A. No. 10425-JL (Del. Ch. Aug. 31, 2016, corrected Sept. 1, 2016) (*Pfizer*); *Haque v. Tesla Motors, Inc.*, C.A. No. 12651-VCS (Del. Ch. Feb. 2, 2017) (*Tesla Motors*).

On Aug. 31, 2016, the Court denied a books and records inspection demand against pharmaceutical company Pfizer Inc. *Pfizer*, slip op. at 1. The plaintiff shareholder alleged that Pfizer's board of directors (the Board) had engaged in wrongdoing or mismanagement in approving financial statements that did not take into account the company's potential tax liability in the event it later decided to repatriate overseas earnings to the U.S. (the Repatriation Tax). *Id.* The Court found that the shareholder failed to establish a credible basis to infer wrongdoing because he presented no evidence that the financial statements violated generally accepted accounting principles (GAAP) or that the Board members' reliance on the opinion of the company's ac-

 ISSN 2330-6300

countants was not reasonable. *Id.* at 12–13; *see* 8 *Del. C.* § 141(e).

For similar reasons, on Feb. 2, 2017, the Court denied a books and records demand against electric car-maker Tesla Motors Inc. *Tesla Motors*, slip op. at 1. In that case, the shareholder alleged that Tesla had fabricated production and delivery problems to conceal flagging demand for its vehicles. *Id*. The Court determined that there was no credible basis for this claim, finding that the shareholder failed to provide any evidence that would call into question Tesla's public statements about production hold-ups and delays—difficulties that were hardly surprising in light of Tesla's complex manufacturing process and long supply chain for specialized parts. *Id.* at 45. Together, these cases reinforce that, although the credible basis standard generally is regarded as a low bar, it is ''not a formality'' and is ''not insubstantial.'' *Id.* at 11; *Pfizer* at 9.

I. The 'credible basis' test for obtaining books and records under Section 220

Under Section 220 of Delaware's General Corporations Law, shareholders of a Delaware corporation have the right to inspect a corporation's books and records for a ''proper purpose.'' 8 *Del. C.* § 202(c) (Section 220). Investigating potential wrongdoing by a corporation's directors or officers is well-established as a ''proper purpose'' for inspection. *Tesla Motors* at 10 (citing *Seinfeld v. Verizon Commc'ns, Inc.*, 909 A.2d 117, 118 (Del. 2006)); *Pfizer* at 8. The Court of Chancery has found that this right to access books and records to investigate potential wrongdoing is ''broad but not unlimited.'' *Tesla Motors* at 9 (citing *City of Westland Police & Fire Ret. Sys. v. Axcelis Tech., Inc.*, 2009 WL 3086537, at *4 (Del. Ch. Sept. 28, 2009), *aff'd*, 1 A.3d 281 (Del. 2010)). Specifically, in order to inspect books and records, a shareholder must present ''some evidence'' to establish a credible basis for the Court to infer legally actionable mismanagement or wrongdoing. *Id.* at 2 (citing *Sec. First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 565 (Del. 1997)); *Pfizer* at 9. The Court of Chancery has emphasized that the credible basis test strikes ''an appropriate balance between encouraging productive Section 220 actions where there is a reasonable likelihood of wrongdoing while preventing inspections without a factual basis from draining corporate resources.'' *Id.* at 33 (quoting *La. Mun. Empls.' Ret. Sys. v. Lennar Corp.*, 2012 WL 4760881, at *3, 2012 BL 262366 (Del. Ch. Oct. 5, 2012)).

II. *Beatrice Corwin Living Irrevocable Trust v. Pfizer*

Case Background

In 2014, Dr. Robert Corwin, trustee of Pfizer-shareholder Beatrice Corwin Living Irrevocable Trust, served a Section 220 demand to inspect Pfizer's books and records. *Pfizer* at 1. Dr. Corwin asserted a need to investigate ''possible breaches of fiduciary duties by Pfizer's board of directors . . . for failing to assure compliance with applicable accounting rules'' by not reporting Pfizer's Repatriation Tax liability. *Id.* at 4. Pfizer rejected the inspection demand, maintaining that Dr. Corwin had failed to articulate a credible basis to infer corporate wrongdoing. *Id.* at 5.

Dr. Corwin decided to bring a Section 220 action against Pfizer after reading an article in *The New York Times* titled ''When Taxes and Profits Are Oceans Apart.'' *Id.* at 4; Gretchen Morgenson; *When Taxes and Profits Are Oceans Apart*, N.Y. Times, July 6, 2014, at BU1. The article described the phenomenon of large, U.S.-based public companies amassing earnings outside the U.S. and ''indefinitely reinvesting'' those earnings overseas, deferring taxes the U.S. would assess if and when the earnings were repatriated. *Id.* at 4. As reported in the article, according to GAAP, a company must report the Repatriation Tax liability it is deferring *unless* the company states that calculating that liability would be ''not practicable.'' *Id.* at 2–3.

The Court noted that Pfizer's 2013 annual report did not include a provision for tax liability based on approximately $69 billion earned by Pfizer's international subsidiaries. *Id.* at 3. The annual report stated, ''As these earnings are intended to be indefinitely reinvested overseas, the determination of a hypothetical unrecognized deferred tax liability as of December 31, 2013 is not practicable.'' *Id.* Pfizer's outside accounting firm, KPMG LLP, offered its opinion to the Board that Pfizer's 2013 financial statements were ''free of material misstatement'' and in conformity with GAAP. *Id.* at 3–4.

At trial, Dr. Corwin's expert, Dr. Casey Schwab, testified that the meaning of ''not practicable'' under GAAP did not align with Pfizer's explanation that the calculation of Repatriation Tax liability was ''hypothetical'' and ''complex.'' *Id.* at 6. In fact, Dr. Schwab asserted, Pfizer and its advisors had the expertise to make the calculation and regularly performed similarly complex calculations. *Id.* Even so, Dr. Schwab conceded that Pfizer had considered the correct factors in weighing whether the calculation was practicable and that an accountant's professional judgment and assessment of the incremental costs and benefits of performing the calculation bore on whether it was ''practicable.'' *Id.* at 7. Dr. Schwab also acknowledged that he could not disagree with KPMG's audit opinion that Pfizer's 2013 financial statements conformed to GAAP and that he was not offering an opinion on the propriety of the Board's decision to approve Pfizer's financial disclosures. *Id.*

The Court's Analysis

The Court (LeGrow, J., sitting by designation) identified the sole issue in the case as ''whether the plaintiffs have demonstrated a proper purpose for the inspection.'' *Id.* at 8. Principally, Dr. Corwin asserted that the inspection's purpose was to investigate mismanagement by Pfizer's Board and evaluate the grounds for potential litigation. *Id.* at 4. Ultimately, the Court determined that Dr. Corwin failed to present the ''minimum quantum of evidence'' necessary to establish a credible basis to infer wrongdoing or mismanagement. *Id.* at 12.

The Court explained that the credible basis test does not require that a shareholder prove by a preponderance of the evidence that mismanagement or wrongdoing has occurred—but it does require ''*some* evidence'' from which the Court could reasonably *infer* wrongdoing. *Id.* at 9 (emphasis added). The only mismanagement at issue involved ''possible breaches of fiduciary duties'' by the Pfizer Board ''for failing to assure compliance with applicable accounting rules.'' *Id.* at 10. The Court concluded that this claim failed to provide a cred-

   ISSN 2330-6300

ible basis to infer wrongdoing for two principle reasons. *See id.* at 12–13.

First, Dr. Corwin's allegations suggested an intent to investigate a *Caremark* claim, but failed to provide any evidence from which a *Caremark* claim could be inferred. *Id.* at 10–11; *see In re Caremark International Inc. Derivative Litigation*, 698 A.2d 267 (Del. Ch. 1996). To prove a *Caremark* claim, a plaintiff must establish that the board failed to act in good faith in carrying out its duties to oversee the company's management, either by failing to implement a reporting system for misconduct or by failing to respond to ''red flags'' suggesting misconduct. *Id.* at 11. The Court concluded, however, that Dr. Corwin had provided no evidence that addressed Pfizer's reporting system or any ''red flags'' that the Board might have ignored. *Id.* at 12.

Second, although Dr. Corwin's expert witness, Dr. Schwab, challenged Pfizer's determination that it was ''not practicable'' to calculate the Repatriation Tax liability, Dr. Schwab provided no evidence that would suggest that the Board members would not be fully shielded from liability by 8 *Del. C.* § 141(e). *Id.* at 12–13. Under Section 141(e), directors are ''fully protected'' when they rely in good faith on an expert's opinions on matters the directors reasonably believe to be within the expert's competence so long as the expert was selected with reasonable care by the corporation. *Id.* Dr. Corwin did not argue or present any evidence to suggest that the Board did not act in reasonable reliance on the expertise of KPMG in approving Pfizer's 2013 financial statements, that the board did not believe that the opinion was within KPMG's expertise, or that KPMG was not chosen with reasonable care. *Id.* at 13. In fact, Dr. Schwab did not opine that KPMG's opinion that Pfizer's financial statements were free of material misrepresentation was wrong, much less that the Board was not justified in relying on it. *Id.* In the absence of ''any quantum of evidence of an identifiable breach of fiduciary duty by the board'' and ''the absence of any evidence upon which the plaintiffs could rely to overcome the presumptions of 8 *Del. C.* § 141(e),'' the Court held that Dr. Corwin had failed to establish a credible basis from which the Court could infer actionable corporate wrongdoing. *Id.* at 14–15 (citing *SEPTA v. Abbvie, Inc.*, 132 A.3d 1 (Del. 2016) in support of analyzing 8 *Del. C.* § 141(e) defenses as part of the ''credible basis'' analysis).

III. *Haque v. Tesla Motors, Inc.*

Case Background

On June 15, 2015, shareholder Shahid Haque sent his first demand to inspect Tesla's books and records pursuant to Section 220. *Tesla Motors* at 1. Relying heavily on a biography of Tesla founder Elon Musk and a ''handful of negative analyst reports,'' Haque claimed that, through its public statements, ''Tesla has repeatedly misled investors as to the Company's capacity, in order to create the false impression that the Company is selling (delivering) as much as it can produce.'' *Id.* at 10. He alleged that, during the third and fourth quarters of 2014 and the first quarter of 2015, Tesla had ''manipulated and understated its manufacturing capacity to create the impression that the level of demand for Tesla's vehicles vastly exceeds Tesla's manufacturing capacity.'' *Id.* Tesla initially rejected the records demand, arguing that Haque had failed to articulate a credible basis to suspect corporate wrongdoing. *Id.* at 7. After continued discussions, however, Tesla produced 878 pages of documents. *Id.* Haque responded that the production was inadequate and, shortly thereafter, issued a second demand, citing new developments in the first and second quarters of 2016. *Id.* at 8. Although the parties engaged in further discussions, they reached an impasse in mid-2016, prompting Haque to seek an order from the Court of Chancery to compel Tesla to produce the documents demanded. *Id.*

The Court's Analysis

By stipulation of the parties, the Court (Slights, V.C.) decided the case on the basis of the paper record and the arguments of counsel. *Id.* at 2. The Court addressed a single question: Had Haque demonstrated a credible basis to infer possible wrongdoing that would warrant additional investigation? *Id.* at 9. Ultimately, the Court's answer to this question was ''no.'' *Id.*

The Court found that Haque's theory of Tesla's wrongdoing was far from credible—indeed it was ''hard to fathom.'' *Id.* at 13. Haque alleged that Tesla repeatedly had fabricated production problems to explain away lower-than-expected shipment numbers, concealing slumping demand for its vehicles. *Id.* at 12. Analyzing the claim quarter by quarter, the Court found that there was little reason to doubt that Tesla experienced occasional production problems given its complex manufacturing process and large supply network for specialized parts. *Id.* at 4. The Court found that Haque had imagined a devious plot based on faulty logic and inconsistencies in Tesla's statements that did not exist. *Id.* at 15–16.

Shareholders cannot obtain corporate books and records based on mere curiosity or suspicion of wrongdoing, and newspaper or trade articles—without more—do not raise a claim above mere suspicion.

In addition, the Court was not persuaded that Haque's sources—an Elon Musk biography and analyst reports—were sufficient to satisfy the credible basis test. *Id.* at 20, 34. The Court found that even if it overlooked that the biography was ''classic hearsay,'' Haque had failed to establish any foundation for the assertions ''plucked'' from the book. *Id.* at 21. The analyst reports, the Court reasoned, contained ''little more than speculation'' and relied on sources ''with a personal interest in swaying the public perception of [Tesla].'' *Id.* at 32. In any event, the Court held, ''negative news articles alone are insufficient bases on which to justify a Section 220 demand.'' *Id.* (quoting *Lennar*, 2012 WL 4760881, at *4, 2012 BL 262366).

The Court's analysis of Haque's assertions of wrongdoing as to the third quarter of 2014 is instructive. *Id.* at 14–17. In its July 2014 Shareholder Letter, Tesla stated that during that third quarter it planned to produce 9,000 vehicles and deliver 7,800. *Id.* at 14. Tesla further

explained that, during the quarter, it intended to retool a factory, resulting in a two-week shutdown that would impact both shipping and production. *Id.* at 15. In November 2014, after the third quarter had ended, Tesla announced that during the quarter it had delivered 7,785 vehicles, consistent with its plan, but had produced only 7,200 vehicles, missing its target by 1,800. *Id.* at 15. Tesla explained that the planned factory-retooling shutdown had lasted two weeks longer than originally expected, resulting in the lower production number. *Id.* at 14. Haque argued that, if the factory were shut down for four weeks, both production and deliveries would, logically, ''be equally negatively impacted.'' *Id.* at 15. The fact that Tesla met its guidance as to deliveries, Haque contended, but came up short on production established a credible basis to infer that Tesla either had held back production or made false claims about production obstacles to conceal low demand. *Id.*

The Court rejected Haque's theory, finding it had ''no support in the evidence or in basic logic.'' *Id.* at 16. Even before the third quarter, Tesla stated that the planned two-week shutdown would have a greater impact on production than on deliveries—an unsurprising prediction given that deliveries could include completed vehicles already in the distribution pipeline prior to the factory shutdown. *Id.* The Court found that Tesla's ''straightforward, credible explanation'' for how it could meet its delivery guidance in spite of a longer-than-expected factory shutdown left ''no room for a credible basis to infer wrongdoing.'' *Id.* at 16–17. In similar fashion, the Court found Haque's theories of wrongdoing for the remaining quarters did not satisfy the ''credible basis'' test. ''When viewed in the aggregate,'' the Court concluded, ''Haque's evidence amounts to nothing more than 'suspicion or curiosity.' '' *Id.* at 33 (quoting *Axcelis Tech., Inc.*, 2009 WL 3086537, at *4, 2009 BL 218058).

IV. Takeaways

The *Pfizer* and *Tesla Motors* decisions demonstrate the Court of Chancery's gatekeeping function in assessing Section 220 demands premised on alleged corporate wrongdoing. While a shareholder ''need not actually prove the wrongdoing itself by a preponderance of the evidence,'' he or she must show ''a credible basis from which the Court of Chancery can infer there is possible mismanagement that would warrant further investigation.'' *Id.* at 11 n.44 (quoting *Sec. First Corp.*, 687 A.2d at 565). Shareholders cannot obtain corporate books and records based on mere curiosity or suspicion of wrongdoing, *Id.* at 12; *Pfizer* at 10, and newspaper or trade articles—without more—do not raise a claim above mere suspicion. *Tesla Motors* at 32. With their careful application of the credible basis test, these decisions give corporate defendants a tool to resist Section 220 demands that amount to, in the Court's words, little more than ''fishing expedition[s].'' *Tesla Motors* at 11 n.46; *Pfizer* at 10.

   ISSN 2330-6300