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Case Number 624,2005

IN THE SUPREME COURT OF THE STATE OF DELAWARE

FRANK D. SEINFELD,	)	No. 624, 2005
	)	
Plaintiff-Below, Appellant,	)	
	)	On Appeal from Court of
v.	)	Chancery,
	)	C.A. No. 1100-N
VERIZON COMMUNICATIONS INC.,	)	
	)	
Defendant-Below, Appellee.	)	

DEFENDANT-BELOW, APPELLEE VERIZON COMMUNICATIONS INC.'S
OPENING SUPPLEMENTAL BRIEF

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NATURE OF THE PROCEEDINGS

This appeal concerns whether the settled law of 8 *Del. C.* § 220 should be changed to permit stockholders of Delaware corporations who *admit* that they have no credible basis to suspect wrongdoing or mismanagement to inspect the corporation's books and records. Appellee, Defendant below, Verizon Communications Inc. ("Verizon") submits that Section 220 should not afford that type of relief.

Verizon asks this Court to reaffirm the well-established law of Delaware, as established in precedent from this Court for almost a decade, that stockholders must show "some evidence" to suggest a credible basis of probable mismanagement before Delaware courts will permit an inspection. There is no middle ground between "some evidence" and no evidence. Verizon therefore assumes that the Court is suggesting consideration of a "rational basis" test that would require no actual evidence of wrongdoing. That change in the law is unwarranted.

The credible basis standard crafts an appropriate balance between providing stockholders who can offer evidence of wrongdoing access to corporate books and records and the right of the corporation (and the interest of stockholders collectively) in not "invit[ing] mischief" by "open[ing] corporate management to indiscriminate fishing expeditions." *Security First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 571 (Del. 1997). Permitting inspection based on anything less than a "credible basis" will not only upset settled Delaware law and the expectations of Delaware corporations, it will result in a deluge of books and records demands that will harm

corporations while providing stockholders with no greater protection from mismanagement or wrongdoing.

On November 23, 2005, the Honorable Stephen P. Lamb issued a Memorandum Opinion and Order (hereinafter, "Opinion" or "Op.") resolving the cross-motions for summary judgment filed in this books-and-records action concerning the compensation of Verizon's three seniormost executives from 2000 to 2002: Charles R. Lee, Ivan G. Seidenberg, and Lawrence T. Babbio Jr. (the "Executives"). After analyzing the evidence in the light most favorable to Plaintiff, including several important admissions made at his deposition, the Opinion concluded Plaintiff could not prevail on the facts shown:

> [T]he court must conclude that [Plaintiff] has not carried his burden of showing that there is a credible basis from which the court can infer that the Verizon board of directors committed waste or mismanagement in compensating these three executives during the relevant period of time. *Instead, the record clearly establishes that Seinfeld's Section 220 demand was made merely on the basis of suspicion or curiosity*.

Op. at 8 (emphasis added).

In his opening brief to this Court, Plaintiff admitted that the Court of Chancery's conclusion was correct. Plaintiff admitted that he "had no actual evidence that in fact wrongdoing had taken place." (Plaintiff's Opening Br. at 2.)

On May 17, 2006, the Court issued an order asking the parties to submit supplemental briefs addressing two questions regarding the appropriate standard to be employed in Section 220 cases involving the investigation of wrongdoing or mismanagement. This is Verizon's Opening Supplemental Brief.

SUMMARY OF THE ARGUMENT

A) Should a stockholder with a proper purpose be entitled to inspect carefully limited categories of corporate books and records, pursuant to Section 220, upon a showing that the stockholder has a rational basis for the stated purposes and no other purpose that would militate against inspection?

1. As this Court has held repeatedly since 1996, no. Since 1993, this Court has admonished stockholders seeking to assert derivative claims to use the "tools at hand," such as Section 220, to investigate those claims prior to filing suit. Knowing that Section 220 was to be used for this purpose, this Court in cases in 1996 and early 1997 reaffirmed prior precedent and established what has become known as the "credible basis" standard for stockholders seeking to investigate wrongdoing or mismanagement. *Security First*, 687 A.2d at 568; *Thomas & Betts Corp. v. Leviton Mfg. Co.*, 681 A.2d 1026 (Del. 1996). The "credible basis" standard carefully balances competing interests: on the one hand, the right of minority stockholders to receive information about the corporation; on the other hand, the right of Delaware corporations (and the collective interest of stockholders) to operate the business without undue and costly interference.

2. The proposed "rational basis" standard would be an unnecessary and unwarranted departure from the careful balance created by present law for the following principal reasons:

- *First*, the "rational basis" standard fails to provide *any* objective review of the wrongdoing alleged, and would thus provide the trial court with no mechanism for winnowing inspections of possibly meritorious claims of wrongdoing from fishing expeditions based solely on a stockholder's mere speculation.

- *Second*, because the "rational basis" standard would require no evidence, an avalanche of largely meritless Section 220 demands will be filed by stockholders. This deluge of demands will come at a high cost for corporations and will interfere with the exercise of business judgment by directors and management.

- *Third*, a "rational basis" standard would be unworkable in practice and provide no protection to Delaware corporations from the abusive use of Section 220 demands.

- *Fourth*, because stockholders will not be limited to the investigation of subjects for which they can show a credible basis of wrongdoing, it will be impossible for Delaware courts to cabin the scope of review to that which is "essential" or "sufficient" to whatever rational basis a stockholder might espouse.

For these reasons and those that follow, Verizon respectfully suggests that the answer to Question "A" should be "no."

> B) If the standard in question "A" would not be appropriate, is there *any* reduced burden of proof under Section 220 that would improve stockholders' ability to obtain the "tools" to pursue derivative claims without disrupting corporations' orderly conduct of business and without inappropriately interfering with corporate decision making? If so, articulate the reduced burden to proof. If not, explain why not.

3. There is no reduced burden of proof that would improve stockholder access to books and records without unduly disrupting Delaware corporations, as numerous courts have acknowledged. Simply put, there is no middle ground between a "rational basis" test that would require *no* credible evidence of wrongdoing and a "credible basis" test that requires only *some* credible evidence of wrongdoing. Because any reduced burden of proof would be tantamount to permitting a stockholder access to books and records based on "mere speculation," and because the "credible basis" standard has successfully balanced the interests of stockholders and corporations for many years, this Court should reaffirm that "credible basis" standard as settled law.

STATEMENT OF FACTS[1]

Plaintiff claims that the purpose of his demand is to investigate "disloyalty, waste, self-dealing and mismanagement" in Verizon's compensation of the Executives. (A-13.) Plaintiff's demand also makes unsupported claims that the Executives: (i) all simultaneously served as CEO of Verizon (A-14-15); (ii) received excessive compensation as a group over those three years of $205 million (A-14); and (iii) were granted stock options not authorized by their employment agreements (A-14-15).

At his deposition, Plaintiff admitted that there was no factual basis for any of these allegations of mismanagement. With respect to his breach of fiduciary duty allegations, Plaintiff admitted "that he had no facts establishing a credible basis of any violation of the duties of loyalty or care in the directors' approval of these executives' compensation." (Op. at 6.) He admitted that:

- He was "not making any … claim" that any director had "any conflict of interest" with respect to compensation decisions for the Executives. (A-49 at 33; Op. at 6 n.22; Ans. Br. at 25.)
- He had "no such knowledge at this point" of "any independence issue with respect to any Verizon director" on compensation issues. (A-49 at 34-35; Op. at 6 n.22; Ans. Br. at 25.)
- He was "[n]ot at this time" "challenging the process through which compensation decisions were made." (A-49 at 34; Op. at 5 n.18; Ans. Br. at 25.)

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[1] For a more comprehensive description of the fatal admissions made by Plaintiff and the absence of evidence supporting the purpose claimed in his demand, see Verizon's Answering Brief (hereinafter, "Ans. Br.") at 6-16. All emphasis in quoted material is added, and all internal citations omitted, unless otherwise indicated.

Plaintiff also admitted that he had no basis for his claim that the Executives' compensation constituted waste or was somehow inconsistent with their employment agreements. For example,

- Plaintiff admitted that Verizon never had three CEOs and the Executives did not perform any duplicative work. (A-66 at 102-04; Op. at 6 n.20, Ans. Br. at 7.)

- Plaintiff had "no reason to challenge the board's business judgment on the issue of having co-CEOs" following Bell Atlantic Corporation's merger-of-equals with GTE Corporation (the surviving corporation was renamed Verizon). (A-66 at 102-04; Op. at 6 n.20; Ans. Br. at 7-8.)

- Plaintiff admitted that he did not know who calculated the $205 million in compensation that he claims the Executives received, or how they did so, and he acknowledged that "there is a possibility" that "every one of the numbers on" his demand was wrong.[2] (A-72-73 at 128-31; Op. at 7 n.24; Ans. Br. at 8-10.)

- Plaintiff admitted he had no reason "to believe that [the Executives] didn't earn the benefits under" their employment Agreements. (A-56 at 62-63; Op. at 6 n.21; Ans. Br. at 15.)

- Plaintiff admitted that the Executives' employment agreements entitled them to stock options or other long-term incentive compensation in certain minimum amounts, contrary to his allegation that certain of the Executives' agreements did not provide for such options. (Op. at 7 n.26; Ans. Br. at 10-15.)

- Plaintiff admitted that he had no support for his claim that the Long Term Incentive Plan was conveniently amended to benefit the Executives. (Op. at 7 nn.25, 26, Ans. Br. at 16.)

In sum, Plaintiff admitted that he "had no actual evidence that in fact wrongdoing had taken place." (Pl's Op. Br. at 2.)

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[2] The only support Plaintiff offered for the $205 million number is an affidavit of Plaintiffs' counsel (which was not based on personal information, as required by Del. Ct. Ch. R. 56(e)) that does not "disclose the expert's work or otherwise explain how Seinfeld or his counsel derived the $205 million figure for total compensation." (Op. at 7 n.24.) The court properly refused to credit this affidavit as evidence.

ARGUMENT

I. PERMITTING INSPECTION BASED ONLY A STOCKHOLDER'S "RATIONAL BASIS" WOULD UPSET SETTLED LAW AND HARM DELAWARE CORPORATIONS.

A. The "Credible Basis" Standard Is Well-Established And Should Not Be Overturned.

This Court has asked whether Delaware corporations should be forced to permit inspection of their books and records by any stockholder whose proper purpose to investigate mismanagement is supported by only a "rational basis."

For almost thirty years, Delaware courts have answered that question with a no. *See, e.g., Skouras v. Admiralty Enters., Inc.*, 386 A.2d 674, 678 (Del. Ch. 1978)(inspection "depends on whether or not a clear indication of wrong-doing … has been established clearly as a result of a trial"). Instead, Delaware courts have uniformly required stockholders who seek to investigate corporate wrongdoing to show "some evidence of possible mismanagement as would warrant further investigation of the matter." *Helmsman Mgmt. Servs., Inc. v. A & S Consultants, Inc.*, 525 A.2d 160, 166 (Del. Ch. 1987).[3]

Ten years ago, this Court reaffirmed the "credible basis" standard set forth in cases such as *Skouras* and *Helmsman*. In *Thomas & Betts Corp. v. Leviton Manufacturing Co.*, this Court held that for a stockholder to meet its "burden of proof, a stockholder must present some credible basis from which the court can infer that waste or

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[3] *See also Everett v. Hollywood Park, Inc.*, C.A. No. 14556, 1996 WL 32171, at *2 (Del. Ch. Jan. 19, 1996) ("Where, as here, the plaintiff's purpose is to investigate possible waste or mismanagement, she must also adduce evidence of potential mismanagement sufficient to support her suspicions and to warrant going forward.").

mismanagement may have occurred." 681 A.2d at 1031. Just six months later, this Court's *en banc* decision in *Security First Corp.* reaffirmed those decisions and held "[t]here must be some evidence of *possible* mismanagement as would warrant further investigation of the matter." *Security First*, 687 A.2d at 568 (emphasis in original, quoting *Helmsman*, 525 A.2d at 166).

This Court was careful to note that the "stockholder need not actually prove the wrongdoing itself by a preponderance of the evidence." *Id.* at 565. But it also held that a stockholder's mere "statement of a purpose" will not justify the burdens such an inspection imposes on the corporation.[4] *Id.* at 565 (quoting *Helmsman,* 525 A.2d at 166).

This Court's holdings in *Thomas & Betts* and *Security First* were made while the Court was simultaneously urging the use of Section 220 as a tool for stockholders to investigate mismanagement. Since 1993, this Court has admonished stockholders contemplating a derivative suit to use Section 220 "to investigate the possibility of corporate wrongdoing." *Rales v. Blasband*, 634 A.2d 927, 934 n.10 (Del. 1993). This Court reaffirmed that salutary use of Section 220 just months before it decided *Thomas & Betts*. *Grimes v. Donald*, 673 A.2d 1207, 1216 n.11 (Del. 1996). Yet when the plaintiff in *Thomas & Betts*

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[4] *See CM & M Group, Inc. v. Carroll*, 453 A.2d 788, 793 (Del. 1982) ("Counterposed to the duty to protect the rights of the stockholder, the Court has the duty to safeguard the rights and legitimate interests of the corporation," citing *State ex rel. Cochran v. Penn-Beaver Oil Co.*, 143 A. 257, 260 (Del. 1926) ("While it is the duty of the court to protect the rights of stockholders, it is equally their duty to safeguard the rights of the corporation as such.")).

suggested that this purpose of Section 220 warranted lowering the requirement that plaintiffs show "some credible basis," this Court rejected that argument:

> Contrary to plaintiff's assertion in the instant case, this Court in *Grimes* did not suggest that its reference to a Section 220 demand as one of the "tools at hand" was intended to eviscerate or modify the need for a stockholder to show a proper purpose under Section 220.

Thomas & Betts, 681 A.2d at 1031 n.3.

Nothing in the decade since *Security First* and *Thomas & Betts* has changed the fact that the "credible basis" standard is the appropriate yardstick in Section 220 cases.[5] While the General Assembly amended

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[5] Indeed, the number of cases in just the last six years in which the "credible basis" standard has been applied (and which would no longer be good law should the Court adopt a lesser, "rational basis" requirement) is massive. *See, e.g., Norman v. US MobilComm, Inc.*, C.A. No. 849-N, 2006 WL 1229115, at *2 (Del. Ch. Apr. 28, 2006) (noting that court was inclined to grant relief under the credible basis standard); *Haywood v. Ambase Corp.*, C.A. No. 342-N, 2005 WL 2130614, at *5 (Del. Ch. Aug. 22, 2005) (granting relief under the credible basis standard); *Deephaven Risk Arb Trading Ltd. v. UnitedGlobalCom, Inc.*, C.A. No. 379-N, 2005 WL 1713067, at *10 (Del. Ch. July 13, 2005) (granting relief under the credible basis standard); *Forsythe v. CIBC Employee Private Equity Fund (U.S.) I, L.P.*, C.A. No. 657-N, 2005 WL 1653963, at *5 (Del. Ch. July 7, 2005) (granting relief under the credible basis standard); *Romero v. Career Educ. Corp.*, C.A. No. 793-N, 2005 WL 1798042, at *2 -*3 (Del. Ch. July 19, 2005) (denying motion to dismiss under the credible basis standard); *Cohen v. El Paso Corp.*, C.A. No. 551-N, 2004 WL 2340046, at *4 (Del. Ch. Oct. 18, 2004) (denying motion to dismiss under the credible basis standard); *Marmon v. Arbinet-Thexchange, Inc.*, C.A. No. 20092, 2004 WL 936512, at *6 (Del. Ch. Apr. 28, 2004) (granting relief under the credible basis standard); *Khanna v. Covad Commc'ns Group, Inc.*, C.A. No. 20481-NC, 2004 WL 187274, at *6 (Del. Ch. Jan. 23, 2004) (granting relief under the credible basis standard); *Freund v. Lucent Techs., Inc.*, C.A. No. 18893, 2003 WL 139766, at *3 (Del. Ch. Jan. 9, 2003) (granting relief under the credible basis standard); *Magid v. Acceptance Ins. Cos.*, C.A. No. 17989-NC, 2001 WL 1497177, at *8 (Del. Ch. Nov. 15, 2001) (granting relief under the credible basis standard); *Dobler v. Montgomery Cellular Holding Co.*, C.A. Nos. 18105, 18499, 2001 WL 1334182, at *4 (Del. Ch. Oct. 19, 2001) (granting relief under the credible basis standard); *Saito v. McKesson HBOC, Inc.*, C.A. No. 18553, 2001 WL 818173, at *4 (Del. Ch. July 10, 2001) (granting relief under the credible basis standard), *aff'd in part and rev'd in part,* 806 A.2d 113, 117 (Del. 2002) (broadening relief granted by trial court); *Carapico v. Phila. Stock Exch., Inc.*, 791 A.2d 787, 792 (Del. Ch. 2000) (granting

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Section 220 to overrule other holdings of this Court in response to the corporate scandals of 2002 and 2003, it has never proposed changing the quantum of evidence required to investigate mismanagement. Instead, the General Assembly made Section 220 a more useful tool for stockholders by overruling other precedent, such as cases preventing stockholders from reviewing the documents of corporate subsidiaries.[6] *See* S.B. 127, 142nd Gen. Assembly (Del. 2003).

The credible basis standard has been employed for almost thirty years without alteration by courts or the legislature. In Delaware and elsewhere,[7] the "credible basis" standard is settled law. Under the doctrine of stare decisis, this Court's "credible basis" standard should not "be departed from or lightly overruled or set aside," and this Court should upset such settled law only "for urgent reasons and upon clear manifestation of error." *Oscar George, Inc. v. Potts*, 115 A.2d 479, 481 (Del. 1955). Plaintiff can show no such urgent reasons or any clear error in the careful balance crafted by this Court's prior decisions, and those rulings should be reaffirmed.

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relief under the credible basis standard); *Sahagen Satellite Tech. Group, LLC v. Ellipso, Inc.*, 791 A.2d 794, 799 (Del. Ch. 2000) (granting limited relief under the credible basis standard).

[6] *See Saito*, 806 A.2d at 118 (reaffirming the "settled principle" that, in most circumstances, "stockholders of a parent corporation are not entitled to inspect a subsidiary's books and records").

[7] The "credible basis" standard is also settled law in those states that look to Delaware law for guidance on matters of corporation law. *See, e.g., Arctic Fin. Corp. v. OTR Express, Inc.*, 38 P.3d 701, 703-04 (Kan. 2002) (looking to *Security First* and *Thomas & Betts* for guidance regarding a books and records inspection under Kansas law); *Towle v. Robinson Springs Corp.*, 719 A.2d 880, 882 (Vt. 1998) (in a books and records case under Vermont law, citing *Thomas & Betts* for the proposition that "[c]laims of mismanagement, however, must be supported by evidence").

B. The "Credible Basis" Test Is A Well-Reasoned Balance Of Competing Interests.

This Court's "credible basis" standard has stood the test of time and been adopted by other states because it deftly balances the competing interests in every Section 220 suit premised on the investigation of mismanagement: stockholder access to information and the burden placed on corporations if that stockholder access is abused.

It is well-established that a stockholder's investigation of wrongdoing or mismanagement is a "proper purpose" under 8 *Del. C.* § 220(b). *Nodana Petroleum Corp. v. State ex rel. Brennan*, 123 A.2d 243, 246 (Del. 1956). Such investigations are a proper purpose because -- where the allegations of mismanagement prove meritorious -- the investigation furthers the interest of all stockholders and should increase stockholder return. *See Saito*, 806 A.2d at 115 ("where a § 220 claim is based on alleged corporate wrongdoing, and *assuming the allegation is meritorious*, the stockholder should be given enough information to effectively address the problem, either through derivative litigation or through direct contact with the corporation's directors and/or stockholders").

However, it is equally well-established that "even though the purpose may be proper in the sense that it is reasonably related to the person's interest as a stockholder, it must also not be adverse to the interests of the corporation."[8] *Skoglund v. Ormand Indus., Inc.*, 372 A.2d 204, 207, 210 (Del. Ch. 1976)(granting inspection where "the

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[8] *See also Thomas & Betts*, 681 A.2d at 1030 n.1 (*citing Ostrow v. Bonney Forge Corp.*, C.A. No. 13270, 1994 WL 114807, at *11 (Del. Ch. Apr. 6, 1994)).

evidence … tends to show that plaintiffs were not merely on a fishing expedition"). This Court has held that an inspection of wrongdoing where there is no "credible basis" is a license for "fishing expeditions" and thus adverse to the interests of the corporation:[9]

> Stockholders have a right to at least a limited inquiry into books and records when they have established some credible basis to believe that there has been wrongdoing.... Yet it would invite mischief to open corporate management to indiscriminate fishing expeditions.

Security First, 687 A.2d at 571.[10]

This Court in *Thomas & Betts* and *Security First* correctly balanced these competing concerns. Because investigations of meritorious allegations of mismanagement benefit the corporation, but investigations that are "indiscriminate fishing expeditions" do not, the Court created the "credible basis" standard to tell the two apart. By requiring a stockholder to show "some evidence of *possible* mismanagement as would warrant further investigation," the "credible basis" standard maximizes stockholder value by limiting the range of permitted stockholder inspections to those that might have merit.

In practice, the "credible basis" standard is a very low standard of proof and has not impeded stockholder inspections. Although scores of Section 220 suits have been filed since *Security First*, this is one

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[9] "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." Fred S. McChesney, *"Proper Purpose," Fiduciary Duties, and Shareholder-Raider Access to Corporate Information*, 68 U. Cin. L. Rev. 1199, 1207-08 (2000).

[10] *See also Skouras*, 386 A.2d at 679 (noting that the use of a books and records inspection to harass the corporate defendant is improper); *Skoglund*, 372 A.2d at 210 (noting that the pursuit of a fishing expedition would be improper).

of only two cases in which a plaintiff's demand to investigate wrongdoing was found to be entirely lacking a credible basis.[11] In contrast, there are innumerable cases in which stockholders who can show a "credible basis," unlike Plaintiff, receive some narrowly tailored right of inspection, often without resort to litigation.[12]

C. A "Rational Basis" Standard Is Unwarranted, Unworkable And Would Harm Stockholders Of Delaware Corporations.

1. *Any standard that does not ask whether any "evidence" supports the claimed mismanagement fails to protect Delaware corporations adequately.*

The proposed "rational basis" standard departs from the "credible basis" test in a crucial respect that renders it fatally unworkable: It would change the inquiry *away* from the evidence of the claimed wrongdoing (or requiring any evidence at all), and *toward* whether the stockholder's desire for inspection is rational. As such, it would change the inquiry *away* from whether the proposed inspection is likely to yield a benefit to all stockholders that will justify its cost, and *toward* a subjective analysis of the stockholder's intent.

Because the "rational basis" test does not analyze whether the plaintiff's allegations are supported by any *evidence*, it accords no protection to the corporation (and stockholders generally) from abuse

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[11] *See Mattes v. Checkers Drive-In Rests., Inc.*, C.A. No. 17775, 2001 WL 337865, at *5 (Del. Ch. Mar. 28, 2001).

[12] "More and more shareholders are making Section 220 demands. More and more corporations are producing books and records for inspection in response to Section 220 demands …" Stephen A. Radin, *The New Stage of Corporate Governance Litigation: Section 220 Demands*, 26 Cardozo L. Rev. 1595, 1647 (2005). *See, e.g., In re Walt Disney Co. Deriv. Litig.*, 825 A.2d 275, 279 & n.5 (Del. Ch. 2003)(noting an out-of-court § 220 demand and response provided "a perfect illustration of the benefit" of using the § 220 process); *Freund*, 2003 WL 139766, at *2 (noting "Lucent produced some documents" in response to a stockholder's demand).

of Section 220 rights without consequent benefit to the corporation. Courts have only one tool from which they can judge whether a stockholder's proposed inspection of wrongdoing is likely to be worth the cost of that inspection -- analysis of the evidence to determine whether it supports the allegations of wrongdoing. As such, this Court's "credible basis" standard sets the lowest possible evidentiary standard available. Any credible evidence that would support an inference of wrongdoing supports a Section 220 inspection. Stockholders need not prove anything other than the mere existence of credible evidence. *See Security First*, 687 A.2d at 565.

A "rational basis" test is thus fatally flawed because it would allow inspections without regard for whether the stockholder has any evidence supporting his allegations. This would be tantamount to permitting inspection based solely on the stockholder's "mere suspicions" or "curiosity," which have been repeatedly rejected as an insufficient basis to justify the costs of an inspection.[13] Requiring that those suspicions be rational, but not requiring any evidence to validate them, does not make those suspicions any less speculative.

2. *A "rational basis" standard will result in an avalanche of Section 220 demands that will only harm corporations.*

Because the "rational basis" test would not require stockholders to show any evidence, much less credible evidence, of wrongdoing, it should be expected to spawn an avalanche of Section 220 demands.

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[13] *E.g.*, *White v. Panic*, 783 A.2d 543, 557 n.54 (Del. 2001); *Security First*, 687 A.2d at 568; *Mattes*, 2001 WL 337865, at *5; *Dobler*, 2001 WL 1334182, at *3; *Sahagen*, 791 A.2d at 796.

Divorced from any need to show evidence beyond a proper purpose and their own rationality, stockholders will routinely file such demands on any matter of rational interest that would ordinarily be subject to the business judgment rule, such as corporate transactions (real or imagined), accounting judgments, regulatory compliance, executive compensation and director nomination.

These inspections will impose a huge cost on Delaware corporations without justifiable benefit. For example, under the "rational basis" standard, any stockholder could simply suggest that a corporate merger might be for inadequate consideration, and that it was "rational" for the stockholder to look into the matter. Any stockholder could allege that the corporation's performance might have disappointed investors, and that it was "rational" to investigate that performance. Any stockholder could allege that executives might be overpaid, and that it was "rational" to investigate and find out. None of these inspections would pass muster under "credible basis review.[14] And while they might be supported by a "rational basis," none of them could be expected to yield a benefit to the corporation where their sole purpose is second-guessing decisions protected by the business judgment rule. *Cf. Marathon Partners, L.P. v. M&F Worldwide*

[14] *See Everett*, 1996 WL 32171, at *6 (a "stock-for-stock merger … which appears to have been an arm's length transaction with no opportunity for self-dealing, does not constitute a credible basis to suspect mismanagement"; "Declines in financial performance, even if substantial, do not, in and of themselves, support an inference of mismanagement" and allegations of "poor financial performance," "without more, do not indicate a credible possibility of mismanagement sufficient to warrant a further investigation"); *Seinfeld v. Verizon Commc'ns, Inc.*, Op. at 8 ("A mere difference of opinion with the board's human resource committee's compensation decision does not evidence wrongdoing and will not satisfy Seinfeld's burden.").

Corp., C.A. No. 018-N, 2004 WL 1728604, at *11 (Del. Ch. July 30, 2004) ("Stockholders cannot satisfy [the credible basis test] merely by expressing disagreement with a business decision."). The administrative costs of responding to such an increase in demands would be significant, and yet there would be little, if any, benefit.[15]

A "rational basis" standard could also harm corporate decision-making. If a director knows that a stockholder can investigate and second-guess ordinary business decisions without any showing of wrongdoing, that mere threat may chill directors' ability to engage in a deliberative process that candidly evaluates alternative courses of action. *See Disney v. Walt Disney Co.*, C.A. No. 234-N, 2005 WL 1538336, at *4 (Del. Ch. June 20, 2005) (noting that courts "need to allow the directors the ability to deliberate openly and candidly with each other. The preliminary deliberations of a corporate board of directors generally are non-public and should enjoy 'a reasonable expectation that they [will] remain private.'" (internal citations omitted)). This chilling effect, which would exist regardless of whether the books and records might later become publicly available, would result in unnecessarily conservative and sub-optimal decision-making.[16]

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[15] Because any stockholder can make a Section 220 demand, the explosion of Section 220 demands would seriously harm a corporation of any size. For example, Verizon has nearly one million (947,767) stockholders of record, and even more than that who own stock beneficially. *See* Verizon Annual Report on Form 10-K at 20 (Mar. 14, 2006); *Wal-Mart Stores, Inc. v. AIG Life Ins. Co.*, 860 A.2d 312, 320 n.28 (Del. 2004) (courts may judicially notice documents filed with the SEC).

[16] The chilling effect of stockholder second-guessing is exacerbated by the risk that, notwithstanding the protections of a confidentiality order, the

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Moreover, decreasing the standard of review for inspection demands will only increase the number of demands in which documents are sought for improper purposes. Because stockholders with an improper purpose are entitled to documents as long as their primary purpose is proper, *see Saito*, 806 A.2d at 116, adopting a "rational basis" test will increase the number of plaintiffs with ostensibly proper purposes who will use the inspection for improper purposes.

3. *In practice, the "rational basis" standard will be no standard at all.*

This Court should not adopt the "rational basis" standard because it is unworkable in practice and will add nothing to the Section 220 analysis. There is no sensible way that Delaware courts can divine requests for information to investigate wrongdoing that are "rational" from those that are not. It is difficult to imagine a demand to investigate wrongdoing where a plaintiff with an ostensibly proper purpose would *not* satisfy the "rational basis" standard. Even stockholders who, like Plaintiff, are motivated by nothing more than idle curiosity can act rationally in seeking an inspection. In practice, any standard based solely on a subjective analysis of a plaintiff's rationality will fail to limit the surge of fishing expeditions to which corporations will be subject.

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books and records could become public. *See Disney*, 2005 WL 1538336, at *4 ("If any shareholder can make public the preliminary discussions, opinions, and assessments of board members and other high-ranking employees, it would surely have a chilling effect on board deliberations.").

4. *It will be impossible to "carefully limit" the categories of books and records stockholders will seek under the "rational basis" standard.*

Respectfully, the Court's question assumes away one of the primary problems with a "rational basis" standard: There will be no way to "carefully limit" the documents to which plaintiffs will be entitled if the "rational basis" standard is employed.

Where a stockholder has shown a credible basis, the law is clear that he or she is only entitled to books and records "necessary and essential" to the investigation of those subjects. *Saito*, 806 A.2d at 116. But if stockholders are entitled to review documents based solely on a rational basis for doing so, then presumably they must be entitled to all books and records "necessary and essential" to any rational basis they can espouse. If a plaintiff has a rational basis to investigate a corporation's accounting practices, for example, the stockholder might then reasonably claim that all documents relating to those accounting practices (such as the ledger, accounting systems, and auditor notes) are "essential" to test for wrongdoing. Anything less will not satisfy the stockholder's interest. Thus, while the inspection of a stockholder under the "credible basis" standard would be limited to those narrow subjects on which it can show a credible basis, under the "rational basis" standard there will be no limit on what is "essential and sufficient" to a plaintiff's purpose.

II. THERE IS NO REDUCED BURDEN OF PROOF THAT WOULD IMPROVE STOCKHOLDERS' ABILITY TO PURSUE DERIVATIVE CLAIMS.

This Court also asked whether "there is *any* reduced burden of proof under Section 220 that would improve stockholders' ability to

obtain the 'tools' to pursue derivative claims …." Verizon submits that this Court has already answered that question no.

In *Security First* and *Thomas & Betts*, this Court cited with approval the following proposition from *Helmsman*:

> A mere statement of a purpose to investigate possible general mismanagement, without more, will not entitle a shareholder to broad § 220 inspection relief. There must be some evidence of possible mismanagement as would warrant further investigation of the matter.

Helmsman, 525 A.2d at 166; *see also Security First*, 687 A.2d at 568; *Thomas & Betts*, 681 A.2d at 1031. This Court never suggested here or elsewhere that there was some other reduced burden of proof that might exist between a "mere statement of a purpose" and "some evidence" of possible mismanagement supporting that purpose.

Nor could there be a standard lower than "some evidence of possible mismanagement" that would leave the court any issue to adjudicate. Under the "credible basis" standard, stockholders are not required to prove any of their claimed wrongdoing and defendants may not litigate the merits of those allegations. *Khanna*, 2004 WL 187274, at *6. Rather, stockholders need only show some evidence of possible mismanagement, a showing that "may ultimately fall well short of demonstrating that anything wrong occurred." *Id.* at *6 n.25. The only way to lower the standard further would be to eliminate any requirement that plaintiffs show evidence of wrongdoing, which would be tantamount to permitting inspection based on a "mere statement" of purpose or "curiosity" and which this Court has repeatedly and correctly refused to do.

CONCLUSION

Verizon respectfully submits that: (A) a stockholder with a proper purpose should not be permitted to review a corporation's books and records based solely on a showing that the stockholder has a rational basis for the inspection, but absolutely no evidence of mismanagement or wrongdoing; and (B) there is no reduced burden of proof lower than the "credible basis" standard, and certainly no reduced burden that would not disrupt corporations' business and interfere with corporate decision-making. The "credible basis" standard is settled law that has been relied on by Delaware corporations and courts to craft a careful balance between the interests of stockholders and corporations, and Plaintiff cannot show any reason that standard should be cast aside.

For these reasons and those set forth in Verizon's Answering Brief, the Court of Chancery's November 23, 2005 Opinion denying Plaintiff's motion for summary judgment and granting Verizon's cross-motion for summary judgment should be affirmed in all respects.

Respectfully submitted,

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