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Court of Chancery Grants the Books and Records Demand of a Director Whose Ties With the Company Were Severed by the Board After His Allegedly Offensive Conduct— Schnatter v. Papa John's

In *Schnatter v. Papa John's* (Jan. 15, 2019), the Delaware Court of Chancery ruled that a director had the right, under DGCL Section 220, to inspect the corporate books and records that related to the board's determination to seek to sever ties with him. The board of Papa John's International, Inc. (the "Company") had terminated contractual arrangements with the director ("JS") and sought his resignation based on his allegedly offensive misconduct involving the use of racial slurs. JS was the founder, largest stockholder, and longtime "public face" of the Company. JS's stated purpose for his Section 220 demand was to determine whether, in severing ties with him, the directors had breached their fiduciary duties to act in the best interests of the stockholders. According to JS, the board's actions had a significant negative impact on the Company and were undertaken without the board having interviewed him or investigated his conduct. The court ruled that JS was entitled to the access he sought.

Key Points

- **The decision clarifies that a director's "proper purpose" for a books and records demand (*i.e.*, a purpose that relates to his duties as a director) will not be undermined by his *also* having a personal purpose**. It is well established that, under Section 220, a director's right to obtain corporate books and records is broader than a stockholder's right. The court held that JS's seeking access to determine whether the other directors, when severing the Company's ties with him, had breached their fiduciary duties to the stockholders was a purpose that related to his duties as a director. This "proper purpose" was not compromised in any way by his also potentially having a personal interest in obtaining the documents (*i.e.*, to restore his public reputation and/or retain his position by establishing that the board had acted improperly when it severed ties with him).
- **The decision serves as a reminder that emails and texts among directors on their personal email accounts or phones may be obtainable in a Section 220 demand.** The court ruled that JS could obtain communications stored on directors' personal devices that related to him and their decision to sever ties with him. In determining whether emails and texts on personal devices are obtainable, the court will consider whether the communications "relate to the rights and obligations of the corporation" (rather than being purely personal) and will balance the need for the information sought against the burdens of production and the availability of the information from other sources.

Notably, the court observed "the reality of today's world" that communications are increasingly by email and text.

- **The decision illustrates that, when fiduciary claims by a director who the board has sought to remove are likely to be dismissed, a books and record demand may be another tool available to the director to increase his leverage in the situation.** When fiduciary claims are likely to be dismissed, a books and records claim still may be successful. Notably, any duty of care violation by the Papa John board would have been exculpated under the company's charter; and a duty of loyalty violation generally would be untenable where the directors, as here, were independent. Although JS's stated purpose for seeking the books and records was to investigate the board's compliance with its fiduciary duties, as a practical matter the inquiry actually might be focused on his trying to restore his reputation or maintain his positions by showing that the board's accusation of misconduct was unfounded. (In addition, a director's making a books and records request in this context could increase his negotiating leverage in connection with a settlement.)

- **The decision potentially has broad applicability in the current era of increased sensitivity to directors' misconduct related to sexual harassment or racism**. We expect that, when a company seeks to sever ties with a director based on offensive conduct, in addition to fiduciary, contractual and/or defamation claims, a books and records demand is likely to be made.

Background

JS was the Company's founder, largest stockholder (with a 30% equity interest), and longtime public spokesperson and "public face." He was also a director and the non-executive Chairman and had recently been the CEO. The board was comprised of five additional directors, all of whom were independent.

The Company was the official pizza sponsor of the National Football League. In November 2017, during an earnings call, JS (against the advice of the Company's outside marketing consultants) criticized the NFL's handling of the dispute between the NFL players and owners over national anthem protests and appeared to blame the Company's weak performance on the "controversies" surrounding the NFL (the "NFL Comments"). Some media reports portrayed JS's comments as "racial in nature." According to JS, the Company's COO ("SR") and others advised against JS trying to clarify his comments; and, over the next two months, SR and the Company blamed the Company's declining sales on the NFL Comments. On December 31, 2017, under pressure, JS resigned as CEO and the board appointed SR as the new CEO. In February 2018, the NFL terminated its sponsorship with the Company and announced that Pizza Hut would be its new pizza sponsor. A significant decline in the Company's stock price followed.

In July 2018, it was reported in an article in Forbes magazine (the "Forbes Article") that, during a Company diversity training exercise among JS, SR and two other Company employees in May 2018, JS had used the "N-word" (the "Training Exercise Comments"). Within days after publication of the article, some professional sports teams and organizations cut ties with the Company. The board asked JS to resign as Chairman, which he did. A few days later, the board asked that JS also resign as a director, which he refused to do. The board then established a Special Committee (comprised of all the directors other than JS) to investigate all aspects of the Company's relationship with JS. Within three hours of its formation, the Special Committee terminated the Company's two agreements with JS (a "founder's agreement" under which he was featured in the Company's marketing and an agreement for his use of office space at the Company's headquarters).

JS then filed a fiduciary action against the CEO and the Special Committee directors. He also made a demand under Section 220 (the "Demand"), in his capacity as a director, to inspect corporate books and records (namely, communications among the directors, the CEO, the General Counsel and/or outside

legal counsel) that related to JS and the board's determination to sever ties with him. JS expressed that he was perplexed about "why the Company made no effort to defend him as the founder and longstanding public face of the company from what he believe[d] was unfair treatment by the media, and why the company instead seemed intent on abruptly cutting ties with him without investigating the matter." He stated: "The purpose of my [D]emand is to inform myself so that I may fulfill my fiduciary duties and ensure that the other members of the Board are fulfilling their fiduciary duties as well." The Company responded by largely rejecting the Demand. In this post-trial decision, Chancellor Bouchard ruled that JS is entitled to inspect the documents he requested because the Company failed to establish that his stated purpose for seeking the inspection was improper.

Discussion

A director has broad rights to inspect the corporate books and records. It is well established, and the court reaffirmed in *Papa John's*, that, under Section 220, a director's right to inspect the company's books and records is broader than a stockholder's right. Section 220 permits a *stockholder* to inspect the company's books and records for any "proper purpose." What constitutes a proper purpose for a stockholder is not specified in the statute (but has been developed by case law); and the burden of proof is on the stockholder to prove that she has a proper purpose. Section 220(d) permits a *director* to inspect the company's books and records for any proper purpose. The statute defines a proper purpose for a director as "a purpose reasonably related to the director's position as a director"; and the burden of proof is on the company to prove that a director does not have a proper purpose. (An officer or executive would not have any right under Section 220 to inspect the books and records unless she were also a shareholder or a director.) In *Papa John's*, JS's stated purpose for his Section 220 demand was to seek to determine whether the board was fulfilling its fiduciary duties to the stockholders in connection with its seeking to sever ties with him. The court held that this purpose was relevant to his duties as a director.

The court found that JS's having a *personal* interest in obtaining the documents did not undermine or compromise his "proper purpose" that related to his duties as a director. The Company argued that JS's purpose was unrelated to his position *as a director* and was *personal* and thus improper. The Company reasoned that JS sought "documents about himself" and had conceded that he "sought to inspect documents because of the unexplained and heavy-handed way in which the Company ha[d] treated him" since the publication of the Forbes Article and that he wanted to obtain documents that would "clear him and his reputation." The court found that, given JS's "unique role" at the Company, the Company's "lack of effort to defend him in response to controversies relating to his public comments and the Company's abruptly severing ties with him" were "relevant concerns that any director, including [JS], would have about the Company's management and oversight." The court concluded, based on JS's testimony and demeanor at trial, that "his Demand arose from a genuine desire to investigate whether the other members of the Board had fulfilled their fiduciary obligations" when, without interviewing him or conducting an investigation, the Special Committee cut the Company's ties with him just days after the publication of the Forbes Article and within three hours after the Special Committee had been formed to look into the Company's relationship with him. "These concerns are legitimate corporate concerns," the court wrote, particularly given that JS's "image and standing ha[d] been inextricably intertwined with the Company's public persona for decades."

The court found that JS's filing of a fiduciary action was not a basis on which to deny his right as a director to access to the documents. The Company argued that JS's purpose in seeking the documents was improper in that he appeared to be seeking documents "to further his current fiduciary suit." The court disagreed as JS had committed to the court that, without the Company's consent, he would not use any documents produced in response to the Demand to file a claim as a stockholder. (We

note that his fiduciary action was not otherwise addressed in this opinion. As discussed above, claims for mismanagement by the board in not taking due care in deciding to sever ties with JS would generally not support monetary damages given that the directors would be exculpated for a duty of care claim.)

Notably, the factual context involved ambiguity as to the offensiveness of JS's conduct. It was not necessarily clear in this case that the director's conduct actually was as offensive as the board took it to be. The NFL Comments did not include any overt reference to race. The comments were that the Company was "disappointed" that NFL leadership had not resolved the controversy between the players and owners; that the problem should have been "nipped in the bud" over a year earlier; that the owners had exhibited "poor leadership" by not resolving the issue; and that the NFL's "best years are ahead." Further, although the Training Exercise Comments involved his use of the N-word, according to him, his use of the word was part of a comment about *other* people using that word. The Forbes Article reported that, in a role-playing exercise during the training, when JS was asked how he would distance himself from racist groups online given his NFL Comments, he "tried to downplay the significance of [the] comments by saying (using the entire racial slur) that 'Colonel Sanders called blacks n—s' yet 'never faced public backlash.'" He also reportedly said: "Colonel Sanders used the N-word. I don't use the N-word, and we're not going to use the N-word." In addition, the New York Post published an article that suggested that SR had organized a coup to oust JS from the Company after he learned that JS was planning to recommend to the board that he be removed as CEO after the first two quarters under his watch were financially disappointing. The Post reported that one of the reasons JS filed the Section 220 action was to prove that SR had obtained his evaluation and knew that JS planned to have him fired.

The court ruled that JS is entitled to access to emails and text messages from directors' and officers' accounts stored on their personal devices. As the court noted, it has in some cases granted (*e.g.*, in *Amalgamated Bank v. Yahoo* (2016)) and in some denied (*e.g.*, *In re Lululemon Athletica Inc.* (2015)) access to personal email accounts and devices of directors and officers in Section 220 actions. The court focused in this case on whether the communications sought constituted "corporate books and records." The court stated that, if the Company's directors, CEO and General Counsel "used personal accounts and devices to communicate about changing the Company's relationship with [JS], they should expect to provide that information to the Company." At the same time, the court observed that when considering requests for information from personal accounts and devices in Section 220 proceedings, there is no "bright-line rule" and "the court should apply its discretion on a case-by-case basis to balance the need for the information sought against the burdens of production and the availability of the information from other sources…" Notably, the court emphasized "the reality of today's world" that people communicate frequently by emails and texts. The court wrote: "Although some methods of communication (e.g., text messages) present greater challenges for collection and review than others, and thus may impose more expense on the company to produce, the utility of Section 220 as a means of investigating mismanagement would be undermined if the court categorically were to rule out the need to produce communications in these formats."

Practice Points

- **Disputes over severing ties with directors can be expected to occur more frequently in the current era of MeToo and increased sensitivity on race and other issues. Boards should expect books and records demands in these situations--and should understand that a director has broad rights in this respect.** When a board seeks to cut ties with a director (or executive), in addition to fiduciary, contractual and/or defamation claims, the director (or the executive, if also a director or a shareholder) may make a books and records demand to investigate whether the directors fulfilled their fiduciary duties to stockholders when acting (*i.e.*, considered what was in the

best interests of the company, rather than, say, acting based on personal motivations). A director has broad rights under Section 220 to access books and records, which may provide an additional tool for directors (to seek to restore their reputations, maintain their positions, and/or obtain leverage in negotiating a settlement) when fiduciary claims against the board are likely to be dismissed. It cannot be emphasized enough that directors should be mindful of the potential that their emails and texts (including those stored on their personal devices) may be obtainable in litigation.

- **Boards should be prepared for other tactics by a director (or executive) who it has sought to pressure to resign.** While generally only stockholders can remove a director from office, a board may seek to pressure a director to resign and to terminate contractual and other arrangements with the director. The board should be prepared in these situations for the director to engage in tactics such as public relations campaigns attacking the company; negative communications with the company's customers, suppliers, or stockholders; communications to governmental agencies, including whistle-blowing claims; and the like. In *Papa John's*, JS created a website (savepapajohns.com) where he has posted information (including filings in this litigation) relating to his view that the Company has unfairly tried to marginalize him.

- **Boards should be prepared to balance the imperatives of (a) acting swiftly to sever ties with an offending director (or executive) and (b) acting with due deliberation.** Critical features of the *Papa John's* situation that appear to raise an issue whether the board acted appropriately include: (i) the board's severing ties with JS apparently without having interviewed him or investigated him; (ii) some ambiguity as to whether JS's conduct actually had been as offensive as the board took it to be; (iii) evidence that SR may have been orchestrating an effort to have JS ousted because SR had discovered that JS intended to have him removed as CEO; and, (iv) critically, the potential of a significant negative impact on the Company of cutting ties with JS given his unique role at the Company, including as its founder and "public face."

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