

STOCKHOLDER DEMANDS FOR BOOKS AND RECORDS: A FEW RECENT DEVELOPMENTS

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Companies incorporated in Delaware increasingly face stockholder demands for books and records under Section 220 of the Delaware General Corporation Law ("Section 220"). Stockholders often make these demands pursuant to Section 220 to assist them in bringing lawsuits against companies and their officers and directors. In evaluating and responding to Section 220 demands, it is therefore critical for companies and their counsel to be aware of numerous recent decisions by the Delaware Supreme Court and Delaware Court of Chancery further clarifying the extent of stockholder rights pursuant to Section 220.

Section 220 Explained

Section 220 affords record and beneficial stockholders the right to inspect their corporation's books and records for any purpose reasonably related to their interests as stockholders. Before they may do so, however, stockholders must meet several important requirements.

Stockholders must strictly comply with the form and manner requirements of the statute.² Stockholders also must state a proper purpose for the requested inspection.³ Where stockholders seek to investigate purportedly improper behavior, they must show a credible basis from which one can infer possible mismanagement.⁴ Finally, stockholders must prove the records requested are necessary and essential to their stated purpose.⁵

If a company refuses to permit an inspection or does not reply to the demand within five business days, a stockholder may apply to the Court of Chancery for an order compelling inspection.⁶ The Court of Chancery has exclusive jurisdiction to determine whether or not a person is entitled to the inspection sought.⁷

Recent Delaware Decisions Relating To Section 220 Demands

The uptick in demands for inspection pursuant to Section 220 has elicited increased attention from the Delaware Courts. Indeed, the Delaware Courts have issued a number of significant opinions regarding stockholder inspection rights.

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²*Smith v. Horizon Lines, Inc.*, C.A. No. 4573-CC, 2009 WL 2913887, at *2 (Del. Ch. Aug. 31, 2009).

³8 Del. C. § 220(b).

⁴*Seinfeld v. Verizon*, 909 A.2d 117, 122-23 (Del. 2006).

⁵*Sec. First Corp. v. U.S. Die Casting & Dev. Corp.*, 687 A.2d 563, 569 (Del. 1997).

⁶8 Del. C. § 220(c).

⁷*Id.*

The Court Will Closely Examine A Stockholder's Purported Purpose For The Books And Records To Ensure That The Requested Documents Are Necessary And Essential.

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

In *Espinoza v. Hewlett-Packard Co.*, the Delaware Supreme Court affirmed the Court of Chancery's ruling, which rejected a stockholder's attempt to obtain a report prepared by outside counsel for the Hewlett-Packard ("HP") board in connection with the termination of former CEO Mark Hurd. The Court of Chancery had concluded that the plaintiff failed to overcome a claim of attorney-client privilege and work product. The Delaware Supreme Court, however, ruled that it did not need to reach the privilege issues, because the plaintiff had not shown the document was essential to the stated purpose of the Section 220 inspection. *Id.* at 374.

The factual background to the decision was well publicized. The stockholder plaintiff contended that the board committed possible waste by terminating its former CEO without cause and awarding him benefits and severance payments estimated at over \$30 million. The stockholder sought various books and records relating to the termination, many of which were voluntarily provided by HP in response to the demand, including board minutes, a letter from attorney Gloria Allred, expense reports, and internal guidelines. *Id.* at 369. HP refused, however, to produce a report prepared by counsel, claiming it was privileged/work product. The stockholder plaintiff filed a Section 220 action seeking to compel production of the report, arguing that it was necessary to his investigation. *Id.* at 370.

The Supreme Court disagreed. The Court reiterated that a Section 220 plaintiff has the burden of demonstrating that the specific books and records he seeks to inspect are essential to the accomplishment of the stockholder's articulated purpose. *Id.* The Court clarified that "[a] document is 'essential' for Section 220 purposes if, at a minimum, it addresses the crux of the shareholder's purpose, and if the essential information the document contains is unavailable from another source." *Id.* at 371.

The Court held that the plaintiff had not met this burden. First, the Court found that plaintiff had failed to show that the report played a role in the board's decision of whether to fire the CEO "for cause," and without evidence that the report played a "central role" in the decision, the document was not essential to the purpose of investigating the alleged wrongdoing. *Id.* at 372. Second, the Court noted that HP had already disclosed sufficient information for plaintiff's purpose, including underlying documents and board minutes describing the actions taken by the board with respect to the termination. In light of these disclosures, plaintiff could not establish a further need for the report. Since the Court held that the plaintiff's Section 220 claims were deficient, the Court explained that it need not reach the issue of whether the report was protected by the attorney-client privilege or work product doctrine.

Broad Sweeping Document Requests Are Not Appropriate In Section 220 Demands.

***Paul v. China MediaExpress Holdings, Inc.*, C.A. No. 6570-VCP, 2012 WL 28818 (Del. Ch. Jan. 5, 2012):**

The stockholder plaintiff in *China MediaExpress Holdings* asserted two purposes for a laundry list of broad sweeping document requests: (1) to investigate possible wrongdoing and (2) to investigate the independence of the directors in anticipation of a litigation demand. The Court of Chancery held that the stockholder had demonstrated a “credible basis . . . from which the Court can infer wrongdoing” by pointing to: (a) the suspension of trading in Company stock by the NASDAQ; (b) resignation of the company’s independent auditor; (c) resignation of three board members; (d) the initiation of an internal investigation, and (e) media reports suggesting fraudulent conduct. *Id.* at *4. The Court further held that this stockholder was entitled to inspect books and records despite the existence of a prior-pending federal securities lawsuit brought by another stockholder, and despite defendants’ arguments that this stockholder might be unfit to serve as a stockholder representative should he later choose to bring a stockholder action. *Id.* at *5.

While the Court allowed inspection, it did so in a limited manner. Consistent with prior rulings, the Court approved only the most narrow requests directly related to the areas of purported misconduct. *Id.* at *7-8. The Court outright rejected the stockholder’s request for “all memoranda, presentations, reports, correspondence, email, minutes, recordings, consents, agendas, resolutions, summaries, analyses, transcripts, notes, and board or committee packages . . . concerning the subjects referenced [above],” noting that such requests were not proper in a Section 220 demand. *Id.* at *8.

***Rock Solid Gelt Ltd. v. The SmartPill Corp.*, C.A. No 7100-VCN, 2012 WL 4841602 (Del. Ch. Oct. 10, 2012)**

Rock Solid Gelt Ltd. v. The SmartPill Corp. involved a stockholder inspection sparked by a new round of preferred stock financing that was negotiated and approved by a special committee. Through this financing, controlling stockholders of SmartPill would receive preferred stock at a significant discount to prior rounds of preferred stock financing while all other preferred stock would be converted into common stock. *Id.* at *1-2. The stockholder plaintiff requested an expansive list of documents based on four purposes: (1) “to investigate whether the Board committed breaches of its fiduciary duties with respect to the [new preferred stock financing];”⁸ (2) “to investigate the independence of the Special Committee that approved the [new preferred stock financing];” (3) “to value its shares in SmartPill;” and (4) “to investigate whether the Board breached its fiduciary duties” in connection with a stock repurchase agreement SmartPill entered into with another minority stockholder who refused to participate in the new preferred stock financing. *Id.* at *3.

The Court rejected the fourth purported purpose, holding that “[a] stockholder’s perception that a fellow shareholder was able to acquire additional shares on favorable terms does not, without more, support a conclusion that mismanagement or other improper conduct was a foundation for the Fox SPA.” *Id.* at *5. While the Court found that the plaintiff had made the requisite showing to obtain

⁸The Court reiterated the well-settled requirement that a stockholder seeking to investigate possible breaches of fiduciary duties must present a credible basis from which the Court might infer that wrongdoing occurred. *Id.* at *3.

some documents responsive to the first three articulated purposes, the plaintiff had not shown that the broad categories of documents requested were all necessary and essential to those purposes.

The Court reiterated that §220 demands should be “circumscribed with rifled precision,” and the “Court should not be burdened with clearing away the clutter that an unjustifiably broad request produces.” *Id.* The requests here “read as if [the stockholder] w[as] pursuing voluminous document discovery under Court of Chancery Rule 34,” which “tempt[ed]” the Court to opt for “[a] broad rejection of [the stockholder’s] requests.” *Id.* Instead, the Court granted inspection of only the narrow requests directly related to the identified proper purposes, noting that “the Court [wa]s not inclined to search out, on its own, what might be a proper justification for some of the other documents which might conveniently fall within the broad scope defined by *Rock Solid*.” *Id.* at *6.

With regard to the plaintiff’s demand for records relating to the independence of the special committee, the Court held that the plaintiff was “entitled to receive copies of the special committee report, minutes of the meeting of the special committee, and minutes of any meeting of the board of directors relating to the creation or the recommendation of the special committee.” *Id.* at *4 (citing *Grimes v. DSC Commc’ns Corp.*, 724 A.2d 561, 567 (Del. Ch. 1998)). The stockholder plaintiff was not entitled to inspect additional documents relating to the independence of the special committee because it had not demonstrated the requisite need. *Rock Solid Gelt Ltd.*, 2012 WL 4841602, at *4.⁹

The Court Will Not Permit A Section 220 Inspection For The Purpose Of Investigating Wrongdoing Without A Credible Basis For Suspecting That Wrongdoing Is Occurring “Now.”

***Louisiana Mun. Police Emps.’ Ret. Sys. v. Lennar Corp.*, C.A. No. 7314-VCG, 2012 WL 4760881 (Del. Ch. Oct. 5, 2012):**

In *Louisiana Municipal Police Employees’ Retirement System v. Lennar Corp.*, a Lennar stockholder sought board minutes and other documents related to Lennar’s compliance with the Fair Labor Standards Act (“FLSA”) in order to investigate possible wrongdoing. This request was purportedly sparked by two Wall Street Journal articles published in September 2011, both of which reported that various government agencies were investigating several of the largest home builders in the United States—including Lennar Corporation—as part of a nationwide effort to enforce compliance with FLSA. Plaintiff also pointed to the fact that, between 2007 and 2009, eight former Lennar employees sued the company, accusing it of wrongfully classifying the employees as exempt from the FLSA to avoid paying overtime. All of the lawsuits were settled without any admission of wrongdoing before plaintiff made its demand under Section 220. *Id.* at *4.

While the Court acknowledged that investigating possible wrongdoing is, abstractly, a proper purpose, it reaffirmed the well-established principle that merely invoking that purpose is not enough. The stockholder must be able to “show, by a preponderance of the evidence, a credible basis from which the Court of Chancery can infer there is possible mismanagement that would warrant further

⁹The Court held that the following documents were “necessary and sufficient” for the purpose of valuing the stockholder’s shares: all valuations of SmartPill from March through July 2010, all pro-formas, projections and budgets during 2008-2010, the minority stockholder stock repurchase agreement, and the banker fairness opinion relating to the new financing. *Id.* at *7.

investigation.” *Id.* at *2. Here, the Court held that the stockholder plaintiff failed to meet its burden of showing a credible basis for suspected wrongdoing, and therefore lacked a proper purpose to conduct an inspection under Section 220.

The Court concluded that the stockholder plaintiff had no proper purpose for trying to investigate any wrongdoing alleged in the settled lawsuits, because it did not have standing to bring such claims. *Id.* at *3. Further, plaintiff disclaimed any notion that it wanted to investigate the specific wrongdoing alleged in those suits. Although it would be a proper purpose to investigate “ongoing mismanagement concerning compliance with labor law,” the old lawsuits did not provide a credible basis because simply pointing out that the company had been subject to lawsuits in the past was not enough to give a credible basis of current or ongoing wrongdoing. *Louisiana Mun. Police Emps.’ Ret. Sys.*, 2012 WL 4760881, at *3 (citing *Graulich v. Dell Inc.*, C.A. No. 5846-CC, 2011 WL 1843813, at *7 (Del. Ch. May 16, 2011)). Furthermore, the Court explained that “negative news articles alone are insufficient bases on which to justify a Section 220 demand.” *Id.* at *4. The Court found that this is especially true where the articles “describe actions by regulators, not wrongdoing by companies under investigation.” *Id.*

A Stockholder Generally Cannot Use Section 220 To Obtain Discovery For Use In A Previously Filed Derivative Action Unless He Has Been Granted the Right to Amend The Derivative Complaint.

***King v. VeriFone Holdings, Inc.*, 994 A.2d 354 (Del. Ch. 2010); rev’d, 12 A.3d 1140 (Del. 2011):**

In *King v. VeriFone Holdings, Inc.*, a stockholder attempted to use Section 220 to bolster demand futility allegations in a derivative action after the court dismissed the derivative action for failure to adequately plead demand futility. The Delaware Court of Chancery originally dismissed the Section 220 action, holding that “[o]nce a plaintiff has chosen to file a derivative suit, it has chosen its course and may not reverse course and burden the corporation (and its other stockholders) with yet another lawsuit to obtain information it cannot get in discovery in the derivative suit.” *King*, 994 A.2d at 357. The Delaware Supreme Court reversed, holding that while the preferred approach is to file a Section 220 demand *before* filing a plenary action, a stockholder’s decision to pursue a derivative action first does *not* “automatically bar” a later filed Section 220 demand. *King*, 12 A.3d at 1151.

***Central Laborers Pension Fund v. News Corp.*, C.A. No. 6287-VCN, 2011 WL 6224538 (Del. Ch. Nov. 30, 2011), aff’d, 45 A.3d 139 (Del. 2012):**

The Court of Chancery first addressed the *King v. Verifone* decision in *Central Laborers Pension Fund v. News Corp.* There, the stockholder plaintiff commenced a Section 220 action approximately one hour after commencing derivative litigation against News Corp. The stockholder claimed to be investigating the same purported misconduct and needed to inspect books and records to determine whether a demand on the board was appropriate with respect to the derivative action. *Id.* at *1. In holding that the stockholder had not stated a proper purpose for the demand, the Court concluded that a “stockholder plaintiff who files a Section 220 action immediately after its derivative action is acting inconsistently” because the certification of the derivative action under Rule 11 is an affirmation that the stockholder “had sufficient information to support its substantive allegations and its allegations of demand futility.” *Id.* Because the stockholder had already conceded that he needed

no further information in order to file suit, the Court held that he could not state a proper purpose under Section 220. *Id.* at *2.

In reaching its decision, the Court clarified the Supreme Court's decision in *Verifone*, holding that "[n]othing in *Verifone* would authorize [a stockholder] to use the tools of Section 220 while actively pursuing a simultaneously-filed plenary derivative action at its early stages." *Id.* The Court further held that, "once the derivative action is filed, and until the judicial processing of the dismissal motion reaches the point where a recasting of the allegations has been authorized, the stockholder may not, as a general matter, demonstrate a proper purpose for invoking Section 220." *Id.* at *1.

The Delaware Supreme Court subsequently affirmed the Court of Chancery's dismissal of the stockholder plaintiff's Section 220 action; however, it did so on the alternative ground that the stockholder plaintiff failed to comply with the form and manner requirements of Section 220. Specifically, the Supreme Court ruled that a "Section 220 plaintiff's compliance with the statutorily mandated procedures is a precondition to having the propriety of its purpose for inspection addressed." 45 A.3d 139, 141 (Del. 2012). Thus, the Supreme Court held that "[t]he Court of Chancery should not have addressed whether Central Laborers had shown a proper purpose for inspecting News Corp.'s records until that court first decided that Central Laborers had complied with the mandatory statutory procedural standing requirements." *Id.*

***Amalgamated Bank v. NetApp, Inc.*, C.A. No. 6772-VCG, 2012 WL 379908 (Del. Ch. Feb. 6, 2012):**

Following the *News Corp.* decision, the Court of Chancery further refined the application of *King v. Verifone*, clarifying that where a Section 220 plaintiff has already filed a derivative action, the Section 220 demand is appropriate only if the derivative action has been dismissed without prejudice or with leave to amend. *Id.* at *7. The stockholder plaintiff in *NetApp* had previously filed a derivative action in California and had only made a Section 220 demand after his initial complaint was dismissed. But, without waiting for any documents to be produced pursuant to the Section 220 demand, the plaintiff filed an amended complaint in the derivative action. Defendants argued the plaintiff did not have a proper purpose because the plaintiff had already amended the complaint. *Id.* at *6.

In its analysis, the Court emphasized that "[i]f the purpose of the Section 220 action is to seek information necessary to meet the pleading requirements in a substantive action, the Plaintiff should, for purposes of economy, and consistent with the requirements of Rule 11, bring the Section 220 action before filing the substantive action." *Id.* at *3. Because the plaintiff had not been granted leave to amend a third time, and because the California court had indicated the time for any further submissions had expired, the Court held that plaintiff failed to demonstrate a proper purpose for additional books and records. The Court noted that, "*King* stands for the limited proposition that when a plaintiff has been granted leave to amend its complaint, a plaintiff may have a proper purpose for demanding such records. When that leave to amend no longer exists, a plaintiff's proper purpose is extinguished." *Id.* at *7.

Key Takeaways

The aforementioned decisions reiterate and clarify several well-settled principles, including:

- (1) The investigation of wrongdoing is a classic “proper purpose” for a Section 220 inspection, but courts in Delaware will not permit such an investigation without proof of a credible basis for suspecting wrongdoing;
- (2) Section 220 requests may not be used as a proxy for discovery, and overly broad requests, such as requests for all documents related to a list of matters, are impermissible;
- (3) A stockholder bears a substantial burden to articulate why the documents sought are necessary and essential to the stated purpose, and that burden appears to be more closely scrutinized where the company has already disclosed core documents; and
- (4) If a books and records examination is necessary to draft a well-pleaded complaint, that examination *should occur before* a complaint is filed.

Additionally, these decisions have provided some clarification of *King v. Verifone*'s holding that a party is not barred from requesting books and records solely because such a person failed to seek books and records before filing a plenary complaint. In particular, these cases have made clear that while a Section 220 demand may be used to amend an existing complaint, no proper purpose exists if there is not right to amend.

In responding to a Section 220 demand, companies should keep these principles in mind and closely scrutinize the stockholder's stated purpose and the specific requests. Companies should also bear in mind the procedural posture of any related litigation, as that may have impact the viability of a Section 220 demand.

