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Chancery Court Decisions Limit Access to Corporate Records in Going-Private Transaction and Following Derivative Suit

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In recent years, shareholder demands to inspect corporate books and records under Section 220 of the Delaware General Corporation Law have become a more prevalent tool for shareholder activists, hedge funds and other market professionals, particularly in the context of mergers and other corporate control transactions. For example, hedge funds, particularly those focused on merger and other event arbitrage, may seek such documents in order to derail a proposed transaction or obtain a higher price for their shares. In addition, derivative plaintiffs, denied the benefits of discovery before they have shown that they have standing to maintain a derivative action, have begun to use shareholder inspection demands more frequently in an attempt to bolster their complaints.

In two recent decisions, the Delaware Court of Chancery has shown that it recognizes the potential burden on companies, as well as the risk for abuse, caused by improper demands under Section 220. As a result, the courts are carefully scrutinizing whether inspection demands under this section are done for a proper purpose. Two recent decisions demonstrate this view. In *Polygon Global Opportunities Master Fund v. West Corp.*,[1] the Chancery Court ruled against a hedge fund's demand to inspect corporate books and records following the announcement of a going-private transaction. In *West Coast Management & Capital, LLC v. Carrier Access Corp.*,[2] the Court ruled against a plaintiff which sought to obtain documents to bolster allegations for a potential derivative case following the dismissal of an earlier derivative action. Although they arise in very different contexts, these decisions have several important implications concerning what constitutes a "proper purpose" for a shareholder inspection demand. Among other things, any shareholder who seeks documents purportedly to determine whether the officers, directors or the company have engaged in wrongdoing must be able to take concrete action with the requested documents. If a shareholder would lack the ability to bring suit, such as by not having standing, then it will face a heavy burden to seek enforcement of its Section 220 demand under the statute.

Background of *Polygon Global Opportunities Master Fund v. West Corp.*

On May 31, 2006, West Corporation (West Corp.), a publicly-held provider of outsourced communication solutions, announced a recapitalization in the form of a squeeze-out merger. West Corp. had two controlling shareholders, Gary and Mary West. Under the terms of the proposed recapitalization, minority investors in West Corp. would be cashed out, receiving a premium of 13 percent over the company's closing stock price on the day before the announcement of the transaction but below the trading price of the stock only a month before. The Wests would receive cash for 85 percent of their shares while converting the remaining 15 percent into shares in the surviving private corporation. The proposed transaction was reviewed and recommended by a special committee of the company's board of directors. The Wests had agreed to vote their shares in favor of the recapitalization, so the transaction was guaranteed approval.

Seeing a potentially lucrative arbitrage opportunity, Polygon Global Opportunities Master Fund (Polygon), a hedge fund focused on merger arbitrage, began purchasing what soon became a significant amount of stock in West Corp. immediately following the announcement of the proposed recapitalization.

Not long after its first purchase of West Corp. stock, Polygon made two shareholder inspection demands under Section 220 of the Delaware General Corporation Law to produce certain books and records regarding the proposed transaction. After the company's refusal, Polygon refined its demand, which West Corp. refused as well.

Polygon then filed suit in Chancery Court seeking to enforce its right to inspect West Corp.'s books and records under Section 220.[3] Section 220 gives shareholders of a corporation a statutory right to inspect that corporation's books and records when the shareholders can demonstrate that they have a proper purpose. The statute defines a proper purpose as one "reasonably related to such person's interest as a stockholder." If that purpose is to investigate potential wrongdoing, which is a proper purpose, the shareholder must produce some evidence that suggests a credible basis from which the court can infer that legitimate issues warranting further investigation exist.[4]

Polygon asserted three purposes. First, Polygon claimed that it sought the documents in order to value its stock and thus determine whether to exercise its appraisal rights rather than accept the consideration being offered to West Corp.'s minority shareholders. Second, Polygon claimed that it sought to investigate possible breaches of fiduciary duty by West Corp.'s directors in approving the proposed recapitalization. Finally, Polygon sought to communicate with other stockholders concerning what it learned through the demand.

The Chancery Court Rules Against Polygon

Following a summary proceeding, the Chancery Court dismissed Polygon's complaint and entered judgment for West Corp. The Court began its decision by examining the nature of the "proper purpose" requirement under Section 220. Noting that it was not sufficient for a shareholder to simply put forward what would constitute a proper purpose, the Chancery Court indicated that such purposes will be scrutinized in order to see whether the nature and scope of the inspection is actually essential to satisfying that purpose.

With regard to Polygon's first purpose — to determine whether to seek appraisal — the Court rejected plaintiff's argument because it found that Polygon had sufficient information available to it to make that decision. The Court noted that an inspection demand has a more limited scope when made on a public company because, as compared to a private company, the public company already disseminates a large amount of information, such as in periodic SEC filings. In this case, the proposed going-private transaction was governed under SEC Rule 13e-3,[5] which requires even more detailed information than under ordinary circumstances. Thus, the company's disclosures concerning the proposed transaction included all of the presentations made by the company's investment bankers, detailed descriptions of two fairness opinions, summaries of board and special committee deliberations, and company forecasts. The Court concluded that "[t]his wealth of detailed information would appear to satisfy the obligation to disclose all facts material to the decision whether to demand appraisal."[6]

The Court declined to impose a *per se* rule that the disclosures made under SEC Rule 13e-3 are always sufficient for minority shareholders facing a squeeze-out merger to determine whether to seek appraisal. However, it pointed out that those disclosures contain more information than regular SEC filings, and it determined that Polygon had sufficient information in this case.

Polygon's second stated purpose—to investigate alleged breaches of fiduciary duties by West Corp.'s board—also failed. Polygon claimed that it sought to determine whether the Wests and the members of the special committee of the board had breached their fiduciary duties, noting that the Wests would be treated differently than other shareholders as they would continue to have an equity interest in the company after the transaction. In addition to claiming that the premium being offered to shareholders was inadequate, Polygon argued that a 21-day "go shop" period contained in the merger agreement, during which West Corp. actively sought out other bidders, was insufficient and may have acted as an obstacle to obtaining a higher price for the minority shareholders.

The Chancery Court found all of these claims concerning an interest in investigating supposed wrongdoing to be insufficient. Reiterating Delaware's "strong public policy against purchasing grievances," the Court noted that Polygon had purchased West Corp. stock following the announcement of the proposed transaction. Thus, when it bought the stock, Polygon was aware of the difference in how the majority and minority shareholders would be treated, the terms of the agreement, and the price offered. Indeed, Polygon purchased the stock based on its view that the consideration was insufficient, thus giving it a potential arbitrage opportunity. Given this background as well as the fact that Polygon could not have maintained a derivative action as the supposed wrongdoing predated its becoming a shareholder of West Corp., the Court rejected this ground as well.

The Court also rejected Polygon's third and final stated purpose—to communicate to other shareholders the information obtained through its Section 220 demand—as moot. The Court determined that because this third purpose depended upon the first two purposes, which were not proper, it was also not proper.

Since Polygon could not state a proper purpose for its inspection demand, the Court denied its request under Section 220 and dismissed the complaint.

Background of West Coast Management & Capital, LLC v. Carrier Access Corp.

In *West Coast Management & Capital, LLC v. Carrier Access Corporation*, plaintiff (WCM) was a shareholder in the defendant corporation. WCM had previously brought a shareholder derivative action on behalf of Carrier Access in federal court in Colorado.

The Colorado federal court dismissed WCM's derivative complaint for failure to show that demand on the Carrier Access board of directors would have been futile. In its order, the District Court denied WCM's request to replead demand futility, and it held that the underlying claims were dismissed "without prejudice."

WCM made its first Section 220 demand to inspect Carrier Access's corporate books and records while the motion to dismiss the derivative suit was pending. Carrier Access rejected the demand as improper because it attempted to circumvent the federal court's denial of discovery during the pendency of the motion to dismiss. WCM did not take any action following the denial of its inspection demand.

WCM made a second Section 220 demand after the federal court dismissed its derivative suit. WCM's only asserted purpose was to investigate alleged wrongdoing. WCM claimed that it wanted to gather information from the Section 220 demand not to amend its original derivative complaint, but to file a second derivative action. WCM asserted that this was proper because the federal court dismissed the action without prejudice. When Carrier Access refused the demand to inspect, WCM filed a complaint in Chancery Court.

The Chancery Court Rules Against WCM

The Chancery Court dismissed WCM's suit to enforce its Section 220 demand. The Court, per Vice Chancellor Stephen P. Lamb, first held that WCM lacked standing to bring a second derivative action under principles of issue preclusion—the federal District Court had held, with finality, that WCM had failed to show that a demand on the Carrier Access board would have been futile. The supposed second derivative suit WCM sought to file would be substantially similar. In light of that, the Chancery Court held that WCM was precluded from relitigating the issue of demand futility in a second derivative action.

The fact that the District Court had dismissed the claims in the derivative suit without prejudice did not save WCM's standing. The dismissal of the claims without prejudice simply meant that the District Court recognized the underlying claims belonged to the corporation and, thus, could conceivably still be asserted by it, such as, for example, following a litigation demand on the board. What the District Court was adjudicating with finality was whether WCM could assert those claims on behalf of the company.

The Chancery Court then considered whether the lack of standing to bring a second derivative suit prevented WCM from obtaining the requested corporate books and records. Linking the proper purpose requirement for a Section 220 demand to the plaintiff's standing to bring suit with that information, the Court determined that "[i]f a books and records demand is to investigate wrongdoing and the plaintiff's sole purpose is to pursue a derivative suit, the plaintiff must have standing to pursue the underlying suit to have a proper purpose."[7] The plaintiff not only had to enunciate a generally accepted proper purpose but also to "state a reason for the purpose, i.e., what it will do with the information, or an end to which that investigation may lead."[8] Since WCM lacked standing to pursue the purpose for the Section 220 demand—investigating wrongdoing to support a second shareholders' derivative suit—it could not have a proper purpose.

Implications of *Polygon* and *Carrier Access*

The Chancery Court's decisions in *Polygon* and *Carrier Access* signal a concern by the Delaware courts regarding the proper purpose of Section 220 demands and the possibility that such demands will be used in a harassing manner.

There are at least two important implications raised by the decision in *Polygon*. The first concerns what will suffice for a shareholder to succeed in a Section 220 inspection demand when the corporation is going private. The second is whether shareholders who purchase stock with an existing grievance may use Section 220 to bolster their position.

In rejecting Polygon's argument that it needed the requested records in order to value its stock and determine whether to seek appraisal, the Chancery Court held that Polygon had sufficient information in West Corp.'s disclosures pursuant to SEC Rule 13e-3. Although the Court did not impose a *per se* rule that the disclosures required in a going-private transaction will always mean that a shareholder would have enough information to determine whether it should exercise its appraisal rights, it will be much more difficult for a shareholder in that position to use a Section 220 demand. Delaware courts have long noted the difference in the amount of information available to the shareholders of public and private companies.[9] Given that shareholders seeking to inspect corporate books and records may only view those

records that are "essential and sufficient" to the shareholders' purpose,[10] *Polygon* suggests that the disclosure requirements of Rule 13e-3 are more than enough to allow a shareholder to decide on its options. Given the vast amount of disclosure required under Rule 13e-3, this is a reasonable conclusion. If, as it must, the corporation has already prepared and disseminated information that is germane and sufficient for the shareholders' consideration concerning a going-private transaction, it would be unduly onerous to allow demanding shareholders to ask for even more information.

With the rise of very large private equity funds and the growing prevalence of going-private transactions, this holding should provide some comfort to participants in such transactions that they will not have to face shareholder inspection demands on top of already stringent SEC disclosure obligations. As a corollary to this, it is important to note that *Polygon* stressed that Section 220 demands are not a substitute for the formal discovery available in an appraisal action. In effect, the Chancery Court is telling shareholders, particularly a sophisticated shareholder like Polygon, that they cannot have it both ways. All of this should serve to protect transactions from opportunistic shareholders seeking to disrupt going-private deals.

The second implication of *Polygon* is the judicial suspicion of shareholders who purchase stock with an existing grievance. The facts of the case were clear: a transaction was announced and a hedge fund bought stock on the belief that the consideration offered was inadequate. The Court reasoned that Polygon could not argue that it sought to investigate a breach of fiduciary duty when its purchase was in effect driven by a belief that the board had breached its duties by agreeing to the proposed transaction. The holding was not limited to that, however. As the Court noted, "Polygon's sole purpose for investigating claims of wrongdoing [was] to determine whether the board members 'breached their fiduciary duties in approving the Recapitalization Transaction.' This purpose is not reasonably related to Polygon's interest as a stockholder as it would not have standing to pursue a derivative action based on any potential breaches."[11] Polygon lacked standing to maintain a derivative action because it bought its stock after the purported wrongdoing occurred.[12] In effect, the Court appeared to hold that because Polygon could not have taken any legal action even if its inspection demand had turned up actual wrongdoing, Polygon did not have a proper purpose. This holding has broader ramifications than just going-private transactions. For example, the Delaware courts (and other courts following Delaware law) have repeatedly held that derivative plaintiffs cannot use discovery to establish their standing to maintain a derivative action.[13] Instead, the courts recommend that shareholders use the mechanism of a Section 220 request before filing a complaint.[14] By making clear that an inspection demand for the purpose of determining whether there has been wrongdoing must be tied to the shareholder's ability to maintain an action for redress of such wrongs, *Polygon* has the potential to discourage fishing expeditions with no ability to benefit the company.

The Chancery Court's decision in *Carrier Access* takes this logic and applies it to the case where a plaintiff has already been held to lack standing to maintain a derivative action. As with *Polygon*, the Court's decision in *Carrier* Access places great weight on what the plaintiff could actually do with the books and records it is demanding. The *Polygon* plaintiff lacked standing because it purchased its stock after the alleged wrongdoing. The plaintiff in *Carrier Access* lacked standing because the Colorado federal court had already held that demand on the company's board would not be futile. In neither case was it enough for plaintiff to invoke a supposed proper purpose. Rather, the Court held that plaintiffs must prove not only that they have a proper purpose but also that they have a valid and feasible end to which they intend to put information gathered from the demand. In the context of these cases, having claimed that they sought to investigate supposed wrongdoing, the plaintiffs had to show that they would have standing to bring a derivative action to redress wrongdoing based on the information plaintiffs sought in their Section 220 demands.

Conclusion

Although the ultimate impact of *Polygon* and *Carrier* Access will need to await further judicial interpretation, the decisions reflect a growing willingness by the Delaware courts to go beyond the stated purpose of a shareholder inspection demand and examine what a shareholder could actually do with the documents it requests. Where that ultimate purpose is improper or simply not available, such as for lack of standing to maintain an action, the decisions suggest that companies will be able to resist such potentially abusive demands successfully.

Notes

1. *Polygon Global Opportunities Master Fund v. West Corp.,* No. 2313-N, 2006 WL 2947486 (Del. Ch. Oct. 12, 2006).
2. *West Coast Mgmt. & Capital, LLC v. Carrier Access Corp.,* No. 2262-N. 2006 WL 3337161 (Del. Ch. Nov. 14, 2006).
3. That section provides in pertinent part: "(a) Any stockholder, in person or by attorney or other agent, shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours of business to inspect for any proper purpose." 8 Del. C. § 220 (2006).
4. *Seinfeld v. Verizon Communications, Inc.,* 909 A.2d 117, 118 (Del. 2006).
5. 17 C.F.R. § 240.13e-3(a) (2006).

6. *Polygon,* 2006 WL 2947486, at *4.

7. West Coast Mgmt., 2006 WL 3337161, at *3.

8. *Id.* at *6.

9. Donald J. Wolfe, Jr. & Michael A. Pittenger, Corporate and Commercial Practice in the Delaware Court of Chancery § 8.6(g) (2005) (Possible defenses to a demand to inspect include "precluding inspections of books and records on the ground that all the information necessary to accomplish the stated purpose may be gleaned from public sources. There exists considerable, albeit dated, precedent supporting the outright denial of inspection rights with respect to books and records on this ground, most often in cases where the avowed purpose is to value the plaintiff's equity interest."). *See, e.g., State* ex rel. *Miller v. Loft,* 156 A. 170, 172 (Del. Super. Ct. 1931) ("[A]s a general rule and unless there is something to indicate that such information was fraudulent or unreliable, there is no reason for the issuance of the writ where the stockholder has already been given all the information as to the corporate affairs that he is reasonably and fairly entitled to receive or that he could procure from an examination of the corporate books and records."); *Delaware* ex rel. *Armour & Co. v. Gulf Sulphur Corp.,* 233 A.2d 457, 465 (Del. Super. Ct. 1967) ("A stockholder may not enforce his right to inspect corporate books where he already has the information to which he reasonably entitled.").

10. *Helmsman Mgmt. Serv., Inc. v. A & S Consultants, Inc.,* 525 A.2d 160, 167 (Del. Ch. 1987). *See* also *Delaware* ex rel. *Brumley v. Jessup & Moore Paper Co.,* 83 A. 30 (Del. Super. Ct. 1912); *Neely v. Oklahoma Publishing Co.,* No. 5293, 1977 WL 2563 (Del. Ch. Aug. 15, 1977), *reprinted at* 3 Del. J. Corp. L. 139, 142 (1977).

11. *Polygon,* 2006 WL 2947486, at *5.

12. Del. Ch. Ct. Rule 23.1 ("In a derivative action...the complaint shall allege that the plaintiff was a shareholder...at the time of the transaction of which the plaintiff complains...").

13. *See, e.g., Beam v. Stewart,* 845 A.2d 1040, 1056 & n.49 (Del. 2004) ("derivative plaintiffs are not entitled to discovery in order to demonstrate demand futility"); *Scattered Corp. v. Chicago Stock Exch., Inc.,* 701 A.2d 70, 77 (Del. 1997), *overruled on other grounds, Brehm v. Eisner,* 746 A.2d 244 (Del. 2000) ("[t]he law in Delaware is settled that plaintiffs in a derivative suit are not entitled to discovery to assist their compliance with the particularized pleading requirement of Rule 23.1;" rather, a derivative plaintiff's standing to sue "must be determined on the basis of the well-pleaded allegations of the complaint"); *Grimes v. DSC Communications Corp.,* 724 A.2d 561, 565 (Del. Ch. 1998) ("It is well settled law in Delaware that a plaintiff who files a derivative suit is not entitled to discovery in that action in order to assist him or her in meeting the particularized pleading requirements of Rule 23.1").

14. *E.g., Guttman v. Huang,* 823 A.2d 492, 504 (Del. Ch. 2003); *Brehm v. Eisner,* 746 A.2d 244, 266-67 (Del. 2000).

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