

THE DIFFERENCE BETWEEN ILLINOIS AND DELAWARE

Shareholder Inspection Rights

By Daniel R. Saeedi and Richard Y. Hu



Shareholders often find themselves in the passive position of watching corporate events unfold through the decision-making of others. When these decisions harm the corporation, one of the most important rights a shareholder has is the right to seek inspection of corporate books and records. The right to seek inspection not only enhances corporate transparency, but conceptually it also may provide necessary evidence for the prosecution of a potential shareholder derivative lawsuit.

Illinois and Delaware cases differ in a number of ways involving shareholder inspection rights. Illinois cases emphasize the value of corporate transparency in applying a shareholder-friendly standard.

Conversely, Delaware emphasizes the importance of not burdening the corporation with intrusive inspection demands, as well as deference to management decisions.

These differences have practical considerations. They affect how lawyers are able to assert a “proper purpose” for an inspection demand. They also impact the permissible scope of inspection, as well as procedural issues such as jurisdiction and permissible remedies. Lawyers who understand these differences will better position their clients, whether minority shareholders or company management, to effectively prosecute or defend against shareholder inspection demands.

Illinois’ “Proper Purpose” Standard—Good Faith Allegations

The most important difference between Illinois and Delaware law lies in each state’s courts’ interpretations of the “proper purpose” standard.

In Illinois, the right of shareholders to inspect records is governed by the Business Corporation Act of 1983, 805 ILCS 5/1 *et seq.* Section 7.75 of the Act provides that any person who is a shareholder of record has the right to examine the corporation’s books, records and minutes, “but only for a proper purpose.” To invoke such right, the shareholder must make a written demand, “stating with particularity the records sought to be examined and the purpose therefor.”

Under Illinois law, the burden of establishing a “proper purpose” falls on the shareholder to articulate in its demand a good faith and specific and honest purpose, such as it believes an officer or director has engaged in self-dealing or other misconduct. These allegations need not be corroborated by documentary proof of the misconduct or made with a high degree of particularity. Illinois courts do not put the onus on the shareholder to prove a derivative claim before it is entitled to documents that would likely inform the contours of the claim.

A recent case, *Sunlitz Holding Co., W.L.L. v. Trading Block Holdings, Inc.*, 2014 IL App (1st) 133938, illustrates this standard. In *Sunlitz*, the plaintiff shareholders made an inspection demand for a vast array of corporate documents and asserted their purpose was to assess whether there had been any self-dealing by the company’s management or directors. The shareholders referenced the board’s approval of a stock option plan that resulted in the dilution of stock to the detriment of shareholders and to the benefit of the directors. The defendants refused to provide records other than profit and loss statements. The shareholders alleged those records showed that while revenues significantly increased each year, net losses continued to accrue due to unspecified operating expenses.

Although the circuit court held that the plaintiffs failed to assert a proper purpose, the appellate court reversed. The court held that even though the plaintiffs failed to allege which directors engaged in self-dealing, or even identify which business actions were self-dealing, a proper purpose was nevertheless asserted. The court noted that although the plaintiffs had not yet reviewed records, the “defendants would have plaintiffs state the details of the alleged mismanagement, which plaintiffs are not certain has even occurred.” Rather, the court held “plaintiffs do not need to establish actual mismanagement or wrongdoing. Good faith fears of mismanagement are sufficient.” *Sunlitz*, 2014 IL App (1st) 133938, ¶ 23.

Although there is no burden shifting, Illinois courts will not always accept

what might otherwise be a facially proper purpose. Where there is evidence that the shareholder is actually using an inspection demand for an improper purpose, courts will prevent such inspection. For example, in *West Shore Assoc. v. Am. Wilbert Vault Corp. et. al.*, 269 Ill. App. 3d 175, 180-81 (1st Dist. 1994), the court found for the defendant corporation where the evidence showed that the plaintiff shareholder had bought only six shares of stock and then immediately made a very burdensome demand, and where the shareholder’s president was also the president of a principal competitor of the defendant. But cases like *West Shore* are the exception, not the rule.

Delaware’s “Proper Purpose” Standard— “Credible Basis” Based on Evidence

Unlike Illinois’ statute, Section 220 of the Delaware General Corporation Law, 8 Del. C. § 220, which governs shareholder inspection, states that “[a] proper purpose shall mean a purpose reasonably related to such person’s interest as a stockholder.” In application, Delaware’s proper purpose standard is management-friendly. Delaware courts require shareholders to present some evidence to suggest a “credible basis” from which a court may infer that mismanagement, waste or wrongdoing may have occurred. The credible basis standard may be satisfied “by a credible showing, through documents, logic, testimony or otherwise, that there are legitimate issues of wrongdoing.” *Seinfeld v. Verizon Communications, Inc.*, 909 A.2d 117, 118-19 (2006).

The rationale for employing the “credible basis” standard is that at some point “the costs of generating more information fall short of the benefits of having more information,” and these costs would be “wealth-reducing” and not in the shareholders’ best interests. *Seinfeld*, 909 A.2d at 122. Delaware courts applying the credible basis standard have dismissed shareholder claims under Section 220 even where the shareholder’s purpose was proper on its face, but not substantiated with any underlying documentation. In such cases, Delaware courts have held the shareholder did not show a credible basis to infer wrongdoing.

More specifically, in *Seinfeld*, a Verizon shareholder sought inspection under Section 220 based on alleged mismanagement and waste. The computations the shareholder performed showed that three Verizon executives were paid \$205 million over three years, despite their questionable and duplicative responsibilities. The Delaware Supreme Court described the legal issue as “narrow”: “should a stockholder seeking inspection under section 220 be entitled to relief without being required to show some evidence to suggest a credible basis for wrongdoing?” The court answered “no” to this question.

While the Delaware Supreme Court never challenged the shareholder’s motivation for alleging mismanagement and waste, the court affirmed the trial court’s ruling that the shareholder “had not met his evidentiary burden to demonstrate a proper purpose to justify the inspection of Verizon’s records.” *Id.* at 118. The shareholder acknowledged in his deposition that he did not have factual support for his claim and that his compensation calculations possibly were wrong. Thus, his attempt to seek records to substantiate his claims was barred because his purpose was based on “mere suspicion.” *Id.* at 123. *See also Westland Police & Fire Axcelis Tech.*, 1 A.3d 281, 288 (2010) (relying on *Seinfeld* and finding that shareholder inspection request did not satisfy the credible basis standard when based on “bare accusations.”).

There is another important difference between the two states’ interpretations of the “proper purpose” standard as it relates to corporate minutes, shareholder records and voting trust agreements. Illinois, by statute, shifts the burden of proof to the corporation to show there was an improper purpose when corporate minutes or voting trust agreements are being sought for examination. 805 ILCS 5/ 7.75(c-d). No such burden shifting occurs in Delaware as it relates to these specific documents. Both states, however, by statute place the burden on the corporation when there is a request for a shareholder list. Delaware also places the burden on the corporation when the shareholder seeks to examine stock ledgers. 8 Del. C. § 220(c).

The Scope of Inspection

In addition to differing on how to interpret a “proper purpose,” Illinois and Delaware differ on the scope of inspection allowed. In Illinois, once a proper purpose has been established, the scope of inspection is broad: a shareholder is entitled to “all books and records necessary to make an intelligent and searching investigation” and “from which he can derive any information that will enable him to better protect his interest.” *Sunlitz*, 2014 IL App (1st) 133938, ¶ 26. A shareholder of an Illinois corporation need not establish a proper purpose with respect to each document he desires to examine. Rather, a proper purpose that would entitle him to inspection generally is sufficient.

Delaware’s standard is again more stringent. Even where a shareholder establishes a proper purpose to inspect under Section 220, the stockholder bears the burden of proving that each category of books and records is essential to accomplishment of the articulated purpose. Delaware courts have wide latitude in determining the proper scope of inspection and will “narrowly tailor the inspection right to a stockholder’s stated purpose.” *Thomas & Betts Corp. v. Leviton Mfg. Co., Inc.*, 681 A.2d 1026, 1035 (1996).

Jurisdiction and the Possibility of Removal

Even where Delaware and Illinois are similar in their standards, the practical effects of those standards may be different. This is especially true regarding jurisdiction.

For counsel defending an Illinois corporation in a shareholder inspection suit, the possibility of removal to federal court based on diversity might seem like a tempting strategy. However, Illinois precludes this maneuver by requiring that inspection actions be brought in the “circuit court of the county in which either the registered agent or principal office of the corporation is located.” 805 ILCS 5/7.75(c). At least one federal court has questioned whether it has jurisdiction to hear a shareholder inspection case brought under Section 7.75. See *Stauffer v. Westmoreland Obstetric & Gynecologic Assocs., S.C.*, 2001 WL 585510, at *9 fn. 9 (N.D. Ill. May 25, 2001).

Delaware also contains an exclusive state jurisdiction requirement. See 8 Del. C. § 220(c). The practical effect of this forum selection provision is, however, much different. The Delaware Court of Chancery’s calendar is dominated by corporate cases, and it is the same forum that has honed the “credible basis” standard discussed above. Attorneys for Delaware corporate defendants generally prefer litigating these issues in Delaware’s management-friendly Chancery Court.

The Remedy for Improper Refusal to Allow Inspection

The statutory remedy for improper refusal to allow inspection of an Illinois corporation’s books and records also differs from Delaware. Under Section 7.75(d) of the Illinois Business Corporation Act, the remedy for improper refusal to allow inspection is “a penalty of up to ten percent of the value of the shares owned by such shareholder,” in addition to any other damages or remedies “afforded by law.” Delaware, on the other hand, affords no such statutory penalty.

The Impact on Derivative Suits

Delaware courts are skeptical of derivative actions filed before a shareholder first attempts to exercise its inspection rights. See *King v. VeriFone Holdings, Inc.*, 12 A.3d 1140, 1145 (Del. 2011) (discussing how Delaware courts “strongly encourage” seeking records inspection before filing a derivative action). While no Delaware court has gone as far as to require a Section 220 action prior to a derivative suit, they have at times dismissed derivative suits and simultaneously advised plaintiffs to first exhaust their inspection rights. In contrast, Illinois courts do not stress the necessity or even importance of exhausting inspection rights before filing a derivative action.

Practical Considerations for Attorneys

Attorneys and businesses should also understand the practical differences between Illinois and Delaware regarding shareholder inspection demands. For example, if the desire is for more transparency and minority shareholder influence,

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Illinois might be appealing. On the other hand, if the prospective corporation seeks to give greater influence to its managers and directors, Delaware will be preferable, both as a place of incorporation and a forum for litigation.

Finally, as a practical matter, the scope of permissible inspection will probably be broader in Illinois. Where Delaware law controls, the corporation will have stronger grounds to limit the categories of production, especially where the shareholder has not shown the relevance of specific documents to the stated purpose. Understanding these differences between Illinois and Delaware can position a party well for prosecuting or opposing an inspection demand. ■

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