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SHAREHOLDER INSPECTION RIGHTS: FROM CREDIBLE BASIS TO RATIONAL BELIEF

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ABSTRACT

Jurisdictions are split on the standard of proof for shareholder inspection lawsuits when inspections are for the purpose of investigating managerial misconduct. Delaware and its followers apply a credible basis standard that calls for extrinsic evidence, beyond mere suspicion, curiosity, or disagreement with management, to permit an inference of misconduct. A minority of jurisdictions require shareholders to show merely a rational belief that mismanagement likely happened. Rational belief can be satisfied by sound logic without referencing extrinsic evidence. The Delaware Supreme Court rejected rational belief for fear that a permissive standard would lead to a cascade of frivolous inspections, although numerous factors suggest otherwise. This paper offers the first empirical verification of the court’s assumption. The Delaware Supreme Court also dismissed shareholders’ argument that credible basis was an insurmountable obstacle to their exercise of statutory inspection rights, reasoning that the standard had only barred inspections in a couple of cases out of a “myriad” of inspection lawsuits. This paper is the first to offer empirical evidence that the court grossly underestimated the deterrence effect of credible basis. The paper shows that both the evil of frivolous lawsuits under rational basis and the evil of over-deterrence under credible basis exist, but the latter overshadows the former in magnitude. The paper suggests that the court adopts rational belief for inspection lawsuits against private companies where credible basis poses the biggest problem, and simultaneously implements cost-shifting for inspections items that impose an onerous burden on the target corporation.

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I. INTRODUCTION

Corporations are owned by shareholders but managed by the board of directors. Shareholders typically have no voice in business decisions except on extraordinary matters (e.g., mergers or dissolutions) or matters for which the corporate charter mandates a shareholder vote. Instead, shareholders influence business decisions indirectly through electing directors and holding them accountable for mismanagement by bringing fiduciary breach lawsuits. Fiduciary breach claims must be pled with sufficient specificity to make it reasonably conceivable that mismanagement

has occurred. Without inspecting records or receiving information from whistleblowers, shareholders who are precluded from managerial roles would find it difficult to meet this specificity requirement.

Shareholders' inspection rights are recognized as an important part of the corporate governance landscape and a "game changer in corporate litigation."¹ Inspection lawsuits increased thirteenfold from 1981-1994 to 2004-2018.² Inspection rights, which originated in common law to curtail the agency problem caused by the separation of ownership and managerial power, are now codified in states' corporate statutes.³

In Delaware, the domicile of the greatest number of publicly traded corporations, Delaware General Corporation Law ("DGCL") Section 220 governs.⁴ This section states that shareholders can inspect, with a written demand stating under oath any proper purpose, the corporation's stock ledger, a list of its stockholders, and its other books and records.⁵ The corporation has five business days to respond to the demand. If the corporation fails to provide the requested documents within the time limit, shareholders may bring a lawsuit to compel production.⁶

In a similar spirit, but with varying details, Model Business Corporation Act ("MBCA") Section 16.02 grants shareholders the right to inspect corporate records by giving the corporation a timely notice.⁷ The MBCA allows shareholders to inspect—without showing a proper purpose—basic documents, such as the articles of incorporation, bylaws, written communications to shareholders generally, names and business addresses of the company's current directors and officers, and the most recent annual report.⁸ Shareholders must show proper purpose to inspect more sensitive items, such as the financial records, minutes for board or committee meetings, records of any action taken without a meeting, or shareholder records.⁹

Consistent with case law, the DGCL and MBCA define "proper purpose" to mean a purpose reasonably related to the interest of the person who demands inspection as a shareholder.¹⁰ Proper purposes include, for example, a desire to determine the corporation's present and past ability to pay dividends, learn more about a transaction to be voted on in an upcoming shareholder meeting, communicate with other shareholders, value the requestor's interest in the corporation, or investigate mismanagement.¹¹ Improper purposes, by contrast, include using inspection to harass and avenge the management, advance the requestor's own political or social goals not directly related to his economic interests in the company, ferret proprietary information out of the company to compete with it, or simply satisfy the requestor's idle curiosity.¹² An inspection can have multiple purposes. If the primary purpose is proper, secondary motives that are otherwise improper

¹ Roy Shapira, *Corporate Law, Retooled: How Books and Records Revamped Judicial Oversight*, 42 CARDOZO L. REV. 1949, 1963 (2021); see also Stephen A. Radin, *The New Stage of Corporate Governance Litigation: Section 220 Demands*, 26 CARDOZO L. REV. 1595, 1647 (2005).

² James D. Cox et al., *The Paradox of Delaware's "Tools at Hand" Doctrine: An Empirical Investigation*, 75 BUS. LAW. 2123, 2127 (2020).

³ *Seinfeld v. Verizon Commc'ns, Inc.*, 909 A.2d 117, 119 (Del. 2007).

⁴ DEL. CODE ANN. tit. 8, § 220 (2020).

⁵ *Id.* § 220(b).

⁶ *Id.* § 220(c).

⁷ MODEL BUS. CORP. ACT § 16.02 (AM. BAR ASS'N 2021).

⁸ *Id.* § 16.02(a).

⁹ *Id.* § 16.02(b)–(c).

¹⁰ DEL. CODE ANN. tit. 8, § 220(b) (2020); MODEL BUS. CORP. ACT § 16.02 cmt.3.

¹¹ Allen Sparkman, *Information Rights—A Survey*, 2 BUS., ENTREPRENEURSHIP & TAX L. REV. 41, 118–19 (2018).

¹² Browning Jeffries, *Shareholder Access to Corporate Books and Records: The Abrogation Debate*, 59 DRAKE L. REV. 1087, 1102 (2011).

do not prevent shareholders from accessing records.¹³ Recent empirical evidence shows that valuation and investigation of mismanagement are the most common reasons for inspection.¹⁴

Jurisdictions are split on who bears the burden to prove “proper purpose.” Delaware law imposes the burden on shareholders, except for inspections of the stock ledger or shareholder list, for which the burden is on the corporation to prove improper purpose.¹⁵ Some jurisdictions impose the burden on corporations in all inspection cases.¹⁶ When the purpose of an inspection is investigating mismanagement, Delaware courts and followers in other jurisdictions require shareholders to show a “credible basis” from which to infer misconduct.¹⁷ The credible basis standard calls for extrinsic evidence, beyond a mere suspicion, curiosity, or disagreement with the management, that permits an inference of corporate misconduct.

The circular requirements to plead specificity and credible basis for inspecting records often put shareholders in an impossible position. Credible basis is particularly onerous for shareholders of private companies. Those companies are not obligated to file periodic reports with regulatory authorities, and they attract little attention from the media. Often, the lack of public information about private companies hinders shareholders from monitoring management’s conduct and verifying information that management chooses to disseminate.

Credible basis is not unanimously applied across jurisdictions. A small number of states impose a lower standard: a “rational” (or “good faith”) belief by shareholders that mismanagement may have occurred. Rational belief can be satisfied by putting forward plausible logic without referencing extrinsic evidence. Once shareholders satisfy rational belief, the burden shifts to the defendant corporation to show that shareholders’ suspicion is preposterous.

The Delaware Supreme Court earlier considered whether credible basis should be replaced with rational belief in response to a shareholder’s complaint that credible basis had turned his statutory inspection right into merely a “mirage.”¹⁸ The court decided against the change, fearing that the lower standard might encourage “indiscriminate fishing expeditions” that would be costly to corporations and detrimental to shareholders’ wealth.¹⁹ Since corporations can simply reject shareholders’ inspection requests, this feared cost of “indiscriminate fishing expeditions” will only materialize if shareholders bring an inspection lawsuit following the rejection.

Would adopting the rational belief standard encourage shareholders to bring frivolous inspection lawsuits? The Delaware Supreme Court’s reasoning implicitly assumes that to be true. However, such an important assumption has never been empirically tested. The decision to bring a legal action depends on a set of complex and pragmatic factors, such as the likelihood of success, budget constraints, time consumption, the emotional drain that accompanies a prolonged adversarial proceeding, and moral values against extracting pecuniary gain by suing innocent

¹³ See *CM & M Grp., Inc. v. Carroll*, 453 A.2d 788 (Del. 1982) (holding that a desire to value the requestor’s shareholdings was a proper purpose even though there might be a “secondary purpose” to obtain financial information to benefit a third person); *Credit Bureau Reps., Inc. v. Credit Bureau of St. Paul, Inc.*, 290 A.2d 691 (Del. 1972) (holding that the desire to solicit proxies for a slate of directors in opposition to management is a proper purpose, and any further or secondary purpose in seeking the shareholder list was irrelevant).

¹⁴ Cox et al., *supra* note 2, at 2147.

¹⁵ DEL. CODE ANN. tit. 8, § 220(b) (2020); see also Jeffries, *supra* note 12, at 1113 (“When a stockholder wants to access the stock ledger, the corporation has the burden of demonstrating the purpose is in fact improper. In order to access other books and records, the shareholder himself has the burden of proving his proper purpose.”).

¹⁶ See discussion *infra* Part II.B.

¹⁷ Gabrielle Palmer, *Stockholder Inspection Rights and an “Incredible” Basis: Seeking Disclosure Related to Corporate Social Responsibility*, 92 DENV. U. L. REV. ONLINE 125, 129 (2015).

¹⁸ *Seinfeld v. Verizon Commc’ns, Inc.*, 909 A.2d 117, 121 (Del. 2007).

¹⁹ *Id.* at 122 (quoting *Sec. First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 571 (Del. 1997)).

people, among others. A lower standard of proof might enhance shareholders' chances of success at gaining access to the desired corporate records, but lawsuits are costly and emotionally taxing, so the idea that a shareholder would be willing to incur such costs without a bona fide suspicion of fiduciary breach is questionable at minimum.

Moreover, even if rational belief induced frivolous inspection lawsuits, the inquiry should not stop there. Incentivizing meritless lawsuits is undesirable, of course, but so is deterring bona fide assertions of a statutory right. The inquiry ultimately requires us to compare the magnitudes of the two evils: If the probability that the heightened burden of credible basis will discourage well-founded inspection lawsuits exceeds the probability that rational belief will encourage frivolous inspection lawsuits, the latter is still a worthy tradeoff for the former. The Delaware Supreme Court opined that credible basis had not been an impediment to shareholders' inspection rights because it had only barred inspections in a couple of cases out of a "myriad" of inspection lawsuits.²⁰ The court's calculation failed to consider the deterrence effect of credible basis, i.e., inspection lawsuits that should be filed because shareholders had genuine suspicions of mismanagement but were not filed because shareholders feared they were unable to satisfy credible basis. That omission likely distorted the court's balance of the pros and cons of credible basis and rational belief.

This paper addresses two questions: (1) Does the rational belief standard incentivize frivolous inspection lawsuits, and (2) how does the probability of frivolous lawsuits compare to the probability of deterrence under credible basis? The paper shows empirical evidence in those regards based on an experiment that examined the propensity to file inspection lawsuits by shareholders of a private company when faced with varying levels of budget, time, and energy constraints, in light of their assessments of the likelihood of mismanagement. The experiment chose a private company setting because that is where credible basis presents the biggest challenge to shareholders. The paper concludes that rational belief increases the probability of frivolous inspections but is nonetheless superior to credible basis given the latter's tendency to over-deter legitimate lawsuits. The paper suggests that the court adopt rational belief and simultaneously implement a cost-shifting mechanism to combat frivolous inspections.

This paper proceeds as follows: Part II demonstrates how different standards of proof, whether credible basis or rational belief, have impacted shareholders' access to corporate information. Part III highlights shareholders' predicaments under credible basis. Part IV discusses the arguments for and against rational belief. Part V reports the experiment's design, data, empirical analysis, and findings. Part VI proposes a new mechanism to deter frivolous inspections under rational belief. Part VII concludes this paper.

II. HOW CREDIBLE BASIS AND RATIONAL BELIEF AFFECT SHAREHOLDER INFORMATION RIGHTS

A. Credible Basis and Its Insistence on Extrinsic Evidence

Credible basis requires extrinsic evidence of mismanagement that would warrant further investigation.²¹ For example, credible basis was found to exist in *Amalgamated Bank v. Yahoo! Inc.*²² because media reports and corporate documents showed that the board performed a

²⁰ *Seinfeld v. Verizon Commc'ns, Inc.*, 909 A.2d 117, 119 (Del. 2007).

²¹ *Thomas & Betts Corp. v. Leviton Mfg. Co.*, 681 A.2d 1026 (Del. 1996); *Sec. First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563 (Del. 1997).

²² *Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752 (Del. Ch. 2016), *abrogated by* *Tiger v. Boast Apparel, Inc.*, 214 A.3d 933 (Del. 2019) on other grounds.

perfunctory role in hiring and firing a senior executive, which resulted in a stratospheric severance payment. In *Wal-Mart Stores, Inc. v. Indiana Electrical Workers Pension Trust Fund IBEW*,²³ news reports of bribery committed by Wal-Mart's overseas subsidiary and an ongoing government investigation into the allegation satisfied credible basis. Similarly, in *Carapico v. Philadelphia Stock Exchange, Inc.*,²⁴ credible basis arose from an investigation by the Securities and Exchange Committee that resulted in sanctions and restraints on the defendant corporation's business. In *Kosinski v. GGP Inc.*,²⁵ the defendant corporation's failure to adopt common procedural safeguards against conflicts of interest in a merger with a controlling shareholder, plus analysts' reports suggesting that the merger was substantially underpriced, satisfied credible basis.

Credible basis should not be confused with the pleading requirements for plenary lawsuits. The Delaware Supreme Court has repeatedly urged stockholders to use the "tools at hand" (i.e., inspection) to investigate before filing plenary claims. The court recognizes that without accessing corporate records, shareholders typically lack the facts to plead with sufficient specificity to survive a motion to dismiss. Therefore, credible basis is necessarily a lower standard than the pleading requirements.²⁶ Delaware courts have, time and again, granted inspection rights after shareholders' derivative actions failed to satisfy the pleading requirements.²⁷

Credible basis is not an insubstantial burden. Mere curiosity, suspicion, under-performance relative to peers, disagreements with the management of business matters, or a generic statement that the inspection's purpose is to investigate possible mismanagement, without more, fails the credible basis requirement. In *Seinfeld v. Verizon Communications, Inc.*,²⁸ the plaintiff owned approximately 3,884 shares of Verizon. He brought a Section 220 lawsuit to inspect Verizon's books and records relating to the compensation paid to the company's three highest corporate officers from 2000-2002. The basis for inspection was that Verizon's board of directors possibly committed waste by paying excessive compensations to those executives at a time when the company's performance was lackluster. The plaintiff calculated that the company paid a total of \$205 million over three years but acknowledged that he had no other evidence of mismanagement or the executives failing to earn the amounts paid to them. He also admitted the possibility that he miscalculated the executives' compensations. The plaintiff wanted to use the "tools at hand" to ascertain whether the seemingly excessive compensations were justified and consistent with the executives' employment contracts. The Delaware Supreme Court affirmed the lower court's ruling that the plaintiff failed his burden to show a credible basis, as his claims were based only on a large compensatory amount without any corroborating evidence from which the court could reasonably suspect that the board committed corporate waste.

Similarly, in *City of Westland Police & Fire Retirement System v. Axcelis Technologies, Inc.*,²⁹ the Delaware Supreme Court held that a shareholder's inspection lacked a credible basis. The

²³ *Wal-Mart Stores, Inc. v. Ind. Elec. Workers Pension Tr. Fund IBEW*, 95 A.3d 1264 (Del. 2014).

²⁴ *Carapico v. Phila. Stock Exch., Inc.*, 791 A.2d 787 (Del. Ch. 2000).

²⁵ *Kosinski v. GGP Inc.*, 214 A.3d 944 (Del. Ch. 2019), *judgment entered*, (Del. Ch. 2020).

²⁶ *AmerisourceBergen Corp. v. Lebanon Cnty. Emps.' Ret. Fund*, 243 A.3d 417, 427–28 (Del. 2020); *see also In re Facebook, Inc. Section 220 Litig.*, No. 2018-0661-JRS, 2019 WL 2320842 (Del. Ch. May 31, 2019) (rejecting Facebook's request to adjudicate the merits of a potential fiduciary breach lawsuit before allowing an otherwise proper demand for inspection to proceed, noting that credible basis asks a fundamentally different question than would be asked at a trial on the merits).

²⁷ *See, e.g., AmerisourceBergen*, 243 A.3d 417.

²⁸ *Seinfeld v. Verizon Commc'ns, Inc.*, 909 A.2d 117 (Del. 2006).

²⁹ *City of Westland Police & Fire Ret. Sys. v. Axcelis Techs., Inc.*, 1 A.3d 281 (Del. 2010).

defendant company's board of directors rebuffed multiple above-the-market acquisition offers from another company. The board's explanation for these rejections was that the offers were for insufficient valuations and the offeror refused to sign a confidentiality agreement. The outraged shareholders used their voting power in the next director election against directors who rejected the merger offers, resulting in those directors failing to receive a majority vote. Under the company's "plurality plus" governance policy, directors who fail to receive a majority vote must submit their resignations to the board, and the board decides to accept or reject the resignations. In this case, the board rejected the resignations, citing the directors' experience and knowledge, their services on the company's key committees, and their role in the board's renewed effort to negotiate with the previously rejected offeror. Indeed, the board subsequently re-opened negotiations with the offeror, but twists and turns in the negotiations and the defendant company's business, including its failure to meet debt obligations, prompted the company to eventually agree to merge into the counterparty at a much lower price than the original offers. The plaintiff shareholder brought an inspection lawsuit to investigate whether the board breached its fiduciary duty related to the merger proposals and its rejection of the resignations of unpopular directors. The plaintiff alleged that the board's rejection of attractive merger proposals and the directorial election results established a credible basis for inferring office entrenchment. The Delaware Supreme Court found credible basis missing because the board's reasons for retaining the directors were consistent with the record, and the board's rejections of the merger proposals were not *per se* a breach of fiduciary duty. The court noted that six of the seven directors were independent and that the board's explanation for rejecting the merger proposals was corroborated by a subsequent increase in the offer amount. The court concluded that no evidence corroborated the shareholder's suspicion that the directors were entrenching their offices. It appears that as long as the board provides a plausible explanation for its conduct, shareholders will be denied access to records for lacking credible basis; that is so even when an equally plausible but incriminating explanation exists and an inspection may reveal the truth.

B. Rational (or Good Faith) Belief

Credible basis is not universal among jurisdictions outside of Delaware. Some courts follow Delaware,³⁰ some apply a good faith (or rational³¹) belief standard, which requires a mere plausible explanation for shareholders' suspicion with or without referencing extrinsic evidence, and some have taken a step further in shareholders' favor by simply shifting the burden of proof that the inspection is for a proper purpose to the defendant corporation. Examples of the two alternatives

³⁰ See, e.g., *Ihrig v. Frontier Equity Exch. Ass'n*, 128 P.3d 993 (Kan. App. 2006) (holding that plaintiff was not entitled to breakdown of compensations paid to individual members of management because plaintiff failed to show evidence that the aggregated sum of compensations to those members was disproportional to compensations paid by similar companies to their management, so there was no credible basis for believing individual compensations were excessive).

³¹ In corporate law, "good faith" and "rationality" are synonymous terms because the former is a subjective mental state that is demonstrated objectively by the latter. For example, directors must believe in good faith that their business decisions are in the best interest of the company in order to benefit from the deferential business judgment review. If a decision is rational, i.e., there is a coherent and plausible explanation for it, then the decision maker's good faith is inferred. See, e.g., *Sam Wong & Son, Inc. v. N.Y. Mercantile Exch.*, 735 F.2d 653, 671, 678 n.32 (2d Cir. 1984) (holding that the rationality of a decision was relevant in determining whether the decision had been made in good faith and that "rationality" meant only a minimal requirement of some basis in reason); see also MELVIN A. EISENBERG & JAMES D. COX, *BUSINESS ORGANIZATIONS CASES AND MATERIALS* 723 (11th ed. 2014) ("Even courts that seem to use the term 'good faith' in a relatively subjective way characteristically go on to review a decision to determine if it is irrational, egregious, or the like, this shows bad faith.").

to Delaware’s credible basis approach are provided below. In practice, shifting the burden of proof to the corporation produces the same results as imposing a rational belief standard on shareholders because if shareholders’ suspicion is irrational, the defendant can rebut the presumption of proper purpose by arguing that shareholders are using mismanagement allegations to disguise some unstated ulterior motives.³²

In *Schein v. Northern Rio Arriba Electric Cooperative, Inc.*,³³ the plaintiff was a member of a non-profit cooperative organized in New Mexico. The plaintiff requested copies of bills the co-op paid to two law firms for work done in previous legal proceedings. The co-op provided the bills in a redacted form that disclosed the total amount of fees but omitted narrative portions detailing the services performed and time spent by the law firms. The plaintiff filed a mandamus action against the co-op under New Mexico’s corporation statute that governed both shareholders of for-profit corporations and members of nonprofit organizations. The statute empowered shareholders and members to inspect, at reasonable times and places, books and records of their companies or organizations for a proper purpose. The plaintiff asserted that her inspection of the attorney bills was premised on her desire to investigate the nature and quality of the legal advice given to the co-op and whether management was spending resources on overpriced legal representation. No evidence showed that the co-op’s payments to the law firms were inappropriate or excessive.

The New Mexico Supreme Court endorsed a policy that shareholders and members of business entities should be granted generous access to information. The court pointed out that such a policy was the majority common law rule, justified by the separation of ownership interests from managerial powers, and conducive to better corporate governance.³⁴ The court explicitly rejected the defendant’s argument that inspections must be premised on evidence of wrongdoing, stating that “[s]uch a proposition would thwart efforts of oversight by shareholders, making abuses of corporate power more likely. Moreover, it would deny owners their proprietary right of monitoring and safeguarding their interests.”³⁵ Ruling in favor of the plaintiff, the court held that although the statute required shareholder inspections to have a proper purpose, propriety was presumed without shareholders meeting any evidentiary burden when the inspection was to investigate managerial misconduct, and the burden should be placed on the corporation or co-op to show that a requested inspection was for an improper purpose.³⁶

In *Ashley Bancstock Co. v. Meredith*,³⁷ shareholders of an Arkansas company demanded, pursuant to the state’s corporate statute, to inspect the company’s records spanning a period of nine years. Like DGCL Section 220, the Arkansas statute permitted inspections at a reasonable time and for any proper purpose.³⁸ The demand for the inspection was triggered by the company’s significant losses and expenses, which shareholders believed were the result of an unfavorable

³² *AmerisourceBergen Corp. v. Lebanon Cnty. Emps.’ Ret. Fund*, 243 A.3d 417, 429 (Del. 2020).

³³ *Schein v. N. Rio Arriba Elec. Coop., Inc.*, 932 P.2d 490 (N.M. 1997).

³⁴ *Id.* at 493–94.

³⁵ *Id.* at 494.

³⁶ For other examples of burden shifting, see *Naquin v. Air Engineered Sys. & Servs., Inc.*, 463 So. 2d 992, 995 (La. App. 3d Cir. 1985) (“[T]he burden of proving that a shareholder possesses ill motive is on the corporation seeking to deny the shareholder’s right to inspect the records.”); *Lang v. W. Providers Physician Org., Inc.*, 688 N.W.2d 403, 407 (S.D. 2004) (“Thus a full statement of our rule is that a member must disclose his purpose for inspecting and this purpose is presumed proper. The burden is then on the corporation to prove there is an improper purpose.”).

³⁷ *Ashley Bancstock Co. v. Meredith*, 534 S.W.3d 762 (Ark. App. 2017).

³⁸ ARK. CODE ANN. § 4-26-715(b) (West 2022) provides: “Any person who shall have been a shareholder of record for at least six (6) months immediately preceding his or her demand, upon written demand stating the purpose thereof, shall have the right to examine, in person or by agent or attorney, at any reasonable time, for any proper purpose, its books and records of account, minutes, and record of shareholders and to make extracts therefrom.”

merger and loan write-offs. The shareholders stated that their demand was made in good faith and for the purpose of reviewing managerial actions to ascertain whether fiduciary breaches had occurred and whether any legal action against management was warranted to recover assets that had been written off and lost by the company. Citing Delaware cases, the company argued that shareholders failed to prove “proper purpose” because they did not produce credible evidence of wrongdoing. The court rejected this argument, citing precedents from other jurisdictions that had adopted a good faith standard rather than credible basis.³⁹ The court reasoned that the plain language of the statute “includes no language requiring a shareholder to include specific allegations of wrongdoing in order to be entitled to records. Only a proper purpose must be established.”⁴⁰ The court found that shareholders had a good faith suspicion of mismanagement because the company had incurred significant losses, expenses, and write-offs from a series of unfavorable transactions in the years leading to the inspection request. The same case would have had a different outcome in a Delaware court because shareholders had no extrinsic evidence beyond a mere logical suspicion of mismanagement based on the company’s financial losses.

III. CREDIBLE BASIS AND SHAREHOLDERS’ PREDICAMENTS

As discussed earlier, credible basis is not an insubstantial burden of proof. In *Seinfeld*,⁴¹ the plaintiff pointed out that the credible basis standard erected an almost insurmountable barrier to shareholders’ information right. In arguing that shareholders should be permitted at least a limited inspection upon showing a reasonable and logical suspicion of wrongdoing, the plaintiff asserted:

This Court and the Court of Chancery have instructed shareholders to utilize § 220 as one of the tools at hand. Yet, the Court of Chancery at bar, in requiring *evidence* makes a § 220 application a mirage. If the shareholder had evidence, a derivative suit would be brought. Unless there is a whistle blower, or a video cassette, the public shareholder, having no access to corporate records, will only have suspicions.⁴²

The plaintiff’s argument was compelling. In *Seinfeld*, *three* executives were paid \$205 million while the company’s business was lackluster. What did these executives do to justify this sizable payment? Was the payment consistent with the terms of their employment contracts? These are legitimate, reasonable questions that a business owner should ask related to managing agents. Similarly, in *City of Westland Police*,⁴³ shareholders were dissatisfied with the board’s decision to reject what the shareholders believed to be a lucrative merger deal, so they exercised their voting right to remove directors who opposed the merger from the board. When the board decided to retain the unpopular directors, shareholders were understandably concerned that the board’s decision was motivated by an aim to entrench the directors’ positions. However, being removed from managerial responsibilities and shunned from the decision-making process, shareholders who did not want to take a *laissez-faire* attitude about governance or to uncritically accept the board’s

³⁹ *Ashley Bancstock Co.*, 534 S.W.3d at 767.

⁴⁰ *Id.*

⁴¹ *Seinfeld v. Verizon Commc’ns, Inc.*, 909 A.2d 117 (Del. 2007).

⁴² *Id.* at 121.

⁴³ *City of Westland Police & Fire Ret. Sys. v. Axcelis Techs., Inc.*, 1 A.3d 281 (Del. 2010).

words had only one way to discover the truth: inspecting the corporate books and records. However, the Delaware courts, à la the credible basis standard, erected an insurmountable barrier.

Credible basis is particularly cumbersome for shareholders of private companies. Private companies are not required to file periodic reports, proxy statements, or pre-merger disclosures with the Securities and Exchange Commission, so little information about them is publicly available. Moreover, private companies are less likely to be the focus of analysts' research reports, media attention, or regulatory surveillance. Recall that in *Yahoo!*,⁴⁴ *Wal-Mart*,⁴⁵ *Carapico*,⁴⁶ and *Kosinski*,⁴⁷ analysts' coverage, media reports, and government investigations offered corroborating evidence that elevated the premise of shareholders' demand for an inspection above mere suspicion and helped shareholders satisfy credible basis. Thus, "[t]o say that [shareholders] have the right, but that it can be enforced only when they have ascertained, in some way without the books, that their affairs have been mismanaged, or that their interests are in danger, is practically to deny the right in the majority of cases."⁴⁸

Credible basis has two immediate downsides for shareholders seeking to gather information in anticipation of a plenary action: first, it can deprive shareholders of the means for pleading with sufficient specificity to survive a motion to dismiss; second, it prolongs the litigation, which increases shareholders' risk of losing standing and the first filer advantage.

A. Difficulty in Meeting Pleading Requirements

1. Pleading for Rebutting Management's Refusal to Sue or Demand Futility

Shareholders asserting a fiduciary breach claim must show that they have requested that the board bring suit on the corporation's behalf, but the request was unjustly rejected, or that such a demand would be futile because the directors are so "'beholden' to an interested director . . . that his or her 'discretion would be sterilized.'"⁴⁹ To rebut the board's refusal to sue, shareholders must plead specific facts that create a reasonable doubt about the strong presumptions behind the business judgment rule, i.e., that the decision was made on an informed basis, in good faith for the best interests of the company, and devoid of conflicts of interest.⁵⁰ Under Delaware law, the plaintiff in a derivative suit is not entitled to Rule 26 discovery⁵¹ to assist with the particularized pleading requirement in a case of demand refusal.⁵² Therefore, "[a] stockholder who makes a serious demand and receives only a peremptory refusal has the right to use the 'tools at hand' to obtain the relevant corporate records, such as reports or minutes, reflecting the corporate action and related information in order to determine whether or not there is a basis to assert that demand was wrongfully refused."⁵³

⁴⁴ *Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752 (Del. Ch. 2016), *abrogated by* *Tiger v. Boast Apparel, Inc.*, 214 A.3d 933 (Del. 2019) on other grounds.

⁴⁵ *Wal-Mart Stores, Inc. v. Ind. Elec. Workers Pension Tr. Fund IBEW*, 95 A.3d 1264 (Del. 2014).

⁴⁶ *Carapico v. Phila. Stock Exch., Inc.*, 791 A.2d 787 (Del. Ch. 2000).

⁴⁷ *Kosinski v. GGP Inc.*, 214 A.3d 944 (Del. Ch. 2019), *judgment entered*, (Del. Ch. 2020).

⁴⁸ *Sparkman*, *supra* note 11, at 44.

⁴⁹ *United Food & Com. Workers Union & Participating Food Indus. Emps. Tri-State Pension Fund v. Zuckerberg*, 262 A.3d 1034, 1060 (Del. 2021).

⁵⁰ *Grimes v. Donald*, 673 A.2d 1207, 1219 (Del. 1996); *Bezirdjian v. O'Reilly*, 107 Cal. Rptr. 3d 384, 391 (Cal. Ct. App. 1st Dist. 2010).

⁵¹ DEL. R. CH. CT. 26.

⁵² *SCATTERED CORP. v. CHI. STOCK EXCH., INC.*, 701 A.2d 70, 77 (DEL. 1997).

⁵³ *See Grimes*, 673 A.2d at 1218.

Demand futility must also be pleaded with specificity to create a reasonable doubt about the directors' independence in evaluating the shareholder's demand to sue. The plaintiff must show that at least half of the directors (1) received a material personal benefit from the alleged misconduct, (2) will face a substantial likelihood of liability on the claims asserted by the shareholder, or (3) lack independence from another person who received a material personal benefit from the alleged misconduct or will face a substantial likelihood of liability on the claims of the shareholder.⁵⁴ Factual specificity must transcend mere acknowledgement of personal or business associations a director has with interested parties. The relationship must be of a "bias-producing nature,"⁵⁵ and business transactions or financial ties must be material to the director's personal or financial interests or have been consummated at less than arm's length.⁵⁶ If the complaint alleges that a director gets "good deal flows" from his association with the interested director, the complaint must specify deals that flowed or were expected to flow to an entity controlled by the receiving director.⁵⁷ An allegation that a board member had an atypical arrangement with the company does not disqualify the director without showing if and what the director was expected to do in exchange for a favor.⁵⁸

Without an inside informant, who comes as a rare, costly, and often unreliable witness, the "tools at hand" offer shareholders the only hope of gathering sufficient factual details to survive the motion to dismiss.⁵⁹ In *In re Oracle Corp. Derivative Litigation*,⁶⁰ shareholders discovered through inspecting corporate records that Oracle's putatively independent directors were in reality beholden to another director (Larry Ellison) who orchestrated a self-interested transaction. One independent director relied on Ellison as a client for future consulting services, while another viewed Ellison as a potential buyer of a company the director owned. The court held that these relationships could prevent the directors from making an independent decision about whether Oracle should sue Ellison and form the basis for demand futility. Without inspecting records, shareholders would have had difficulty in collecting such detailed information to satisfy the pleading requirements.

2. Pleading Fiduciary Breaches

The prevalence of exculpatory provisions resembling DGCL Section 102(b)(7)⁶¹ means that shareholders seeking monetary damages against management for fiduciary breaches must plead non-exculpated claims of bad faith, self-interest, or breach of the duty of loyalty.⁶²

⁵⁴ *Zuckerberg*, 262 A.3d at 1060. The Delaware Supreme Court refined pleading standards previously articulated in *Aronson v. Lewis*, 473 A.2d 805, 814–817 (Del. 1984), and *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993), which required plaintiffs to plead particularized facts raising a reasonable doubt that (1) the challenged transaction was a valid business judgement or the directors were disinterested and independent or (2) the majority of the board in place could have properly exercised its independent and disinterested business judgment in responding to a demand.

⁵⁵ *Zuckerberg*, 262 A.3d at 1061.

⁵⁶ *Id.* at 1062.

⁵⁷ *Id.* at 1063.

⁵⁸ *Id.* at 1064.

⁵⁹ Shapira, *supra* note 1, at 1956–57.

⁶⁰ *In re Oracle Corp. Derivative Litig.*, No. 2017-0337-SG, 2019 WL 6522297 (Del. Ch. Dec. 4, 2019).

⁶¹ DEL. CODE ANN. tit. 8, § 102(b)(7) (2020). See Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Suits*, 57 VAND. L. REV. 1747, 1786 (2004) ("It is very rare for a public company not to have taken advantage of this exculpation.").

⁶² See Robert S. Reder & Lorin Hom, *Chancery Court Dismisses Breach of Fiduciary Duty Claims Against Target Company Directors Despite Unavailability of Corwin Defense*, 73 VAND. L. REV. EN BANC 111 (2020),

Pleading bad faith requires the plaintiff to show that directors took or omitted actions against the interest of the company with scienter.⁶³ For example, when bad faith is premised on directors' failure to consider alternatives when choosing a disputed course of action for the company, the plaintiff must show that the directors "were aware of these alternatives, understood that they would maximize value, but nonetheless chose instead to act against the interests of the [c]ompany and its stockholders."⁶⁴ For claims that the directors breached their *Revlon* duty⁶⁵ in bad faith, the plaintiff's pleading must show that it is reasonably conceivable that the directors knowingly ignored their duty.⁶⁶ Factors like whether the directors sought legal or financial advice, obtained a fairness opinion, considered alternative bids, and whether directors' personal financial interests were aligned with those of the company are relevant to the issue of bad faith.⁶⁷ Shareholders asserting that directors failed to fulfill the oversight duty under *Caremark*⁶⁸ must identify specific red flags that are deemed substantial by the court and convince the court that the directors likely knowingly ignored the red flags.⁶⁹ A claim of self-interest or breach of the duty of loyalty must plead in specificity why the directors who were involved in a challenged transaction had personal interests incompatible with those of the company or extraneous considerations that caused them to intentionally and completely disregard their fiduciary responsibilities.⁷⁰ As the court has acknowledged, "an extreme set of facts is required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties."⁷¹

While pleading specific facts about what defendants knew and intended to do with only public information is a nearly insurmountable hurdle, information unearthed from inspections has helped shareholders survive motions to dismiss in many instances.⁷² In *Inter-Local Pension Fund GCC/IBT v. Calgon Carbon Corp.*,⁷³ an inspection of management's personal emails revealed evidence that the board tried to circumvent the *Revlon* duty by setting up an overly restrictive deal process to lock in personal benefits.⁷⁴ In *In re Clovis Oncology, Inc. Derivative Litigation*,⁷⁵ shareholders satisfied the pleading requirements for a *Caremark* case by using information from an inspection to show that the directors repeatedly ignored indications that the company was violating Food and Drug Administration protocols.

3. Pleading Federal Securities Fraud

A shareholder may file a securities fraud claim in a federal court against the company or individuals related to the company for sales, trading, or price manipulations of securities in

<https://vanderbiltlawreview.org/lawreview/2020/05/chancery-court-dismisses-breach-of-fiduciary-duty-claims-against-target-company-directors-despite-unavailability-of-corwin-defense>.

⁶³ *Morrison v. Berry*, No. 12808-VCG, 2019 WL 7369431 (Del. Ch. Dec. 31, 2019).

⁶⁴ *Id.* at *11.

⁶⁵ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

⁶⁶ *Morrison*, 2019 WL 7369431, at *13.

⁶⁷ *Houseman v. Sagerman*, No. 8898-VCG, 2014 WL 1478511 (Del. Ch. Apr. 16, 2014).

⁶⁸ *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

⁶⁹ Amanda Marie Payne, *What the Hack?! Reexamining the Duty of Oversight in an Age of Data Breaches*, 53 GA. L. REV. 727, 756 (2019).

⁷⁰ *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235 (Del. 2009).

⁷¹ *Id.* at 243 (citing *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 654–55 (Del. Ch. 2008)).

⁷² Shapira, *supra* note 1, at 1976–82.

⁷³ *Inter-Local Pension Fund GCC/IBT v. Calgon Carbon Corp.*, No. 2017-0910-MTZ, 2019 WL 479082 (Del. Ch. Jan. 25, 2019).

⁷⁴ *Id.* at *11.

⁷⁵ *In re Clovis Oncology, Inc. Derivative Litig.*, No. 2017-0222-JRS, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019).

violation of the Securities Exchange Act of 1934 (the “Exchange Act”).⁷⁶ The majority of securities fraud claims are brought under Section 10(b) of this statute, pursuant to SEC Rule 10b-5.⁷⁷ In a Rule 10b-5 action, the plaintiff must allege and prove that the defendant made a material misrepresentation or omission in connection with the purchase or sale of securities with scienter, causing the plaintiff to suffer an economic loss.⁷⁸ The complaint must satisfy the rigorous pleading standard established by the Private Securities Litigation Reform Act of 1995 (“PSLRA”).⁷⁹ If the basis of the claim is that the company’s management or staff made material misrepresentations, the complaint must identify statements or omissions that were believed to be fraudulent, state where and when the statements or omissions were made, explain why the statements or omissions were material misrepresentations of the true state of the company’s business, and show facts giving rise to a strong inference of scienter.⁸⁰ Again, this extreme set of facts must be pled without the benefit of Rule 26 discovery.⁸¹ Therefore, the ability to inspect corporate records under state corporate statutes becomes a crucial step in a successful securities litigation.⁸²

4. Pleading *Corwin* and *MFW*

Management’s common defense to a fiduciary breach claim arising from a disputed transaction is that the transaction was approved by a fully informed, uncoerced vote of disinterested shareholders. The validity of this defense was recognized by the Delaware Supreme Court in *Corwin v. KKR Financial Holdings LLC*.⁸³ Once management meet the conditions of *Corwin*, they can benefit from the deferential business judgment review. Practically speaking, business judgment review means that management can dismiss the lawsuit at the pleading stage, prior to discovery.⁸⁴ To refute the management’s defense that shareholders approved the disputed transaction, shareholders can show that the directors secured approval without disclosing all material information.⁸⁵ This rebuttal relies on a careful comparison of the information disclosed to shareholders and facts embedded in corporate records. Again, the opportunity to inspect corporate records is vitally important to shareholders’ ability to survive a motion to dismiss. In *Morrison v. Berry*,⁸⁶ the plaintiff’s inspection of the company’s internal emails revealed that the company’s founder received separate personal benefits in a merger deal, that he failed to disclose that information to the board in a timely manner, and that the company’s public disclosures did not include such material information. The revelation helped the shareholder successfully rebut a *Corwin*-based defense.

In *Kahn v. M&F Worldwide Corp.*,⁸⁷ the Delaware Supreme Court held that freezeout mergers, in which a controlling shareholder acquires shares from minority shareholders and takes the

⁷⁶ 15 U.S.C. § 78a.

⁷⁷ 17 C.F.R. § 240.10b-5.

⁷⁸ *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336 (2005).

⁷⁹ Private Securities Litigation Reform Act of 1995 § 101(b), 15 U.S.C. § 78u-4.

⁸⁰ *In re IAC/InterActiveCorp Secs. Litig.*, 478 F. Supp. 2d 574 (S.D.N.Y. 2007).

⁸¹ Shapira, *supra* note 1, at 1956.

⁸² Elizabeth Chamblee Burch, *Securities Class Actions as Pragmatic Ex Post Regulation*, 43 GA. L. REV. 63, 74 n.40 (2008).

⁸³ *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015).

⁸⁴ Shapira, *supra* note 1, at 1962; *Singh v. Attenborough*, 137 A.3d 151, 152 (Del. 2016) (“When the business judgment rule standard of review is invoked because of a vote, dismissal is typically the result.”).

⁸⁵ *See, e.g., Morrison v. Berry*, 191 A.3d 268 (Del. 2018) (finding that defendant was not entitled to the *Corwin* defense because shareholders’ approval was not on a fully informed basis).

⁸⁶ *Id.*

⁸⁷ *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

company private, could benefit from deferential business judgment review if dual procedural safeguards were implemented: (1) the deal was negotiated *ab initio* by a well-functioning, full-powered special committee of independent directors, and (2) the deal was conditioned on the approval of the majority of the minority shareholders. “*Ab initio*” means that a controlling shareholder must agree to the foregoing protective conditions before negotiations take place.⁸⁸ Issues like when negotiations first took place, whether special committee members were indeed independent, and who qualified as a minority shareholder for the “majority of the minority” condition⁸⁹ often cannot be ascertained from public disclosures. Hence, record inspections are important “tools at hand” to shareholders challenging self-dealing acquisitions pursuant to the *MFW* formulation.

In sum, it is hard to overstate the importance of inspections in helping shareholder plaintiffs meet the pleading requirements. Inspections are particularly valuable because they may produce informal communications from social media and email that, unlike formal board documents like resolutions and meeting minutes, have not been carefully edited by cautious lawyers intending to generate an impeccable paper trail. These informal communications shed light on what truly occurred in the decision-making process and in the decision-maker’s mind. Courts have repeatedly urged shareholders to use the “tools at hand” to enhance the quality of pleadings.⁹⁰

B. THE DOWNSIDE OF DELAYS IN INSPECTION LAWSUITS

Although inspection lawsuits are supposedly “summary” and “expeditious,”⁹¹ the proceedings can extend for much longer than intended. After a shareholder demands an inspection, DGCL gives the corporation five business days to answer.⁹² If the demand is in whole or part denied, the shareholder may petition the court for a writ of mandamus or an injunction. Contentions frequently arise regarding the shareholder’s purposes for the inspection, the parties’ satisfaction of their burden of proof, the necessity and essentiality of the requested documents, and limits on use of the information (e.g., confidentiality).⁹³ If a writ of mandamus or injunction is finally issued, the shareholder will have experienced a delay much longer than five days. At that point, the corporation may appeal the court’s decision, extending the lengthy delay even further.⁹⁴ Research shows that, on average, it takes ten months from the initial filing of an inspection lawsuit to the resolution of the case.⁹⁵ “In [plaintiffs’] eyes, defendants have turned books and records litigation into a surrogate proceeding to litigate the possible merits of the suit where they place obstacles in the plaintiffs’ way to obstruct them from employing it as a quick and easy pre-filing discovery

⁸⁸ *Flood v. Synutra Int’l, Inc.*, 195 A.3d 754, 756 (Del. 2018).

⁸⁹ *See, e.g., In re Pure Res., Inc., S’holders Litig.*, 808 A.2d 421 (Del. Ch. 2002) (refusing to label shareholders who had extraneous incentives to approve the merger as “minority” shareholders in the “majority of the minority” calculation).

⁹⁰ *See, e.g., Seinfeld v. Verizon Commc’ns, Inc.*, 909 A.2d 117, 119 (Del. 2007); *Grimes v. Donald*, 673 A.2d 1207, 1219 (Del. 1996).

⁹¹ *See AmerisourceBergen Corp. v. Lebanon Cnty. Emps.’ Ret. Fund*, 243 A.3d 417, 437 (Del. 2020) (stating that Section 220 proceedings are intended to be “summary” and thus “managed expeditiously”).

⁹² DEL. CODE ANN. tit. 8, § 220(c) (2020).

⁹³ LAWRENCE A. HAMERMESH & MICHAEL L. WACHTER, *THE IMPORTANCE OF BEING DISMISSIVE: THE EFFICIENCY ROLE OF PLEADING STAGE EVALUATION OF SHAREHOLDER LITIGATION*, 42 J. CORP. L. 597, 612 (2017).

⁹⁴ Ruari James O’Sullivan, *Skimming from the 2%: The Status of Georgia’s Restrictions on Shareholder Access to Corporate Information*, 46 GA. L. REV. 835, 859 (2012).

⁹⁵ Cox et al., *supra* note 2, at 2149–50.

tool.”⁹⁶ A contentious standard of proof such as credible basis increases the risk of protraction in inspection litigations, and a prolonged inspection litigation has numerous negative consequences for shareholders.

1. A Higher Risk that a Plenary Action Is Barred by Collateral Estoppel

An investigating shareholder may be barred from bringing a derivative or class action lawsuit if a lawsuit filed in another jurisdiction for the same cause of action is dismissed with prejudice while the inspection lawsuit is pending. An oft-cited example is *California State Teachers’ Retirement System v. Alvarez*,⁹⁷ one of the fiduciary breach lawsuits filed in multiple jurisdictions by different shareholders of Wal-Mart in conjunction with the bribery scandal of the company’s Mexican division. Some shareholders followed the Delaware court’s instruction to use the “tools at hand” and initiated a Section 220 proceeding, while other shareholders brought a plenary lawsuit in federal court in Arkansas without inspecting records, relying solely on public information. The Arkansas federal court refused to consolidate the lawsuits because the claims also alleged federal securities law violations. The court also denied a motion to stay the Arkansas proceeding pending a resolution of the Delaware Section 220 action, pointing to the substantial delays that had already occurred in the Delaware proceeding. The Arkansas federal judge warned that the court would rule on Wal-Mart’s motion to dismiss based on demand futility and that if the motion was granted, it would likely have a preclusionary effect under the doctrine of collateral estoppel.⁹⁸ The Delaware plaintiffs attempted to convince the Arkansas plaintiffs to join the Delaware action. However, “[f]or whatever reason, the two groups—both of whom were seeking permission to act on behalf of the same corporate entity—could not manage to work together.”⁹⁹

The Delaware Supreme Court expedited the inspection proceeding, but before the court reached a decision, the Arkansas lawsuit was dismissed on demand futility grounds.¹⁰⁰ The Arkansas ruling prompted the Delaware court to dismiss the Delaware action by applying collateral estoppel.¹⁰¹ The court held that the Delaware plaintiffs were not deprived of due process because they were deemed in privity with the Arkansas plaintiffs due to their identical cause of action, and there was no evidence of gross deficiency in the Arkansas plaintiffs’ advocacy of their lawsuit.¹⁰² By this time, the Delaware plaintiffs had been pursuing the Section 220 action for three years. From the information collected, the Delaware plaintiffs believed they had a much stronger case against Wal-Mart’s directors than the one filed and dismissed in Arkansas.¹⁰³

⁹⁶ *Id.*

⁹⁷ CAL. STATE TCHRS.’ RET. SYS. V. ALVAREZ, No. 295, 2016, 175 A.3d 86 (TABLE), 2017 WL 6421389 (DEL. JAN. 18, 2017).

⁹⁸ *Id.* at *2.

⁹⁹ *Id.*

¹⁰⁰ *In re Wal-Mart Stores, Inc. S’holder Deriv. Litig.*, No. 12-cv-4041, 2015 WL 1470184 (W.D. Ark. Mar. 31, 2015), amended by 2015 WL 13375767 (W.D. Ark. Apr. 3, 2015), *aff’d*, *Cottrell ex rel. Wal-Mart Stores, Inc. v. Duke*, 829 F.3d 983 (8th Cir. 2016).

¹⁰¹ *In re Wal-Mart Stores, Inc. Del. Derivative Litig.*, No. 7455-CB, 2016 WL 2908344, (Del. Ch. May 13, 2016).

¹⁰² *In re Wal-Mart Stores, Inc. Del. Derivative Litig.*, 167 A.3d 513, 519 (Del. Ch. 2017).

¹⁰³ Kevin M. LaCroix, *The Curse of Multi-Jurisdiction Litigation: A Problem for Everyone, Not Just Defendants*, LEXISNEXIS LEGAL NEWSROOM (Apr. 3, 2015), <https://www.lexisnexis.com/legalnewsroom/corporate/b/blog/posts/the-curse-of-multi-jurisdiction-litigation-a-problem-for-everyone-not-just-defendants>.

2. A Higher Risk of Losing Standing Due to the Defendant’s Tactical Merger

DGCL Section 220 requires claimants to be a “stockholder” at the time of the demand for inspection.¹⁰⁴ The statute defines “stockholder” as “a holder of record of stock in a stock corporation, or a person who is the beneficial owner of shares of such stock held either in a voting trust or by a nominee on behalf of such person.”¹⁰⁵ A person or entity that has lost the “stockholder” status at the time of demanding inspection loses the statutory inspection right. In *Weingarten v. Monster Worldwide, Inc.*,¹⁰⁶ a shareholder sought to inspect corporate records for investigative purposes against management relating to a merger. Shortly after the merger agreement was signed, but before the transaction was closed, the plaintiff sent a demand letter to the management. The management rejected the shareholder’s list of requests but expressed a willingness to discuss the scope of a narrowly tailored inspection. The plaintiff responded that he would abstain from filing an inspection complaint pending a resolution of the demand. Plaintiff also requested that the company renounce any standing-based defense if the merger had been consummated before the parties reached a resolution. The company refused to disclaim any potential defenses. Around two weeks after the shareholders’ initial demand for inspection, but before the plaintiff filed an inspection lawsuit, the merger was closed, rendering the plaintiff’s inspection demand moot.

A merger can also sound a death knell to a *pending* inspection lawsuit. Shareholders of the dissolving company to a merger lose the standing to sue derivatively any person who has perpetrated a wrong against the company. The right to pursue such a legal action passes on to the surviving company after the merger.¹⁰⁷ From that point onward, the board of the surviving company must decide whether to continue the lawsuit. The loss of standing in a derivative action also deprives shareholders of the dissolving company of a “proper cause” for a pending inspection lawsuit if the inspection is *solely* in furtherance of a derivative lawsuit.¹⁰⁸ Inspections for purposes other than or in addition to preparing for a derivative lawsuit can continue if the inspection demand was filed prior to the merger.¹⁰⁹ Shareholders who intend to pursue an investigative inspection post-merger can assert other purposes, such as valuation or communication with shareholders, but the court could determine that such purposes are inauthentic given the corporation’s dissolution.¹¹⁰

Minority shareholders of private companies are particularly vulnerable to fraud perpetrated by management: the board is typically dominated by controlling shareholders, who can authorize self-dealing transactions, usurp corporate opportunities, siphon funds out of the company, and, faced with a lawsuit by minority shareholders who suspect wrongdoing, orchestrate a merger with a

¹⁰⁴ DEL. CODE ANN. tit. 8, § 220(b) (2020).

¹⁰⁵ *Id.* § 220(a)(1).

¹⁰⁶ *Weingarten v. Monster Worldwide, Inc.*, No. 12931-VCG, 2017 WL 752179 (Del. Ch. Feb. 27, 2017).

¹⁰⁷ *Schreiber v. Carney*, 447 A.2d 17, 21 (Del. Ch. 1982).

¹⁰⁸ *United Techs. Corp. v. Treppel*, 109 A.3d 553, 559 (Del. 2014) (holding that inspection was not reasonably related to plaintiff’s interest as a shareholder if he would not have a standing to pursue a derivative action based on any potential breaches).

¹⁰⁹ *See, e.g., Cutlip v. CBA Int’l, Inc. I.*, No. 14168 NC, 1995 WL 694422 (Del. Ch. Oct. 27, 1995) (granting shareholder’s inspection demand filed prior to the company’s merger with two wholly-owned subsidiaries as the purposes of the inspection included, in addition to investigating fraud and fiduciary breaches, valuation and communication with other shareholders regarding a possible proxy solicitation).

¹¹⁰ *See, e.g., Pagliara v. Fed. Home Loan Mortg. Corp.*, 203 F. Supp. 3d 678 (E.D. Va. 2016) (denying inspection for valuation because company was a public company, so its valuation was reflected in the market price); *Lambrecht v. Bank of Am. Corp.*, No. 650182/09E, 2010 WL 7378662 (N.Y. Sup. Ct. N.Y. Cnty. Oct. 1, 2010) (finding that the primary purpose of the inspection, i.e., to investigate managerial misconduct, was improper given the plaintiff’s loss of standing to pursue a derivative action after the company’s merger and denying the inspection for the secondary purpose of communicating with other shareholders).

wholly-owned subsidiary created specifically for the merger. This tactic denies minority shareholders standing to sue and an opportunity to discover the frauds by inspecting corporate records.

3. A Higher Risk of Losing Lead Plaintiff Status

In addition, protracted inspection lawsuits prevent shareholders from obtaining the information needed to file a plenary action in a timely manner. Shareholders who follow the court's suggestion about using the "tools at hand" risk losing the first-filing advantage to shareholders who hastily file a lawsuit for the same cause of action in another jurisdiction without inspecting records. First-filer status is a weighty factor in the court's appointment of a lead plaintiff for a class action. The lead plaintiff takes a proactive role in the lawsuit and is influential in negotiating a settlement. In general, the lead plaintiff receives a larger percentage of a settlement in exchange for time and effort devoted to the lawsuit. Shareholders covet lead plaintiff status for the benefits it provides over the course of the litigation, including potential pecuniary rewards. For that reason, shareholders often forego utilizing the "tools and hand" to investigate the company before filing a complaint. A lengthy fight over access to books and records distorts the incentive further away from the "investigate first, sue later" policy.¹¹¹

IV. THE MERITS AND CONCERNS OF RATIONAL BELIEF

Previous parts of this paper have shown the challenges that shareholders face under credible basis. Rational belief is a less contentious standard of proof in favor of shareholders, so adopting it is likely to alleviate shareholders' concerns. This part of the paper presents arguments for and against rational belief as the universal standard of proof for inspection lawsuits based on allegations of mismanagement.

A. Rational Belief Promotes Governance

Corporations, with separate management and ownership, are a "web of agency relationships."¹¹² Transparency is instrumental in dealing with agency problems.¹¹³ Indeed, transparency is considered a "the fundamental anchor for corporate governance" in organizations laden with potential conflicts among promoters, directors, managers, and majority and minority shareholders,¹¹⁴ as it provides outside directors and shareholders with relevant and reliable information for mutually monitoring frontline management and, in the case of shareholders, monitoring directors.¹¹⁵

¹¹¹ HAMERMESH & WACHTER, *SUPRA* NOTE 93, AT 612.

¹¹² Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 *YALE L.J.* 698, 700 (1982).

¹¹³ PAUL G. MAHONEY, *MANDATORY DISCLOSURE AS A SOLUTION TO AGENCY PROBLEMS*, 62 *U. CHI. L. REV.* 1047, 1048–51 (1995).

¹¹⁴ Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World*, 2 *U. BROOK. J. CORP., FIN. & COM. L.* 81, 116–17 (2007).

¹¹⁵ Christopher S. Armstrong, Wayne R. Guay, Hamid Mehran, & Joseph P. Weber, *The Role of Financial Reporting and Transparency in Corporate Governance*, *FED. RES. BD. N.Y. ECON. POL'Y REV.* 107, 109 (2016), https://www.newyorkfed.org/medialibrary/media/research/epr/2016/epr_2016_post-crisis-proposal_armstrong.pdf.

The law promotes transparency by mandating disclosures. Under the Exchange Act,¹¹⁶ public companies must file quarterly, annual, and event-specific reports on the company's financial and operational conditions, management's compensation, and interested transactions. Disclosures help shareholders to value investments and monitor management's behavior.¹¹⁷ The Securities Act of 1933¹¹⁸ also requires companies to disclose key aspects of their business when they sell securities to the public.¹¹⁹ Public disclosures must be supplemented by mechanisms that verify the disclosures' accuracy and reveal information that would otherwise be hidden from public scrutiny or camouflaged with euphemisms. A law that grants shareholders a generous inspection right serves that purpose well.

Transparency, as a tool for tackling the agency problem, must also be bolstered by a potent enforcement apparatus to ensure that fiduciary breaches face adverse consequences in court proceedings. A prohibitive inspection right reduces the potency of that enforcement apparatus, as it prevents vigilant enforcers (i.e., shareholders) from gaining enough evidence to convince the court that breaches have occurred. Reputational deterrence is also important. Inspections expose managerial wrongdoing, which helps the public reconsider the risks of doing business with the wrongdoers' company. Previous research has shown that shareholders' inspections incentivize better corporate governance.¹²⁰

Information is essential for shareholders to participate in the corporate decision-making process. Scholars have argued that shareholders often have superior decision-making skills, which justifies sharing corporate authority to achieve more efficiency and shareholder wealth.¹²¹ Research has documented that shareholder activism can create sustainable values.¹²² Generous shareholder inspection rights encourage management to be diligent when documenting the decision-making process. Some lawyers send reminders to their corporate clients about keeping a good paper trail after each landmark decision on inspection rights. Although any improvements to management's documentation practices are likely intended to cover tracks for liability purposes, well-documented decision-making is nonetheless a hallmark of good corporate governance.¹²³

B. A Uniform Standard of Proof Avoids a Difficult Conflict of Laws Issue

As previously discussed, some jurisdictions have adopted rational belief as the standard of proof when shareholders claim that the purpose behind the inspection is to investigate mismanagement. The lack of a uniform standard creates a messy conflict of laws issue.

¹¹⁶ 15 U.S.C. § 78a.

¹¹⁷ MAHONEY, SUPRA NOTE 113, AT 1051.

¹¹⁸ 15 U.S.C. § 77a.

¹¹⁹ Mahoney, *supra* note 113, at 1052; *see also* Joseph A. Franco, *Why Antifraud Prohibitions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure*, 2002 COLUM. BUS. L. REV. 223, 290 (2002).

¹²⁰ Shapira, *supra* note 1, at 1986–87 (noting that Facebook improved privacy protection after shareholders' inspection revealed the company's scant regard for users' privacy and generated substantial media coverage, as well as how Section 220 became a source of media scrutiny and created a huge reputational risk for Blue Bell Creameries over its food safety problems).

¹²¹ Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance*, 2014 B.Y.U. L. REV. 1015 (2014).

¹²² Lucian A. Bebchuk, Alon Brav, & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1088 n.5 (2015).

¹²³ *See* Shapira, *supra* note, 1 at 1995 (noting that after every key Section 220 juncture, law firms sent memos to clients imploring them to start keeping more robust documentation of board discussions and company records).

Restatement (Second) of Conflict of Laws § 304 provides that under the internal affairs doctrine, the law of the state of incorporation governs issues related to “the right of a shareholder to participate in the administration of the affairs of the corporation,” except in the unusual case where another state has a more significant relationship to the shareholder or the corporation, in which case applying that state’s law is justified.¹²⁴ However, Comment d to § 304 explicitly excepts shareholders’ right to inspect corporate records from the internal affairs doctrine, so “a court will apply to a foreign corporation doing substantial business in the state a local statute providing for the inspection of books by a shareholder if in the court’s opinion the statute embodies an important policy.”¹²⁵

U.S. jurisdictions are divided on whether shareholders’ inspection rights are an internal affair of a corporation. Given that most companies are incorporated in Delaware, it is not surprising that Delaware courts answered this question affirmatively. In *Juul Labs, Inc. v. Grove*,¹²⁶ Juul Labs was incorporated in Delaware but headquartered in San Francisco, California. Juul Labs’ articles of incorporation designated Delaware as the forum for adjudicating disputes between shareholders and management. Grove was a shareholder who acquired shares by exercising his stock options. When he was granted the stock options, Grove signed two agreements containing provisions that purportedly waived his statutory inspection rights. Despite these waivers, Grove later demanded an inspection according to the California corporate statute, which granted shareholders an absolute right to receive certain information from the company. Responding to this demand, Juul Labs sought declaratory and injunctive relief at the Delaware Court of Chancery, asking the court to declare, among other things, that Delaware law as opposed to California law should govern Grove’s inspection rights.

The Delaware Court of Chancery held that “[s]tockholder inspection rights are a core matter of internal corporate affairs” and, therefore, Delaware law should apply.¹²⁷ The court pointed out that “[t]hrough its Section 220 jurisprudence, the Delaware Supreme Court seeks to maintain ‘an appropriate balance’ between the interests of stockholders to obtain information and the right of the corporation to deny unwarranted and burdensome requests.”¹²⁸ Highlighting key differences between DGCL § 220 and the corresponding provisions in the California statute, the court opined that those two statutes balanced the interests of shareholders and the corporation differently.¹²⁹ The court reasoned that “[i]f other states could define the terms by which stockholders can inspect books and records, then a Delaware corporation could be subjected to different provisions and standards in jurisdictions around the country.”¹³⁰ The court concluded that the Constitution’s Full Faith and Credit Clause¹³¹ required application of the internal affairs doctrine, except where “national policy is outweighed by a significant interest of the forum state in the corporation and its shareholders.”¹³²

New York courts and the Second Circuit view the issue differently. An oft-cited case is *Sadler v. NCR Corp.*¹³³ NCR, a large computer company, was incorporated in Maryland, had its principal

¹²⁴ RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 304 (AM. L. INST. 2022).

¹²⁵ *Id.* § 304 cmt. d.

¹²⁶ *Juul Labs, Inc. v. Grove*, 238 A.3d 904 (Del. Ch. 2020).

¹²⁷ *Id.* at 915.

¹²⁸ *Id.*

¹²⁹ *Id.* AT 916.

¹³⁰ *Id.* AT 918.

¹³¹ U.S. CONST. art. IV, § 1.

¹³² *JUUL LABS*, 238 A.3d at 914.

¹³³ *Sadler v. NCR Corp.*, 928 F.2d 48 (2d Cir. 1991).

place of business in Ohio, and conducted substantial business in New York. The plaintiff asked NCR to provide a shareholder list and related materials to facilitate communications with other shareholders in an upcoming proxy fight. When NCR refused, the plaintiff brought a lawsuit in a federal district court in New York to compel production. The court ruled in Sadler's favor, so NCR appealed to the Second Circuit.¹³⁴

A conflict of laws issue was triggered because New York law permitted any New York resident who had been a shareholder of record for six months of a foreign corporation doing business in New York to obtain a shareholder list from the corporation,¹³⁵ but Maryland law did not obligate the corporation to provide such information to any shareholder who held less than 5% of the company's shares.¹³⁶ The plaintiff satisfied New York's requirement but failed Maryland's. NCR claimed that the compulsory production of shareholder records pursuant to New York law subjected NCR to inconsistent regulations and violated the Commerce Clause.¹³⁷ NCR argued that Maryland's inspection statute was part of a balanced plan to regulate the relationship between a corporation and its shareholders. Compared to New York law, Maryland law was more restrictive on shareholder inspections but more generous on shareholders' right to call for special meetings upon collecting a mere 25% of the shares,¹³⁸ while both rights were pertinent to proxy fights. In contrast, New York did not afford shareholders any statutory right to call a special meeting. NCR argued that by applying New York's less restrictive inspection law to shareholders who could also avail themselves of Maryland's lenient special shareholder meeting provisions, the court would grant shareholders a right that "the Maryland legislature implicitly wished to deny in balancing the competing claims of management and shareholders."¹³⁹

The Second Circuit rejected NCR's arguments. First, the court pointed out that "[s]tates are not prohibited from enacting regulations simply because they require more of an entity that is already subject to some less demanding regulation elsewhere."¹⁴⁰ Then, the court cited Comment d to Restatement (Second) of Conflict of Laws § 304,¹⁴¹ which excepts shareholders' inspection rights from the internal affairs doctrine, stating that "[a]ccess to shareholder lists was a long-recognized exception to the internal affairs doctrine as a matter of corporate law and conflicts of law, and it should take a substantial threat of conflict adversely affecting interstate commerce before a court invalidates a state's assertion of this traditional authority."¹⁴² Responding to NCR's argument that allowing Sadler to access a shareholder list would lead to a result unintended by Maryland's legislature, the Court stated:

Though Maryland may well have balanced limited shareholder access to stockholder lists with generous authority for calling special meetings, it did so against the background of traditional foreign state regulation of such access, and it cannot expect courts to provide constitutional insulation for the particular arrangements it adopted. If the traditional role of states

¹³⁴ *Id.* at 49.

¹³⁵ N.Y. BUS. CORP. L. § 1315(a) (McKinney 1986).

¹³⁶ MD. CORPS. & ASS'NS CODE ANN. § 2-513(a) (1985).

¹³⁷ *Sadler*, 928 F.2d at 53.

¹³⁸ MD. CORPS. & ASS'NS CODE ANN. § 2-502 (1985 & Supp. 1990).

¹³⁹ *Sadler*, 928 F.2d at 54.

¹⁴⁰ *Id.*

¹⁴¹ RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 304 cmt. d (AM. L. INST. 2022).

¹⁴² *Sadler*, 928 F.2d at 55.

concerning access to stockholder lists of foreign corporations is to be circumscribed, that alteration will have to be undertaken by Congress.¹⁴³

The Second Circuit was unable to discern any unjustified burden on interstate commerce from applying New York law instead of Maryland law. The court believed that “even if some slight burden could be identified, it is adequately justified by the legitimate local interest in protecting local shareholders.”¹⁴⁴

Both Delaware’s view and the Second Circuit’s view on the internal affairs doctrine relating to shareholder inspection rights have appeared in judicial decisions in other jurisdictions.¹⁴⁵ This delicate conflict of laws problem, when combined with a bifurcated standard of proof for investigative inspections (i.e., credible basis or rational belief), means shareholders of the same corporation can be granted or denied access to corporate records based on their residence or other extraneous factors unrelated to their shareholding. As will be shown in subsequent parts of this paper, achieving legal uniformity by transitioning from credible basis to rational belief is, on balance, an advisable way to sidestep the problem.

C. Delaware Supreme Court’s Basis for Rejecting Rational Belief

1. *Seinfeld* and Its Assumption About Frivolous Inspection Lawsuits

Should rational belief replace credible basis as the standard of proof for a limited investigative inspection of corporate books and records? In *Seinfeld v. Verizon Commc’ns, Inc.*,¹⁴⁶ the Delaware Supreme Court pondered this question and curtly answered no,¹⁴⁷ stating:

The “credible basis” standard achieves an appropriate balance between providing stockholders who can offer some evidence of possible wrongdoing with access to corporate records and safeguarding the right of the corporation to deny requests for inspections that are based only upon suspicion or curiosity. . . . Investigations of meritorious allegations of possible mismanagement, waste or wrongdoing benefit the corporation, but investigations that are “indiscriminate fishing expeditions” do not. . . . At some point, the costs of generating more information fall short of the benefits of having more information. At that point, compelling production of information would be wealth-reducing, and so shareholders would not want it produced.¹⁴⁸

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *See, e.g.*, *Hartman Income REIT, Inc. v. MacKenzie Blue Ridge Fund III, L.P.*, No. 01-20-00218-CV, 2022 WL 243992 (Tex. App. 1st Dist. Jan. 27, 2022) (holding that shareholders’ right of inspection was an internal affair of the company to justify applying the law of Maryland because it was the state of incorporation); *Hollander v. Rosen*, 555 So. 2d 384, 386 (Fla. Dist. Ct. App. 1989) (holding that a foreign corporation authorized to do business in Florida is subject to Florida law respecting a shareholder’s access to corporate books and records); *Jefferson Indus. Bank v. First Golden Bancorporation*, 762 P.2d 768, 770 (Colo. App. 1988) (holding that Colorado’s corporate statute applied to foreign corporations that transacted substantial business in the state).

¹⁴⁶ *Seinfeld v. Verizon Commc’ns, Inc.*, 909 A.2d 117, 121 (Del. 2007).

¹⁴⁷ *Id.* at 119 (considering whether a shareholder with a proper purpose should be entitled to inspect carefully limited categories of corporate books upon showing that the shareholder has a rational basis for suspecting mismanagement).

¹⁴⁸ *Id.* at 118–22.

The above explanation underscores the court's concern that rational belief would entice "indiscriminate fishing expeditions" (i.e., frivolous lawsuits) and that tending to such demands would generate more costs than benefits. A corporation faces two types of direct costs following shareholders' demand for information: (1) the cost of producing the requested documents and revealing sensitive information and (2) the cost of defending against an inspection lawsuit. When shareholders want corporate information, they must first send a demand to the corporation. If the corporation rejects this demand, as it often does, shareholders then decide whether to bring an inspection lawsuit. Since the corporation's cost of writing a rejection letter is likely insubstantial—perhaps a few hours' worth of legal fees charged by the corporation's lawyer for drafting the letter—the onerous costs feared by the court only eventuate if the requesting shareholders decide to sue. Thus, the Delaware Supreme Court's rejection of rational belief is premised on a fundamental assumption that a lenient standard will open the floodgates for frivolous inspection lawsuits. The court fears that shareholders who do not earnestly suspect corporate mismanagement will flock to the courthouse to fish for information that may, if luck strikes, pay off.

2. Factors Casting Doubt on the Delaware Supreme Court's Assumption of Frivolous Lawsuits

Legal scholars argue that shareholders bring frivolous lawsuits for the following reasons: (1) because potential recovery is high relative to the cost of litigation;¹⁴⁹ (2) to elicit a settlement from an opponent whose stakes in losing the lawsuit are high;¹⁵⁰ and (3) to elicit a settlement from an opponent whose litigation costs are high and who, accordingly, desires to settle.¹⁵¹ However, these factors are not especially relevant in shareholder inspection lawsuits.

First, unlike plenary lawsuits in which shareholders receive a pecuniary reward from a favorable judgment or settlement, shareholders win an inspection lawsuit by gaining access to corporate records. Monetary compensation may come later in a plenary action if the inspection reveals damning information about management and the information is strong enough to survive a motion to dismiss and therefore entice the defendant to settle. This process is laden with uncertainty at every stage leading to the final resolution: no one knows what information the inspection will uncover, how long the inspection lawsuit will last and cost, and for how much the defendant will be willing to settle (which depends on the evidence discovered through inspection). These uncertainties make performing a cost-benefit analysis difficult for shareholders initiating an inspection lawsuit.

Second, while the defendant corporation may have a high stake (e.g., the risk of a tarnished reputation and a large damage assessment) in an eventual plenary action that incentivizes a no-admit-no-deny settlement, the defendant's desire to settle does not typically exist when shareholders initiate an inspection lawsuit. This is because if the inspection produces evidence that helps shareholders survive a motion to dismiss, the defendant can *then* assess the strength of the

¹⁴⁹ Charles M. Yablon, *The Good, the Bad, and the Frivolous Case: An Essay on Probability and Rule 11*, 44 UCLA L. REV. 65, 89 (1996) (“[I]f the potential recovery is high relative to litigation costs, that fact alone may make it worthwhile to bring low-probability claims.”).

¹⁵⁰ Theodore Eisenberg, *Litigation Models and Trial Outcomes in Civil Rights and Prisoner Cases*, 77 GEO. L.J. 1567, 1581 (1990). In cases of asymmetrical stakes, such as labor disputes, the loss to the defendant includes reputational damage and a greater likelihood of additional claims being filed and succeeding. Accordingly, defendants have a strong incentive to settle all cases if there is a palpable chance of losing. Plaintiffs' counsel, aware of this effect, will have an incentive to bring claims even when the chance of success of such claims is rather low.

¹⁵¹ See Paul Stancil, *Balancing the Pleading Equation*, 61 BAYLOR L. REV. 90, 146 (2009) (stating that the risk of strike suit is low if pretrial costs are typically balanced or favor the defendant).

shareholders' claims and make an informed settlement offer. This is what happens in practice.¹⁵² A defendant's offer to settle before shareholders even start to inspect the corporate records is considered inherently incriminating.

Third, litigation is costly, and the cost asymmetry in inspection lawsuits does not necessarily skew in favor of shareholders like it does in plenary actions. In the U.S., parties to a lawsuit bear their own legal costs, although the court may award attorney fees to the successful party when the other side acts "in bad faith, vexatiously, wantonly, or for oppressive reasons," or for any other equitable causes.¹⁵³ "Bad faith" arguably includes intentionally bringing frivolous lawsuits and other bad behavior during litigation.¹⁵⁴ The average hourly rate for a Delaware corporate lawyer is \$373.00.¹⁵⁵ On average, the period between the date of the initial court filing and the date of the final outcome in an inspection lawsuit spans about 10 months.¹⁵⁶ The average plaintiff files 182 pages of court documents (while the average defendant files 152 pages).¹⁵⁷ Inspection lawsuits are no longer summary proceedings, given the long wait for a resolution and the copious legal workload involved. A lower standard of proof for shareholders could speed up the battle somewhat, but the cost may still be sizable, as disputes about the scope of the inspection, the conditions for granting the inspection, the requestor's status as a shareholder, and more can drag on. Given the importance of shareholders' investigation to subsequent proceedings on the merits of the complaint, "defendants [corporations] have turned books and records litigation into a surrogate proceeding to litigate the possible merits of the suit where they place obstacles in the plaintiffs' way to obstruct them from employing it as a quick and easy pre-filing discovery tool."¹⁵⁸

Empirical evidence shows that only about 30 percent of investigative inspections lead to shareholders subsequently filing a merit-based lawsuit.¹⁵⁹ Since an inspection lawsuit generates no immediate financial compensation, and the inspection outcome is unknown *ex-ante*, shareholders' attorneys are unlikely to accept a contingent fee arrangement unless they believe, based on existing evidence, that such a proceeding is an integral part of a lucrative future litigation.¹⁶⁰ Contingent fee is even harder to obtain for shareholders of private corporations. That is because even if an inspection lawsuit is successful and the inspection fruitful, there are fewer similarly situated shareholders to form a class for the subsequent merit-based lawsuits,¹⁶¹ so the financial stakes are much lower than those in cases involving large public companies.

Moreover, because of a (much) smaller shareholder base, shareholders of private corporations each bear a disproportionately higher portion of the litigation costs than shareholders of large public companies in a similar lawsuit. Compared to the defendant corporation, shareholders of private companies do not enjoy any apparent cost asymmetry that would motivate them to utilize inspection as a tool to extort a lucrative settlement. For these reasons, scholars have argued that

¹⁵² Iljoong Kim & Jaehong Kim, *Frivolous Suits in the Infinitely-Repeated Litigation Game with Uncertainty*, 56 HITOTSUBASHI J. ECON. 21–33 (2015).

¹⁵³ Hall v. Cole, 412 U.S. 1, 5 (1973); see also Thomas Allan Heller, *An Overview of the Law of Attorney Fees in the United States: The American Rule Is Not So Simple After All*, 10 LEXONOMICA 45, 53 (2018).

¹⁵⁴ Hall, 412 U.S. at 15.

¹⁵⁵ *How Much Do Lawyers Charge in Delaware?*, CLIO, <https://www.clio.com/resources/legal-trends/compare-lawyer-rates/de/>(last updated 2021).

¹⁵⁶ Cox et al., *supra* note 2, at 2149–50.

¹⁵⁷ *Id.* AT TBL.3.

¹⁵⁸ *Id.* at 2150.

¹⁵⁹ *Id.* at tbl.4.

¹⁶⁰ *Id.* at 2153.

¹⁶¹ See DEL. CH. CT. R. 23(a) (providing in pertinent part that a class action may be maintained "only if . . . the class is so numerous that joinder of all members is impracticable . . .").

frivolous lawsuits by shareholders of private companies are not a serious concern that would warrant the same degree of evaluation at the pleading stage as lawsuits brought by shareholders of public companies.¹⁶²

3. The Delaware Supreme Court's Underestimation of Credible Basis's Deterrence Effect

In *Seinfeld*,¹⁶³ the plaintiff agonized over how credible basis had turned shareholders' inspection rights into merely "a mirage." In response, the Delaware Supreme Court pointed out that over the decade leading up to the dispute, *Seinfeld* was only the second time when a shareholder was denied access to corporate records for failing to satisfy credible basis, while in "a myriad of cases" shareholders had successfully satisfied the burden.¹⁶⁴ In its counting, the court apparently failed to consider the cases where shareholders had a bona fide suspicion of corporate mismanagement, demanded records from the corporation unsuccessfully, and chose not to assert their rights in court due to concerns about lacking the extrinsic evidence needed to meet the credible basis requirement.

Statute grants shareholders a right to inspect corporate records for a proper purpose, case law recognizes that investigating managerial misconduct is a proper purpose, and the court exhorts shareholders to use the "tools at hand" to gather evidence before pleading their cases. Still, the law circularly insists that shareholders meet a burdensome evidence threshold before making the "tools at hand" available. If, as a result, sincere shareholders are deterred from asserting their statutory rights in court, fundamental distrust of the legal system will grow. Lack of confidence in the law is a social problem that affects not just the monetary value of a corporation but the wellbeing of a society made up of billions of people. Thus, in the court's cost-benefit analysis, credible basis's deterrence effect should not be ignored. The inquiry should not stop at whether a lower standard (i.e., rational belief) might induce frivolous lawsuits but instead should weigh the likelihood of inducement with the likelihood of deterrence under credible basis. If both evils exist, but inducement occurs less often—and there is basis for suspecting so, given the diminished incentives discussed in previous paragraphs—rational belief is a worthy tradeoff for credible basis.

V. CREDIBLE BASIS OR RATIONAL BELIEF: EMPIRICAL EVIDENCE

This part of the paper answers two questions: (1) whether there is evidence that rational belief induces frivolous lawsuits; and (2) how probable inducement is under rational belief compared to how probable deterrence is under credible basis. As discussed earlier, the Delaware Supreme Court in *Seinfeld* assumed the answer to the first question was affirmative and, based on that assumption, rejected rational belief. However, that assumption's validity has not been empirically verified, nor is the assumption self-evident in light of the mitigating factors discussed in the previous section. If the assumption finds support in data, then the second question grows in importance.

This analysis focuses on the propensity of shareholders to file an inspection lawsuit when faced with varying levels of budget and time constraints, give their assessments of managerial

¹⁶² HAMERMESH & WACHTER, *SUPRA* NOTE 93, AT 647.

¹⁶³ *Seinfeld v. Verizon Commc'ns, Inc.*, 909 A.2d 117, 119 (Del. 2007).

¹⁶⁴ *Id.* at 124 ("Although many cases 220 proceedings have been filed since we decided *Security First* and *Thomas & Betts*, Verizon points out that *Seinfeld*'s case is only the second proceeding in which a plaintiff's demand to investigate wrongdoing was found to be *entirely* without a 'credible basis.' In contrast, there are a myriad of cases where stockholders have successfully presented 'some evidence' to establish a 'credible basis' to infer possible mismanagement and thus received some narrowly tailored right of inspection.").

misconducts and chances of successfully meeting the applicable burden of proof. This analysis adopts the setting of a *private* company that is incorporated in Delaware because, as discussed earlier, shareholders of private companies are most vulnerable to the evidentiary burden of credible basis.

A. Experimental Design

The empirical analysis in this section draws on data from a survey that the author conducted in 2021 (the “Survey”). The participants were 52 second- and third-year law students enrolled in a Business Associations class at the University of Cincinnati College of Law. Each participant took the role of a minority shareholder of a *private* company who had no representative on the board nor any direct information about the board’s decisions and activities.

The participants in this Survey are reasonable representatives of the claimants of inspection rights against private companies. There are two types of shareholders investing in private companies—institutions and individuals. Institutions include private equity funds, mutual funds of varying sizes, as well as industrial companies that have taken a stake for strategic or operational reasons. Institutional shareholders typically are informed about the company’s financial and operational conditions and the reasons for the board’s business decisions through appointing representatives on the board, stationing observers in the board room, or contracting for information rights upon making investments.¹⁶⁵ Thus, institutional shareholders usually do not need to rely on their statutory inspection rights to access corporate information. Inspection rights are most likely asserted by individual shareholders (e.g., employees who became shareholders through exercising stock options) who lack representatives on the board and the ability to bargain for information rights. Such individual shareholders typically seek legal advice when deciding whether to bring a lawsuit, and their decisions are likely influenced by the views of their attorneys. The second- and third-year law students participating in this Survey will provide such legal advice to their clients after graduation, so their views on the advisability of an inspection lawsuit likely reflect the decisions of individual shareholders of private companies.

The Survey instructions briefed the participants on DGCL § 220, the proper purpose requirement, and two different standards of proof (i.e., credible basis and rational belief). The descriptions of those two standards mirrored courts’ definitions and requirements.

The participants were then given two scenarios about the performance of a hypothetical small *private* company incorporated in Delaware. In Scenario 1, the company’s sales revenue had been flat over the previous 3 years. In Scenario 2, the company had not only experienced flat revenue growth over the previous 3 years but also lost a substantial market share (from 70% to 20%) to its direct competitors. The company failed to capture the tailwind of an overall increase in market demand for the type of product the company made. The participant demanded to inspect the minutes of board meetings to ascertain whether the board was reasonably diligent in managing the

¹⁶⁵ See Michael Ewens & Nadya Malenko, *Board Dynamics over the Startup Life Cycle*, NBER Working Paper Series, Working Paper 27769 (2020), <https://www.nber.org/papers/w27769> (noting, from a data sample of 7,780 startup companies, a widespread phenomenon of shared control of the board by entrepreneur-founders and venture capital investors); Paul A. Gompers et al., *How Do Venture Capitalists Make Decisions?*, 135 J. FIN. ECON. 169, 171 (2020) (finding that venture capitalists attach great importance to board control when making investment decisions); Jennifer Fan, *The Landscape of Startup Corporate Governance in the Founder-Friendly Era*, 18 N.Y.U. J.L. & BUS. 317, 330–31, 350 n.173 (noting that venture capital firms actively participate in the business decisions of portfolio startup companies and that mutual funds, pension funds, and strategic industrial investors often get board observer seats).

company. The board rejected the demand. The participant now faced the decision of whether to bring an inspection lawsuit.

For each scenario, the participants were asked to answer an *identical* set of questions about their belief in the likelihood of mismanagement, their ability to meet the burden of proof under credible basis and rational belief (or good faith belief), respectively, and the likelihood of incurring a budget deficit for the lawsuit. The participants were also asked to indicate the level of time and energy that they could spare on the lawsuit. In the end, the participants were asked to decide whether they would bring the lawsuit and to rank the importance of a given set of factors in their decision (i.e., likelihood of a successful lawsuit, cost, time and energy, managerial misconduct, and getting revenge or harassing management). The Survey provided 52 sets of paired data that formed the basis for analyzing the participants’ propensity to bring an inspection lawsuit under credible basis and rational belief, respectively. A full description of the Survey is provided in Appendix A.

B. Summary Statistics

Tables 1 through 3 show the summary statistics of the participants’ decisions on whether they would bring an inspection lawsuit in light of their beliefs in the likelihood of mismanagement. The statistics offer preliminary evidence on credible basis’s deterrence and rational belief’s inducement.

Table 1 To Sue or Not to Sue

| | Scenario 1 (Weak Case) | | Scenario 2 (Stronger Case)* | |
|-----------------|------------------------|---------|-----------------------------|---------|
| | Sue | Not Sue | Sue | Not Sue |
| Credible Basis | 0 | 52 | 15 | 36 |
| Rational Belief | 11 | 41 | 42 | 9 |

* One participant did not answer this question, so the total entries for this question is 51.

According to Table 1, none of the participants chose to file an inspection lawsuit in Scenario 1 under credible basis. In contrast, about 21.2% (i.e., 11 out of 52) would sue under rational belief. In Scenario 2, an overwhelming majority of the participants (70.6% or 36 out of 51) still chose not to sue under credible basis, but once the standard is lowered to rational belief, the vast majority (82.4% or 42 out of 51) chose to sue. Recall from the experimental design that Scenario 1 involved a flat revenue growth but no other signs of mismanagement, so it was a weak case. Scenario 2 involved an additional factor that the company had lost a significant market share to its competitors, so it was a stronger case.

Table 2 Assessment of Mismanagement
(Unlikely = 1, Almost Certainly = 5)

| | 1 | 2 | 3 | 4 | 5 | Mean | Median |
|----------------------------|----|----|----|----|----|------|--------|
| Scenario 1 (Weak Case) | 14 | 26 | 8 | 3 | 1 | 2.06 | 2 |
| Scenario 2 (Stronger Case) | 1 | 4 | 12 | 24 | 11 | 3.77 | 4 |

Table 2 shows the participants’ assessment of the likelihood of mismanagement. For Scenario 1, a strong majority of the participants (76.9% or 40 out of 52) entered “1” or “2” for a low probability, but a few (7.7% or 4 out of 52) entered “4” or “5” for a high probability. For Scenario

2, a few participants (9.6% or 5 out of 52) entered “1” or “2”, whereas a strong majority (67.3% or 35 out of 52) entered “4” or “5.”

Table 3 combines entries for Scenarios 1 and 2 to show the number and percentage of participants who chose to bring an inspection lawsuit under varying beliefs about mismanagement.

Table 3 Deterrence v. Inducement
(Number and Percentage of Participants Who Decided to Sue)

| | Credible Basis | Rational Belief |
|------------------------|----------------------|---------------------|
| Mismanagement = 4 or 5 | 15/39 (38.5%) | 36/39 (92.3%) |
| Mismanagement = 1 or 2 | 0/45 (0.0%) | 7/45 (15.6%) |
| Mismanagement = 3 | 0/19 (0.0%) | 10/19 (52.6%) |

Among participants who strongly suspected that mismanagement occurred (i.e., Mismanagement = 4 or 5), only 38.5% (or 15 out of 39) chose to sue under credible basis, and that number changed to 92.3% (or 36 out of 39) once the standard was lowered to rational belief. The difference between the two numbers (53.8%) was attributable to the deterrence effect of credible basis. Among participants who believed that mismanagement was unlikely or had a very low probability (i.e., Mismanagement = 1 or 2), only 15.6% (or 7 out of 45) chose to sue under rational belief, whereas none chose to sue under credible basis. This difference reflects the inducement effect of rational belief. Rational belief induced 15.6% of the participants to file frivolous lawsuits, but credible basis deterred 53.8% of them from bringing bona fide lawsuits. Deterrence outweighed inducement.

Table 4 shows the participants’ assessments of the likelihood of a successful inspection lawsuit. Unsurprisingly, rational belief boosted a participant’s confidence in winning the lawsuit in both scenarios. That observation was evident from the higher mean and median values under rational belief. The differences between the standards were statistically significant.¹⁶⁶

Table 4 Assessment of Likelihood of Success
(Unlikely = 1, Almost Certainly = 5)

| | 1 | 2 | 3 | 4 | 5 | Mean | Median |
|-----------------------------------|----|----|----|----|----|------|--------|
| Scenario 1 (Weak Case) | | | | | | | |
| Credible Basis | 38 | 11 | 0 | 2 | 1 | 1.4 | 1 |
| Rational Belief | 3 | 17 | 15 | 13 | 4 | 2.96 | 3 |
| Scenario 2 (Stronger Case) | | | | | | | |
| Credible Basis | 10 | 14 | 16 | 11 | 1 | 2.6 | 3 |
| Rational Belief | 0 | 3 | 9 | 17 | 22 | 4.14 | 4 |

Since cost was likely a key factor in a participant’s decision on whether to bring a lawsuit, Table 5 reports the participants’ assessment of their budget constraints (i.e., how likely they believed litigation costs would exceed the resources they could spend on the litigation).

¹⁶⁶ The paired t-tests for the difference in the mean and the sign tests for the difference in the median all had a p-value of near 0.

Table 5 Assessment of Budget Constraints
(Unlikely = 1, Almost Certainly = 5)

| | 1 | 2 | 3 | 4 | 5 | Cannot Assess | Mean | Median |
|----------------------------|---|---|----|----|----|---------------|------|--------|
| Scenario 1 (Weak Case) | | | | | | | | |
| Credible Basis | 4 | 5 | 1 | 6 | 31 | 5 | 4.17 | 5 |
| Rational Belief | 1 | 4 | 17 | 19 | 6 | 5 | 3.53 | 4 |
| Scenario 2 (Stronger Case) | | | | | | | | |
| Credible Basis | 2 | 9 | 7 | 14 | 15 | 5 | 3.66 | 4 |
| Rational Belief | 3 | 5 | 20 | 12 | 7 | 5 | 3.32 | 3 |

In Scenario 1, Budget Constraints had a higher mean and median under credible basis than rational belief, and the differences were statistically significant.¹⁶⁷ A more difficult standard portended a tougher and prolonged battle in court, necessitating a higher litigation cost that was more likely to exceed a participant’s budget. In Scenario 2, credible basis was also associated with a higher mean and median, but the differences with those under rational basis were weakly significant in the median only.¹⁶⁸ Under rational belief, a substantial number of participants (46.2% or 24 out of 52) still entered “4” or “5,” even in the stronger case of Scenario 2.

Lawsuits consume time and energy, and that likely influences a person’s decision to sue. Table 6 reports participants entries in this regard, given their existing commitments to other matters in life.

Table 6 Time & Energy for Lawsuit
(No Time or Energy =1, Can Spend Full Time and Energy = 5)

| | 1 | 2 | 3 | 4 | 5 | Mean | Median |
|----------------------------|----|----|----|----|---|------|--------|
| Scenario 1 (Weak Case) | 13 | 18 | 19 | 1 | 0 | 2.1 | 2 |
| Scenario 2 (Stronger Case) | 6 | 11 | 20 | 15 | 0 | 2.8 | 3 |

Participants entered “3” more than other numbers. That choice signifies uncertainty in the participants’ assessments of the time and energy they could devote to a lawsuit. The mean and median were in the lower half of the spectrum for both scenarios. Interestingly, Scenario 2 (the stronger case with a higher chance of successful litigation) engendered a more optimistic assessment about available time and energy, which was reflected in the higher mean and median values relative to Scenario 1.¹⁶⁹

At the end of the Survey, participants were asked to rank the factors in terms of importance to them in deciding whether to sue. Tables 7 and 7A show the results.

¹⁶⁷ The paired t-test for the difference in means had a p-value of 0.003, and the sign test for the difference in medians had a p-value of 0.0005.

¹⁶⁸ The paired t-test for the difference in means had a p-value of 0.12, and the sign test for the difference in medians had a p-value of 0.05.

¹⁶⁹ The paired t-test for the difference in means had a p-value of 0.0000002, and the sign test for the difference in medians had a p-value of 0.0000002.

Table 7 Factor Ranking in Litigation Decision (Scenario 1 Weak Case)
(Least Important = 1, Most Important = 5)

| | 1 | 2 | 3 | 4 | 5 | Mean | Median |
|-------------------|----|----|----|----|----|------|--------|
| Lawsuit Success | 1 | 6 | 7 | 16 | 22 | 4.0 | 4 |
| Budget Constraint | 2 | 1 | 11 | 19 | 19 | 4.0 | 4 |
| Mismanagement | 4 | 18 | 14 | 9 | 7 | 2.9 | 3 |
| Time and Energy | 0 | 22 | 17 | 12 | 1 | 2.9 | 3 |
| Harassment | 44 | 3 | 1 | 1 | 3 | 1.4 | 1 |

Table 7A Factor Ranking in Litigation Decision (Scenario 2 Stronger Case)
(Least Important = 1, Most Important = 5)

| | 1 | 2 | 3 | 4 | 5 | Mean | Median |
|-------------------|----|----|----|----|----|------|--------|
| Lawsuit Success | 1 | 8 | 8 | 12 | 21 | 3.9 | 4 |
| Budget Constraint | 4 | 4 | 16 | 13 | 13 | 3.5 | 4 |
| Mismanagement | 3 | 8 | 14 | 15 | 10 | 3.4 | 3.5 |
| Time and Energy | 3 | 23 | 11 | 12 | 1 | 2.7 | 2 |
| Harassment | 38 | 5 | 1 | 0 | 6 | 1.6 | 1 |

The first four factors have the same meaning as they do in previous tables. The last factor, Harassment, represents the participant's desire to harass or distract management through inspection requests. Malicious litigation is the extreme form of frivolous lawsuit that the law should prevent. Financial reward is not included in the list of choices because a successful inspection lawsuit merely allows the plaintiff to access corporate records instead of receiving any financial compensation.

The factors were ranked identically across scenarios. Lawsuit Success ranks the highest, followed closely by Budget Constraints, then Mismanagement. This hierarchy suggests that practical considerations, such as the prospect of winning the lawsuit, and litigation costs are more important than the likelihood of mismanagement. In other words, a participant could *possibly* choose to sue if the probability of winning is high and the cost is low, with the likelihood of mismanagement being relegated to a lesser concern. This ranking hints at the possibility of an increase in frivolous lawsuits once the standard of proof is lowered. The lowest rank of Harassment indicates that lawsuits driven by malice are rare occurrences.

C. Logit Regression

A logit regression was run by pooling observations from both scenarios. The dependent variable was a dummy that took the value of "1" if a participant chose to file an inspection lawsuit, and "0" otherwise. The explanatory variables included a dummy for Rational Belief, Mismanagement, Budget Constraint, and Time&Energy that the participant could devote to the lawsuit. The regression result is produced in Table 8.

Table 8 Logit Regression for Filing Inspection Lawsuit

| | Estimate | Std. Error | z Value | Pr(> z) |
|-------------------|----------|------------|---------|----------|
| (Intercept) | -10.43 | 3.19 | -3.27 | 0.001 |
| Rational Belief | 3.87 | 1.10 | 3.50* | 0.0005 |
| Mismanagement | 1.66 | 0.52 | 3.19* | 0.001 |
| Budget Constraint | -0.43 | 0.27 | -1.58 | 0.113 |
| Time&Energy | 1.29 | 0.46 | 2.81* | 0.005 |

* Significant at 5%. R² is 0.66

Rational Belief is positive and significant at the 5% level. That predicts an increase in the probability of inspection lawsuits if the standard of proof is lowered, holding other factors constant. This regression result corroborates the summary statistics reported in Table 3 in that some participants chose to sue even though they had a low assessment of the probability of mismanagement. The numbers validate the Delaware Supreme Court’s assumption that rational belief increases frivolous lawsuits.

Other observations from this regression are consistent with expectations: the probability of filing a lawsuit increases with the participant’s suspicion of mismanagement, as evinced by the positive and significant coefficient for Mismanagement. The propensity to litigate is negatively correlated with Budget Constraint and positively correlated with Time&Energy that a participant could spare on the litigation.

Rational belief will increase frivolous lawsuits, but to what extent? More importantly, how does the probability of frivolous lawsuits compare to the probability of deterrence by credible basis? These questions can be answered by calculating the probabilities of filing suit from the estimated logit model with an assumed value for each independent variable. An inducement effect is captured by the *difference* in the probabilities of filing suit under the two standards of proof when the potential litigant has a low assessment of Mismanagement (i.e., Mismanagement = 1 or 2). Conversely, a deterrence effect is measured by the *difference* in the probabilities when the potential litigant has a high assessment of Mismanagement (i.e., Mismanagement = 4 or 5).

To conserve space without sacrificing the accuracy of the analysis, Table 9 reports the differences in the probabilities by holding Time&Energy constant at “3.” Recall from Table 6 that “3” was selected most often by the participants for this variable in the survey. This value reflects the participant’s ambivalence about how much time and energy to devote to the lawsuit. Intuitively, this choice is close to reality because how much effort we put into a particular matter (e.g., a work project, investment, education, relationship, or lawsuit) often depends on the matter’s financial and/or emotional payoff, and the payoff estimation fluctuates throughout the course of the matter, making it difficult for us to know *ex-ante* how much effort we are willing and able to expend.

Table 9 Differences in Probabilities of Lawsuit between Credible Basis and Rational Belief
(Time&Energy = 3)

| | <u>Budget Constraint</u> | | | | |
|-------------------|--------------------------|------|------|------|------|
| | 1 | 2 | 3 | 4 | 5 |
| Mismanagement = 1 | 0.18 | 0.13 | 0.09 | 0.06 | 0.04 |
| Mismanagement = 2 | 0.52 | 0.43 | 0.33 | 0.24 | 0.17 |
| Mismanagement = 3 | 0.75 | 0.73 | 0.68 | 0.60 | 0.51 |
| Mismanagement = 4 | 0.56 | 0.64 | 0.70 | 0.74 | 0.75 |
| Mismanagement = 5 | 0.21 | 0.28 | 0.38 | 0.48 | 0.57 |

When Mismanagement = 1 (i.e., the potential litigant does not believe that mismanagement has occurred), rational belief causes the probability of lawsuit to increase by 4-18%, signifying the extent of its inducement of frivolous lawsuits. On the other end of the spectrum, when Mismanagement = 5 (i.e., the potential litigant is almost certain that mismanagement has occurred), credible basis causes the probability of lawsuit to decrease by 21-57%, denoting the extent of its deterrence of bona fide inspection lawsuits. Deterrence overshadows inducement at every Budget Constraint level.

When Mismanagement = 2 (i.e., the potential litigant is very weakly suspicious of mismanagement), rational belief causes the probability of lawsuit to increase by 17-52%. For those people who believe that lawsuits should not be filed when the litigant has just a weak suspicion of wrongdoing, this range quantifies rational belief’s inducement effect. In comparison, when Mismanagement = 4 (i.e., the potential litigant strongly suspects, but is unsure, that mismanagement has occurred), credible basis lowers the probability of filing suit by 56-75%. Again, deterrence outweighs inducement at every Budget Constraint level.

In sum, the above analysis shows that for inspection lawsuits involving private companies, rational belief’s inducement and credible basis’s deterrence both exist, but deterrence outweighs inducement by a large margin at every level of Budget Constraint. The Delaware Supreme Court grossly underestimated deterrence by ignoring bona fide inspection lawsuits that should have been filed but were not due to shareholders’ inability to obtain extrinsic evidence. It appears that at least for shareholders of private companies (which typically provide little information to the public), replacing credible basis with rational belief is a worthy tradeoff.

VI. HOW TO MITIGATE AGAINST THE COSTS OF FRIVOLOUS INSPECTIONS UNDER RATIONAL BELIEF

If the law adopts the permissive standard of rational belief, how should it mitigate the concern about frivolous inspection suits and the consequential costs to the corporation? The costs include not only the pecuniary expenses of making the documents ready for inspection but also the damage resulting from exposing proprietary information. This section first discusses the existing preventative measures and then proposes an additional mechanism to bolster the defense.

A. Existing Preventative Measures: “Necessary and Essential” with “Rifled Precision,” the Tiered Approach, and the Condition of Confidentiality

Courts endeavor to minimize inspection costs by narrowly tailoring the scope to include documents that are necessary and essential to the stated purpose. The requested documents must address the crux of the shareholder’s stated purpose and be unavailable from other, more accessible

sources.¹⁷⁰ The Delaware Supreme Court cautioned that “a Section 220 proceeding should result in an order circumscribed with rifled precision.”¹⁷¹

The degree of precision required by “necessary and essential” is illustrated in *Espinoza v. Hewlett-Packard Co.*,¹⁷² where a shareholder demanded to inspect records related to the resignation of Hewlett-Packard’s CEO and his subsequent receipt of a large severance pay. The CEO was subject to sexual harassment allegations, so the company retained an outside counsel, Covington & Burling, to investigate. The investigation resulted in a report (the “Covington Report”) that revealed the CEO violated the company’s Standards of Business Conduct. The shareholder wanted to obtain a copy of the Covington Report, among a long list of documents, to ascertain whether the company might have been able to fire the CEO for cause, avoiding the large severance pay. The Delaware Supreme Court denied the request on the grounds that the shareholder failed to meet his burden of proving that the Covington Report was “necessary and essential” to the articulated purpose behind the inspection. The Court’s finding was premised on the company’s representation that the Covington Report did not discuss any for-cause termination option and the shareholder’s failure to show by a preponderance of the evidence that the Covington Report was central to the board’s decision not to terminate the CEO for cause.¹⁷³ So, the test of essentiality is document-specific, requiring more than a litigation-related reason for an inspection for which there is credible evidence to believe a claim exists.

Courts have also adopted a tiered approach to granting inspections as a way of mitigating costs. Formal board documents, such as resolutions and board meeting minutes, are first-tier documents used to satisfy shareholders’ requests. Such documents are typically stored in electronic form and readily provided without substantial costs to the corporation.¹⁷⁴ If these documents fail to meet the inspection’s purposes, courts move on to the second tier, which includes informal board documents (e.g., draft resolutions and emails to and from board members) and officer-level documents.¹⁷⁵ The production of such informal documents can be costly, as redaction may be necessary to protect proprietary or customer information.¹⁷⁶

¹⁷⁰ *Wal-Mart Stores, Inc. v. Ind. Elec. Workers Pension Tr. Fund IBEW*, 95 A.3d 1264 (Del. 2014).

¹⁷¹ *First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 570 (Del. 1997).

¹⁷² *Espinoza v. Hewlett-Packard Co.*, 32 A.3d 365 (Del. 2011).

¹⁷³ *Id.* at 372–73.

¹⁷⁴ *SEE LEB. CNTY. EMPS.’ RET. FUND V. AMERISOURCEBERGEN CORP*, C.A. No. 2019-0527-JTL, 2020 WL 132752, AT *24-25 (DEL. CH. JAN. 13, 2020) (FOOTNOTES OMITTED) (CITATIONS OMITTED), *AFF’D* 243 A.3D 417 (DEL. 2020) (“A CORPORATION SHOULD BE ABLE TO COLLECT AND PROVIDE ITS FORMAL BOARD MATERIALS PROMPTLY AND WITH MINIMAL BURDEN. IN MANY ORGANIZATIONS, THE CORPORATE SECRETARY MAINTAINS A CENTRAL FILE FOR EACH BOARD MEETING IN EITHER PAPER OR ELECTRONIC FORM THAT CONTAINS THE MINUTES AND OTHER FORMAL BOARD MATERIALS FOR THAT MEETING.”).

¹⁷⁵ *See, e.g., Woods v. Sahara Enters., Inc.*, 238 A.3d 879 (Del. Ch. 2020) (holding that shareholders’ requests for formal board materials related to the company’s financial information were pertinent to the valuation purpose but requests for informal board and officer-level materials concerning financial forecasts were not necessary and essential to the valuation purpose); *KT4 Partners LLC v. Palantir Techs. Inc.*, 203 A.3d 738 (Del. 2019) (granting an inspection of board members’ emails after the shareholder showed that the corporation did not honor traditional corporate formalities and had acted through emails in connection with the alleged wrongdoing that was the subject of the investigation); *Wal-Mart Stores, Inc. v. Ind. Elec. Workers Pension Tr. Fund IBEW*, 95 A.3d 1264 (Del. 2014) (granting inspection of officer-level documents because such documents help discover the extent of the wrongdoing and any shortcomings in Wal-Mart’s compliance program).

¹⁷⁶ *Geeyoung Min & Alexander M. Krischik, Realigning Stockholder Inspection Rights*, 27 *STAN. J.L. BUS. & FIN.* 225, 247 (2022).

Courts have broad discretion to limit the scope of an inspection and prescribe conditions shareholders must follow before, during, and after the inspection.¹⁷⁷ In exercising this discretion, courts have shown a keen concern for protecting corporations' proprietary information; they have denied access to otherwise "necessary and essential" documents when an overriding confidentiality need is present¹⁷⁸ and imposed a finite or indefinite duration of confidentiality as a condition for inspection. Courts also routinely arrange an in-camera review to determine if materials that allegedly contain sensitive information should be excluded from inspection.¹⁷⁹

B. A Proposal for Cost-Shifting to Deter Frivolous Inspections

If the law replaces credible basis with rational belief as the burden of proof for a proper inspection purpose, it should also adopt a cost-shifting paradigm to work alongside "necessary and essential" in fending off frivolous inspections. The author proposes a paradigm that works in sequence as follows: (1) Upon showing a rational (or good faith) belief of mismanagement through evidence or sound logic, shareholders will be granted access to "necessary and essential" documents that the corporation can produce without undue burden. These documents typically include, but are not limited to, formal board resolutions, minutes for board and committee meetings, etc., that courts regard as first-tier in the order of inspection discussed in the previous section of this paper. The corporation bears the burden of proof for "undue burden." (2) If the first-tier documents reveal evidence that would have satisfied credible basis, inspection of other documents can proceed, just as under the current regime. On the other hand, if the first-tier inspection still fails the credible basis requirement, the court has discretion to deny further inspections, sample the requested documents at the expense of the corporation to ascertain the utility of further inspections, or allow inspections to continue but shift the production costs in full or in part to the requestors, with an understanding that the cost will be reimbursed by the corporation if inspections reveal incriminating evidence commensurate with credible basis. In exercising this discretion, the court should consider a wide range of factors, such as the likelihood of finding relevant information from the requested documents, the cost of inspections, and the resources of the parties and their incentives to control costs. It is worth emphasizing that "necessary and essential" is an overarching requirement in this process, so cost-shifting is not a greenlight to "indiscriminate fishing expeditions" by wealthy shareholders who are willing to pay for inspections.

The above paradigm can be summarily stated as rational belief plus cost-shifting. It offers a few benefits: (1) Shareholders can quickly access formal board and committee materials in most cases to help them assess the strength of their claims, plead a plenary action, or build a credible basis for further inspections. This is an improvement from the current regime because shareholders are better off while the corporation is not significantly worse off. (2) Cost-shifting for expensive items deters "indiscriminate fishing expeditions" or malicious inspections, and this deterrence

¹⁷⁷ DEL. CODE ANN. tit. 8, § 220(c) (2020); Cox et al., *supra* note 2, at 2133.

¹⁷⁸ *Pershing Square, L.P. v. Ceridian Corp.*, 923 A.2d 810, 820 (Del. Ch. 2007) (denying a shareholder's request to inspect two letters written by an executive to the board of directors because the letters were marked "Confidential" and their disclosure would chill candid communications between executives and the board).

¹⁷⁹ *See, e.g., N.Y. Times Co. v. Jascalevich*, 439 U.S. 1317 (1978) (holding that a trial court is responsible for determining, through *in camera* review, if each individual document presented by the party claiming privilege is indeed privileged material).

effect has been applauded by legal scholars advocating for cost-shifting.¹⁸⁰ (3) Reimbursement ensures that compared to the current regime of credible basis, cost-shifting does not benefit the corporation at the expense of shareholders if inspections reveal evidence that would have satisfied credible basis. Reimbursement also addresses the concern that corporations would deliberately store records in a manner that makes their production costly to deter inspections under a cost-shifting mechanism. Such a concern has been raised by scholars about shifting pre-trial discovery costs to the plaintiff.¹⁸¹

Although producer-pay is the default modality in the U.S. for adversarial discoveries, there is no statute or rule that mandates it.¹⁸² Courts have often sanctioned cost-shifting for pre-trial electronic discoveries that are particularly costly. Rule 26(b)(2)(B) was added to the Federal Rules of Civil Procedure¹⁸³ in 2006 to address the discoverability of electronically stored information. The rule makes data whose restoration imposes an “undue burden or cost” presumably undiscoverable.¹⁸⁴ The responding party to the discovery has the burden of proving this aspect.¹⁸⁵ However, this presumption can be overcome by the requesting party showing a “good cause.” The rule’s advisory committee’s notes introduced seven factors to help courts determine “good cause”: (1) the specificity of the discovery request; (2) the quantity of information available from other and more easily accessed sources; (3) the failure to produce relevant information that seems likely to have existed but is no longer available from more easily accessed sources; (4) the likelihood of finding relevant, responsive information that cannot be obtained from other, more easily accessed sources; (5) predictions as to the importance and usefulness of the information; (6) the importance of the issues at stake in the litigation; and (7) the parties’ resources.¹⁸⁶

Although Rule 26(b)(2)(B) does not directly reference cost-shifting, the advisory committee’s notes seem to endorse the application of the factors to cost-shifting by stating that “[a] requesting party’s willingness to share or bear the access costs may be weighed by the court in determining whether there is good cause.”¹⁸⁷ Some courts have indicated a willingness to use those factors as guidance for cost-shifting.¹⁸⁸

¹⁸⁰ See, e.g., Jonathan Remy Nash & Joanna Shepherd, *Aligning Incentives and Cost Allocation in Discovery*, 71 VAND. L. REV. 2015, 2028 (2018) (“Because the requesting party could no longer externalize the costs of his discovery requests, he would have the incentive to only request discovery for which he expected the benefits to exceed the costs. The externality that was created under the producer-pays rule by allowing requesting parties to impose costs on producing parties would be eliminated.”).

¹⁸¹ See, e.g., Vlad Vainberg, *When Should Discovery Come with a Bill? Assessing Cost Shifting for Electronic Discovery*, 158 U. PA. L. REV. 1523, 1557 n.217 (2010).

¹⁸² Martin H. Redish, *Discovery Cost Allocation, Due Process, and the Constitution’s Role in Civil Litigation*, 71 VAND. L. REV. 1847, 1855 (2018).

¹⁸³ FED. R. CIV. P. 26(b)(2)(B).

¹⁸⁴ *Id.*

¹⁸⁵ FED. R. CIV. P. 26(b)(2) advisory committee’s note to 2006 amendments.

¹⁸⁶ *Id.*

¹⁸⁷ *Id.*

¹⁸⁸ See, e.g., *Pipefitters Local No. 636 Pension Fund v. Mercer Hum. Res. Consulting, Inc.*, No. 05-74326, 2007 WL 2080365, at *2 (E.D. Mich. July 19, 2007) (reversing a magistrate judge’s order that plaintiffs pay for restoring defendants’ data because the magistrate failed to engage in an analysis under the Rule 26(b)(2)(B) of whether accessing the requested information entails an undue burden and cost).

In addition to Rule 26(b)(2)(B), Rule 26(b)(1)¹⁸⁹ specifies general conditions for granting discovery. This section requires courts to consider the importance of (1) the issues at stake in litigation; (2) the amount in controversy; (3) the parties' relative access to information; (4) the parties' resources; (5) the importance of the discovery in resolving the issues; and (6) whether the burden or expense of the proposed discovery outweighs its likely benefit. Some courts use these conditions as guidance for cost-shifting, with a focus on balancing the likelihood of retrieving relevant information and the undue burden on the responding party.¹⁹⁰

There are also courts that use Rule 26(b)(2)(B) solely for determining whether there is good cause for granting discovery of costly items and, once that is established, switch to a seven-factor test proffered by *Zubulake v. UBS Warburg LLC*¹⁹¹ for cost-shifting.¹⁹² These factors are: (1) whether the request is specifically tailored to discover relevant information; (2) whether the requested information is available from other sources; (3) the total cost of production, compared to the amount in controversy; (4) the parties' resources; (5) the ability of each party to control costs and its incentive to do so; (6) the importance of the issues at stake in the litigation to the general public; and (7) the relative benefits derived by the parties from obtaining the information. The *Zubulake* court emphasized that these factors were intended to illustrate the types of considerations that should be factored in courts' cost-shifting analyses and cautioned against using them for a "check-list" application.¹⁹³

The *Zubulake* court also stressed the importance of sampling in assessing the marginal utility of discovery when the responding party harps on its cost.¹⁹⁴ In that case, the court asked the defendant corporation subject to an employment discrimination lawsuit to produce emails from a sample of five inaccessible backup tapes selected by the plaintiff to see if they produced evidence of a hostile and discriminatory working environment. Following the sampling, the court applied the seven factors to reach a conclusion that the plaintiff should share 25% of the cost of restoring the backup-tapes.¹⁹⁵ The advisory committee's notes to Rule 26(b)(2) also encourage courts to use sampling in determining "good cause" for the purpose of this rule.¹⁹⁶

While shareholder inspections are more defined in scope than a full-scale pre-trial discovery, they share the same concern about excessive production costs amidst uncertainty about the informational value of production. The cost-shifting dynamic proposed above for shareholder inspections is consistent with the courts' approach to expensive pre-trial discoveries. Both Rule 26(b)(2)(B) and *Zubulake* require courts to consider the degree of specificity of the requested information and its availability from cheaper sources. In the context of shareholder inspections,

¹⁸⁹ FED. R. CIV. P. 26(b)(1).

¹⁹⁰ Vainberg, *supra* note 181, at 1562.

¹⁹¹ 217 F.R.D. 309, 322–23 (S.D.N.Y. 2003).

¹⁹² *Supra* note 190.

¹⁹³ *Zubulake*, 217 F.R.D. at 322–23.

¹⁹⁴ *Id.* at 323–24.

¹⁹⁵ *Id.* at 282, 285–86.

¹⁹⁶ *Supra* note 185 (“The good-cause determination, however, may be complicated because the court and parties may know little about what information the sources identified as not reasonably accessible might contain, whether it is relevant, or how valuable it may be to the litigation. In such cases, the parties may need some focused discovery, which may include sampling of the sources, to learn more about what burdens and costs are involved in accessing the information, what the information consists of, and how valuable it is for the litigation in light of information that can be obtained by exhausting other opportunities for discovery.”).

such considerations are already encompassed in a “necessary and essential” analysis for setting the scope of an inspection. For inspections that are costly (although “necessary and essential”), the proposed paradigm gives courts an opportunity to balance the utility of inspection against cost and halt inspection if justified by the analysis, as is the case under Rule 26(b)(2)(B) and Rule 26(b)(1). The fact that prior inspections have failed to unearth evidence sufficing for credible basis should be considered in the court’s balance. The proposed paradigm also embraces the court’s need to sample the requested documents to ascertain the utility of further inspections, a practice promoted by the advisory committee’s notes to Rule 26(b)(2) and the *Zubulake* court. Should the court decide to allow inspections to continue, the proposed paradigm acknowledges the court’s discretion in shifting some or all costs to the requesting shareholders after considering the parties’ resources, their incentive and ability to control costs, and any other factor that the court deems relevant. Such discretion and the impactful factors are also embodied in Rule 26(b)(2) and the *Zubulake* test.

In sum, as the law lowers the standard of proof from credible basis to rational belief, it should also adopt a cost-shifting mechanism as proposed above to buttress the existing preventative measures against frivolous inspections.

VII. CONCLUSION

Jurisdictions are divided over which standard of proof applies when shareholders seek to exercise their statutory inspection rights due to concerns about mismanagement. Delaware and its followers insist on a credible basis standard, which requires shareholders to show extrinsic evidence beyond a mere suspicion, curiosity, or disagreement with management, even though the purpose of the inspection is to gather evidence. Shareholders claim that this circular requirement of external evidence has rendered their statutory rights merely “a mirage.” The burden is particularly onerous for shareholders of private companies, as such companies typically generate little public information that shareholders can use to build a credible basis for their investigative inspections. Without inspecting records, shareholders likely face difficulty in meeting the pleading requirements for fiduciary breach lawsuits. A heightened burden of proof intensifies disputes on the issue and causes delays in its resolution. A protracted inspection lawsuit further increases shareholders’ risk of collateral estoppel and loss of standing not only in the inspection suit but also in subsequent plenary actions.

Some jurisdictions apply a rational belief standard, which instead requires shareholders to show a good faith suspicion of mismanagement with or without corroborating evidence. Those jurisdictions believe that a generous inspection policy promotes good corporate governance, and that belief is well-founded. However, the dichotomous standards lead to a difficult conflict of laws issue that has yet to be resolved.

The Delaware Supreme Court openly rejected rational belief, fearing that this lower standard would entice frivolous inspection lawsuits at the expense of corporations and, ultimately, all shareholders. The court also doubted that credible basis impeded shareholders’ inspection rights because shareholders’ requests for inspections had only rarely been barred.

This paper evaluates both reasons behind the court’s decision. The court’s assumption about frivolous lawsuits is not self-evident because common factors that incentivize such suits are missing in the shareholder inspection context. This paper offers the first empirical verification of the court’s assumption, showing that rational belief indeed increases the likelihood of inspection

lawsuits, even when suspicion about mismanagement is at a low level. This result suggests that rational belief can induce frivolous lawsuits. However, this paper also reveals evidence that credible basis has a bigger deterrent effect on the use of inspection rights than the court realized. The court's counting failed to consider the volume of inspection lawsuits that should have been filed, but were not, because shareholders could only show a suspicion—albeit a bona fide one—of corporate mismanagement. This paper shows that the probability of frivolous lawsuits under rational belief pales in comparison to the probability of over-deterrence under credible basis.

For shareholders of private companies that are most vulnerable to the evidentiary burden of credible basis, the law should apply rational belief as the standard of proof. Concerns about “indiscriminate fishing expeditions” and concomitant externalities could be mitigated by a cost-shifting mechanism for expensive productions, together with other measures routinely employed by the court, such as in camera reviews, tiered inspections, and the court's discretion in limiting, conditioning, and ultimately denying inspections when circumstances justify.

Practical concerns aside, the law should change for a fundamental reason: if the law grants shareholders a right, but through erecting an “insurmountable hurdle,” as shareholders call it, simultaneously makes it almost impossible for the sincerest of them to enforce that right in court, the integrity of the law will be questioned, and distrust will grow. What is at stake here is not just a finite pecuniary cost to a corporation that obstinately refuses its owners' demand for an inspection, but an immeasurable cost imposed on a society that prides itself on the rule of law. This cost-benefit analysis has but one logical outcome, and it is not what the Delaware Supreme Court concluded.

APPENDIX A. SHAREHOLDER INSPECTION RIGHT SURVEY

Background Information

- 1) Delaware law: The Delaware General Corporation Law (DGCL) §220 and judicial decisions interpreting this provision have provided shareholders a right to inspect corporate records as outlined below:
 - a) Shareholders have a right to inspect corporate records at reasonable hours and upon giving an advance notice to the company.
 - b) The purpose of the inspection must be “proper” in the sense that it is related to the interest of the requestor as a shareholder. Examples of proper purposes are valuing the shareholder’s interest in the company, communicating with other shareholders, and investigating management wrongdoing.
 - c) The scope of the inspection must be “necessary and essential” to the stated purposes, and the court may in its discretion further limit access to protect the company’s proprietary information and confidential communications of the management.
 - d) If the purpose of inspection is to uncover corporate wrongdoing or mismanagement, the shareholder must have a “credible basis” for believing that a wrongdoing or mismanagement has happened. “Credible basis” allows the court to draw a reasonable inference of wrongdoing or mismanagement to warrant further investigations. For example, investigations by regulatory authorities or reliable information provided by whistle blowers have all been found to be a “credible basis.” On the other hand, mere suspicions uncorroborated by at least some evidence does not satisfy the requirement. The Delaware court has also held that disappointing business outcomes alone does not satisfy the “credible basis” requirement. Although in theory, shareholders who suspect of mismanagement but lack evidence may file a fiduciary breach claim directly without first investigating though inspecting corporate documents, such a claim will likely be dismissed for failure to meet the “pleading specific facts” requirement of the Delaware law. Thus, your access to corporate records is of crucial importance to the success of your subsequent fiduciary breach claim.

Some other jurisdictions, however, have merely required shareholders to have a “good faith belief” in claiming mismanagement in order to inspect corporate documents. That is a lower standard than “credible basis” because it does not require any independent evidence to corroborate the shareholders’ claim; all it requires is a rational basis for making such a claim. However, there is no direct case law on whether consecutive years of operating losses satisfies this lower burden of proof.

- 2) Litigation costs: Lawsuits to enforce shareholders’ inspection rights under DGCL §220 are costly. *First*, you need to hire a lawyer. Statistics show that the median successful litigation lasted 3 months, while an unsuccessful shareholder-litigant waited 9 months. In both types of cases, the parties expended substantial resources. Successful plaintiffs filed a mean of 93 pages and a median of 35 pages court documents; unsuccessful plaintiffs filed a mean of 87 pages and a median of 25 pages. Lawyers do not accept a contingency fee arrangement because there is typically no monetary award in a shareholder inspection right litigation – if you win, you get

to inspect the documents you have requested. *Secondly*, if the court finds that you have brought the lawsuit in bad faith, it may in its discretion require you to pay the attorney fees or other costs incurred by your opponent. A corporate lawyer in Delaware charges an averages of \$373/per hour, but it is impossible to predict the total legal fees for a litigation.

Scenario 1

You are a minority shareholder of ABC Corp., a small private company incorporated in Delaware 5 years ago. The company’s sales revenue has been flat in the past 3 years. You have no representation on the board, so you have no direct information on its decisions and activities. You are not sure if the board has used a reasonable diligence in managing the company. You would like to review board meeting minutes to see whether that is the case. You have no other evidence to corroborate your suspicion. The board rejects your request. You are considering whether to bring a lawsuit under DGCL §220.

Scenario 2

The facts are the same as in Scenario 1, except that the company not only has had a flat revenue growth in the past 3 years, but also has lost a substantial market share to its direct competitors: It occupied 70% of the market 3 years ago, but now it has only 20%. The overall market demand for this type of product has increased substantially, but that extra demand seems to have all been picked up by your competitors.

Poll Questions under Scenario 1 (i.e., flat revenue growth only)

1) Question 1: How strongly do you believe that the board has failed to use reasonable diligence in managing the business? Choose one number from 1 – 5, with 1 being “Unlikely, it is a mere possibility” and 5 being “It is almost certainly the case.”

1 2 3 4 5

2) Question 2: How likely do you think the court will find that you have satisfied your burden of proof under the “credible basis” and the “good faith belief” standards, respectively? Choose one number from 1 – 5, with 1 being “not likely at all” and 5 being “almost certainly.”

a) “Credible basis” standard: 1 2 3 4 5

b) “Good faith belief” standard: 1 2 3 4 5

3) Question 3: You have either consciously or subconsciously set a budget for paying the total costs of this litigation. That budget depends on many factors, including but not limited to your financial wealth, your willingness to spend money on a litigation that has an uncertain outcome, your eagerness to find the truth through inspection, etc. For example, all else being equal, a billionaire like Jeff Bezos of Amazon likely should have a higher budget for this litigation than someone who earns a salary to make a living.

What is your current assessment of the probability that the total costs by the end of this lawsuit will *exceed* your budget? Choose one number from 1 – 5, with 1 being “very low probability” (e.g., I am extremely wealthy, and I am willing to litigate at all costs) and 5 being “almost

certainly” (e.g., I have only \$1,000 surplus each month and insubstantial savings, so I cannot afford a prolonged lawsuit). Indicate “unable to assess” if you cannot make an assessment.

a) If your standard of proof is “credible basis” (i.e., more contentious and demanding):

1 2 3 4 5 unable to assess

b) If your standard of proof is “good faith belief” (i.e., less contentious, and easier to satisfy):

1 2 3 4 5 unable to assess

4) Question 4: Litigation also consumes your time and energy. How much time and energy are you willing and able to devote to this lawsuit? Choose one number between 1 - 5, with “1” being “I have no time for this lawsuit” and “5” being “I have no other major commitments, so I can devote almost 100% of my time and energy to this lawsuit.”

1 2 3 4 5

5) Question 5: Taking all factors into consideration, would you bring this lawsuit?

a) If your standard of proof is “credible basis” (i.e., more contentious and demanding):

Yes
No

b) If your standard of proof is “good faith belief” (i.e., less contentious, and easier to satisfy):

Yes
No

c) Rate each of the following factors in terms of its importance in your decision, with “1” being the least important, and “5” being the most important.

- Litigation cost
- The time and energy needed to pursue this lawsuit
- The likelihood that directors did something wrong
- The likelihood of success
- The joy from annoying the management

6) Any comments you would like to make about your decision on litigation and/or about any question of this survey.

[Please continue to the next page]

Poll Questions under Scenario 2 (i.e., flat revenue growth + substantial decline in market share)

- 1) Question 1: How strongly do you believe that the board has failed to use reasonable diligence in managing the business? Choose one number from 1 – 5, with 1 being “Unlikely, it is a mere possibility” and 5 being “It is almost certainly the case.”

1 2 3 4 5

- 2) Question 2: How likely do you think the court will find that you have satisfied your burden of proof under the “credible basis” and the “good faith belief” standards, respectively? Choose one number from 1 – 5, with 1 being “not likely at all” and 5 being “almost certainly.”

a) “Credible basis” standard: 1 2 3 4 5

b) “Good faith belief” standard: 1 2 3 4 5

- 3) Question 3: You have either consciously or subconsciously set a budget for paying the total costs of this litigation. That budget depends on many factors, including but not limited to your financial wealth, your willingness to spend money on a litigation that has an uncertain outcome, your eagerness to find the truth through inspection, etc. For example, all else being equal, a billionaire like Jeff Bezos of Amazon likely should have a higher budget for this litigation than someone who earns a salary to make a living.

What is your current assessment of the probability that the total costs by the end of this lawsuit will *exceed* your budget? Choose one number from 1 – 5, with 1 being “very low probability” (e.g., I am extremely wealthy, and I am willing to litigate at all costs) and 5 being “almost certainly” (e.g., I have only \$1,000 surplus each month and insubstantial savings, so I cannot afford a prolonged lawsuit). Indicate “unable to assess” if you cannot make an assessment.

- a) If your standard of proof is “credible basis” (i.e., more contentious and demanding):

1 2 3 4 5 unable to assess

- b) If your standard of proof is “good faith belief” (i.e., less contentious, and easier to satisfy):

1 2 3 4 5 unable to assess

- 4) Question 4: Litigation also consumes your time and energy. How much time and energy are you willing and able to devote to this lawsuit? Choose one number between 1 - 5, with “1” being “I have no time for this lawsuit” and “5” being “I have no other major commitments, so I can devote almost 100% of my time and energy to this lawsuit.”

1 2 3 4 5

5) Question 5: Taking all factors into consideration, would you bring this lawsuit?

a) If your standard of proof is “credible basis” (i.e., more contentious and demanding):

Yes

No

b) If your standard of proof is “good faith belief” (i.e., less contentious, and easier to satisfy):

Yes

No

c) Rate each of the following factors in terms of its importance in your decision, with “1” being the least important, and “5” being the most important.

- Litigation cost
- The time and energy needed to pursue this lawsuit
- The likelihood that directors did something wrong
- The likelihood of success
- The joy from annoying the management

6) Any comments you would like to make about your decision on litigation and/or any question of this survey

[End of the survey]