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Ousted Directors Have Broad Records Inspection Rights

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In Schnatter v. Papa John's,[1] 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. had terminated contractual arrangements with the director John Schnatter and sought his resignation based on his alleged misconduct involving the use of racial slurs.



Brian Mangino

Schnatter was the founder, largest stockholder and longtime "public face" of the company. Schnatter 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 Schnatter, 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 Schnatter was entitled to the access he sought.

Key Points



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- 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 Schnatter'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 Schnatter 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 whom 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 Schnatter'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

Schnatter was the company's founder, largest stockholder (with a 30 percent equity interest) and longtime public spokesperson and "public face." He was also a director and the nonexecutive 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, Schnatter (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. Some media reports portrayed Schnatter's comments as "racial in nature." According to Schnatter, the company's COO Steve Ritchie and others advised against Schnatter trying to clarify his comments; and, over the next two months, Ritchie and the company blamed the company's declining sales on the NFL comments. On Dec. 31, 2017, under pressure, Schnatter resigned as CEO and the board appointed Ritchie 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 that, during a company diversity training exercise among Schnatter, Ritchie and two other company employees in May 2018, Schnatter had used the "N-word." Within days after publication of the article, some professional sports teams and organizations cut ties with the company. The board asked Schnatter to resign as chairman, which he did. A few days later, the board asked that Schnatter also resign as a director, which he refused to do. The board then established a special committee (comprised of all the directors other than Schnatter) to investigate all aspects of the company's relationship with Schnatter. Within three hours of its formation, the special committee terminated the company's two agreements with Schnatter (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).

Schnatter then filed a fiduciary action against the CEO and the special committee directors. He also made a demand under Section 220, 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 Schnatter and the board's determination to sever ties with him. Schnatter expressed that he was perplexed about "why the company made no effort to defend him as the founder and long-standing 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 demand 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 Andre Bouchard ruled that Schnatter 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, Schnatter'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 Schnatter's purpose was unrelated to his position as a director and was personal and thus improper. The company reasoned that Schnatter 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 Schnatter'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 [Schnatter], would have about the company's management and oversight." The court concluded, based on Schnatter'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 Schnatter's "image and standing ha[d] been inextricably intertwined with the company's public persona for decades."

The court found that Schnatter'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 Schnatter'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 Schnatter 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 Schnatter 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 Schnatter'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 Schnatter 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 Ritchie had organized a coup to oust Schnatter from the company after he learned that Schnatter 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 Schnatter filed the Section 220 action was to prove that Ritchie had obtained his evaluation and knew that Schnatter planned to have him fired.

The court ruled that Schnatter 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[2]) and in some denied (e.g., In re Lululemon Athletica Inc.[3]) 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 Schnatter, 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, Schnatter 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 Schnatter apparently without having interviewed him or investigated him; (ii) some ambiguity as to whether Schnatter's conduct actually had been as offensive as the board took it to be; (iii) evidence that Ritchie may have been orchestrating an effort to

have Schnatter ousted because Ritchie had discovered that Schnatter intended to have him removed as CEO; and, (iv) critically, the potential of a significant negative impact on the company of cutting ties with Schnatter given his unique role at the company, including as its founder and "public face."

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[1] 'l, Inc., No. 2018-0542-AGB, 2019 Del. Ch. LEXIS 18 (Ch. Jan. 15, 2019)' target='_blank' style='color: #990000'>Schnatter v. Papa John's Int'l Inc., No. 2018-0542-AGB, 2019 Del. Ch. LEXIS 18 (Jan. 15, 2019).

[2] Amalgamated Bank v. Yahoo Inc., 132 A.3d 752 (Del. Ch. 2016).

[3] In re Lululemon Athletica Inc., 220 Litig., 2015 Del. Ch. LEXIS 127 (Ch. Apr. 30, 2015).