

Inspection Rights Are Not Granted For Fishing Expeditions

Saturday, April 20, 2019

In *David A. Hoeller v. Tempur Sealy International, Inc.*, C.A. No. 2018-0336-JRS (Del. Ch. February 12, 2019), the Delaware Court of Chancery denied a shareholder's request to inspect the Company's books and records, because he failed to provide a credible basis to suspect mismanagement or wrongdoing.

Tempur Sealy (the "Company") is a mattress manufacturer incorporated in Delaware and supplies products to various retailers and department stores. In 2015, Mattress Firm and Sleepy's accounted for approximately 24% of the Company's overall sales. In February 2016, Mattress Firm acquired the holding company for Sleepy's. The Company took this opportunity to renegotiate the Master Retailing Agreements (the "Agreements") they had in place with Mattress Firm and Sleepy's in order to exact more favorable terms.

In August 2016, Mattress Firm announced that it was being acquired by a European manufacturer with a vertically integrated product line. The Company continued to renegotiate the Agreements to seek more favorable terms.

During this time, the Company's public disclosures emphasized that the Company's dependence on a relatively small number of large customers created risk. However, the Company's CEO stated at a conference that he was "very optimistic long-term" and that "within a quarter or two, we'll be back on what I'll call a normal basis [with Mattress Firm]."

In January 2017, at an industry convention, Mattress Firm advised the Company that it would terminate the Agreements and no longer sell its products unless the Company agreed to different terms. Shortly thereafter, Mattress Firm proposed more balanced terms in favor of the Company, but the Company was unwilling to compromise. Toward the end of January 2017, the Company terminated the Agreements immediately and stated that it would send no further products to Mattress Firm. Mattress Firm sued for breach of contract and other claims.

In October 2017, a Company shareholder named David A. Hoeller (the "Plaintiff") served a books and records demand seeking to investigate potential wrongdoing, distribution of false information, and breach of fiduciary duty in connection with the Company's termination of the Agreements. The Company rejected the Plaintiff's demand but eventually produced four documents, including an email chain, a list of meetings, and board meeting minutes.

The Court's analysis started by summarizing Section 220, which permits a stockholder of a Delaware corporation to inspect the corporation's books and records if the demand complies with (1) the statute's form and manner requirements, and (2) states a proper purpose. While investigation of mismanagement or wrongdoing is a proper purpose, the stockholder must present a credible basis from which the court can infer that mismanagement or wrongdoing occurred.

The Plaintiff contended that mismanagement of the Company's relationship with Mattress Firm led to the loss of its largest customer. The Court stated that when a stockholder's purpose in seeking books and records is on account of alleged breach by the board of its duty of oversight (i.e., a *Caremark* claim), the stockholder must provide some evidence from which the Court can infer that the board failed to implement a reporting system or ignored obvious signs of concern. The Court found that such evidence was lacking in this case. The fact that the Company lost a major customer and was sued for breach of contract by such customer is not enough in itself to



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warrant a *Caremark* claim. Moreover, there was no evidence that the Company officers were motivated by self-interest in the negotiations with Mattress Firm.

Finally, the Court dismissed the Plaintiff's argument that the CEO distributed false or misleading information, because (1) the Plaintiff was not able to prove that the CEO knew his statements were false when made, and (2) the CEO's statements contained no representations of fact and were simply "expressions of opinions about the future." Regarding the Company's SEC filings, the Court found that the Company repeatedly disclosed the business risk of losing its largest customer.

In short, while "[i]nvestigations of meritorious allegations of possible mismanagement, waste or wrongdoing" are beneficial to a corporation, "indiscriminate fishing expeditions" are not.

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