Directors' and Officers' Liability

Delaware Records Inspection Litigation and U.S. Securities Law

JOSEPH M. MCLAUGHLIN*
SIMPSON THACHER & BARTLETT LLP

OCTOBER 8, 2009

A stockholder of a Delaware corporation has a statutory right to inspect the books and records of the corporation under Section 220 of the Delaware General Corporation Law. The statute prescribes form and manner requirements for a request, chief among them that the stockholder has a "proper purpose" for the inspection. It is not uncommon for stockholders, whether acting together or not, simultaneously to pursue a federal securities class action and a state court books-and-records initiative, ostensibly to investigate a possible derivative suit relating to the same core facts as the federal suit. It is now generally accepted that in enacting the Private Securities Litigation Reform Act ("PSLRA") and the Securities Litigation Uniform Standards Act ("SLUSA") Congress did not intend categorically to preempt lawsuits by stockholders under Section 220 seeking to compel an inspection of books and records related to the conduct at issue in a parallel federal class action. The intersection of a books-and-records action with a related putative federal securities class action raises important jurisdictional and strategic issues for the corporation and its management. Recent decisions from the Delaware Court of Chancery and elsewhere provide importance guidance on the interplay between the PSLRA and SLUSA, and a stockholder's demand rights under Section 220.

Books and Records Inspections

Any stockholder of a Delaware corporation who satisfies specified procedural requirements and demonstrates a specific proper purpose may use the summary procedure embodied in 8 Del. C. § 220 to inspect and copy the corporate

* Joseph M. McLaughlin is a partner at Simpson Thacher & Bartlett LLP.

stock ledger, stockholder list and other corporate books and records of corporations in which they have an ownership interest. The inspection process begins with service on the corporation at its registered Delaware office or principal place of business of a written demand that states under oath the purpose of the requested inspection. If the corporation declines to permit the requested inspection or does not respond to it within five business days of the demand, the stockholders may seek to compel inspection by way of a summary proceeding in the Delaware Court of Chancery.

Section 220 provides that a stockholder is entitled "to inspect for any proper purpose the corporation's stock ledger, a list of its stockholders, and its other books and records, and to make copies or extracts therefrom." Where the stockholder seeks to inspect books and records other than the stock ledger or stock list, the burden of proof is on the stockholder to establish "that the inspection he seeks is for a proper purpose."[1] A proper purpose is one reasonably related to the plaintiff's interest as a stockholder.

Although there is no exhaustive list of proper purposes, the most commonly recognized proper purposes are to: (a) investigate suspected corporate mismanagement, (b) determine the value of the corporation's stock, particularly in connection with a potential exercise of a right to put those shares to the corporation, (c) communicate with other stockholders on matters pertaining to the investment, and (d) solicit the participation of other stockholders in legitimate non-derivative litigation against the defendant corporation.[2]

When the asserted proper purpose for the inspection is to investigate alleged wrongdoing within the corporation, a stockholder is entitled to inspect corporate books and records only upon establishment of a credible basis to believe that wrongdoing has occurred. At the trial of a summary proceeding, the plaintiff must demonstrate the credible basis by a preponderance of the evidence. The plaintiff does not, however, need to establish in the Section 220 proceeding the underlying wrongdoing by a preponderance of the evidence.

A petitioning stockholder who satisfies the requirements of Section 220 is entitled to inspect those books and records reasonably necessary to effectuate the stockholder's rights and not harmful to the corporation's interests. The entitlement is not open-ended; inspection is restricted to the books and records

needed to perform the established proper purpose.[3] The limitation on the scope of inspection is a corollary to a broader policy which recognizes that the court is "empowered to protect the corporation's legitimate interests and to prevent possible abuse of the stockholder's right of inspection by placing such reasonable restrictions and limitations as it deems proper on the exercise of the right."[4] Accordingly, the plaintiff must describe with considerable particularity its purpose and the records it seeks to inspect.

The PSLRA and SLUSA

The PSLRA imposes a discovery stay in private federal securities litigation during motion to dismiss proceedings.[5] Section 101(b)(2) of SLUSA further amended the federal securities laws to empower a federal court "[u]pon a proper showing ... [to] stay discovery proceedings in any private action in a State court, as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery pursuant to [the PSLRA]."[6] SLUSA's legislative history explains that the purpose of this provision is "to prevent plaintiffs from circumventing the stay of discovery under the [PSLRA] by using State court discovery, which may not be subject to those limitations, in an action filed in State court...."[7]

Federal and state courts have held that these federal securities law stay provisions do not broadly preempt a stockholder's state law right to demand inspection.[8] When a federal court is asked to apply its authority under SLUSA to stay state court discovery, relevant considerations include the risk of federal plaintiffs obtaining the state plaintiff's discovery, the extent of factual and legal overlap between the state and federal actions, and the burden of state-court discovery on defendants.[9] The issue often arises in the context of defense efforts in federal securities class actions to stay discovery in a state court putative derivative action that is based on substantially similar facts as the concurrent federal action. The express language of SLUSA, however, does not limit federal power to stay state court proceedings to derivative actions only. In Newby v. Enron Corp.,[10] the Fifth Circuit upheld a district court decision staying discovery in a parallel non-derivative action brought by an individual in state court, pending the federal court's determination of a motion to dismiss the federal claims. The court noted that the plain language of SLUSA gives a federal court power to stay discovery proceedings in "any" state court action, and that in enacting SLUSA Congress sought "to curb all

efforts to circumvent the reforms put into place by the PSLRA" not just state court derivative suits.

Recent Decisions

Several recent Delaware opinions have addressed the scope of a stockholder's rights to inspect books and records under Section 220 when a parallel federal securities class action involving the same corporation is pending. In Beiser v. PMC-Sierra, Inc.,[11] a plaintiff stockholder brought a putative derivative action in federal court, which the corporation moved to dismiss for failure to adequately plead demand futility. Discovery was stayed in the federal action pursuant to the PSLRA. The same plaintiff then made a demand to inspect the books and records of the corporation, for the stated purpose of investigating possible wrongdoing at the corporation. After the board refused, plaintiff sued in state court under Section 220, which defendant resisted on the ground that plaintiff lacked a "proper purpose" for the inspection.

The court agreed with the corporation and dismissed the books-and-records complaint with prejudice because plaintiff failed to establish a "proper purpose." Acknowledging that investigation of possible wrongdoing is a long-standing proper purpose under Section 220, the court nevertheless held that "a plaintiff must do more than merely state, in a conclusory manner, a generally accepted proper purpose. [A plaintiff] must state a reason for the purpose, i.e., what it will do with the information, or an end to which that investigation may lead." Since the plaintiff had already filed suit, no "proper purpose" was evident because "the only reasonable use for the evidence is to aid [plaintiff] in the Federal Action through discovery that has been foreclosed by the PSLRA." Summarizing the case law, the Delaware court concluded that when it appears Section 220 may be used to circumvent the PSLRA stay, the Section 220 action may only proceed where (1) the plaintiff was not currently involved in the federal action, (2) the plaintiff's counsel was not currently involved in the federal action, and (3) the plaintiff agreed to enter into a confidentiality agreement preventing it from sharing the information obtained with the plaintiff or counsel in the federal action.[12]

In Norfolk County Retirement System v. Jos. A. Bank Clothiers, Inc.,[13] also before the Delaware Court of Chancery, the court examined the effect on a Section 220 demand of prior rulings in a parallel federal class action. A prior federal

putative derivative action had been dismissed because plaintiff failed to make pre-suit demand on the company's board of directors and failed to show that demand would have been futile. Post-dismissal, the federal plaintiff made pre-suit demand and in response the board formed a special litigation committee ("SLC") to investigate the proposed claims. The SLC determined that the demand was unfounded. A separate plaintiff then filed a federal securities class action complaint against the company, which survived motions to dismiss and for summary judgment.

A third plaintiff not involved in either of the federal cases filed a books-and-records action seeking to inspect documents concerning the core facts alleged in both federal actions. In response to the demand, the corporation provided the plaintiff in the Section 220 action with the report of the SLC (and accompanying exhibits), the SLC's meeting minutes and the minutes of the board's meetings regarding the creation and duties of the SLC.

The Section 220 plaintiff contended that it was entitled to inspect the books and records beyond what the corporation had provided in order to determine whether wrongdoing had occurred and, more broadly, to investigate whether the board had properly discharged its fiduciary duties. The company countered that the voluntary production of the SLC materials more than adequately satisfied the plaintiff's stated purpose and, further, that the results of the SLC's review of the facts underlying the allegations-and its determination that no cause of action was warranted-was sufficient evidence that the board appropriately discharged its duties.

The court ruled that the plaintiff was not entitled to any further documents because it failed to demonstrate that the documents provided by the company were insufficient for its stated purpose of investigating wrongdoing, as the SLC had investigated the same facts. The court explained that the scope of the documents available under Section 220 is limited. Even where a plaintiff has a "proper purpose," it is not entitled to inspect all documents that it believes relevant to that purpose. The scope of a Section 220 demand is limited to books and records that are "necessary, essential and sufficient" to the stated purpose.

The court also addressed whether the plaintiff's broader purpose concerning the board's fiduciary duties entitled it to the broader documents sought. Though a stockholder is not required to prove that actual mismanagement occurred, the court stated, it "must make a credible showing, through documents, logic, testimony or otherwise, that there are legitimate issues of wrongdoing." Plaintiff pointed to the parallel federal class action claims that had survived dismissal and summary judgment motions, and contended these claims provided the very low "credible basis" threshold. The company responded that plaintiff's books-and-records request should be evaluated in light of the SLC report's findings that no breaches of fiduciary duty had occurred. The court agreed with the company, stating that absent the SLC report, the decision of the federal court might well have been sufficient for plaintiff to carry its burden. Since plaintiff had delayed in bringing its Section 220 demand, it could not expect the court to ignore the additional findings of the SLC which contradicted plaintiff's claims. The federal court had only been asked to assess the pleadings in response to a 12(b)(6) motion, the Delaware court reasoned, so the SLC report could not have factored into its decision. In light of that report—and with the benefit of its findings—the Delaware court determined that plaintiff's claim of corporate wrongdoing was not founded upon a "credible basis." The plaintiff's two-year delay in bringing its action also counted in the court's analysis, as it noted plaintiff should have acted more promptly when it was first on inquiry notice of potential wrongdoing through the earlier-filed federal actions. The court also emphasized that the interests of the corporation must be considered, noting the "countervailing concern that at some point a books and records request has diminishing returns for wealth creation and at some point begins to harm the company."

In another decision of the Delaware Court of Chancery, Highland Select Equity Fund, L.P. v. Motient Corp.,[14] the court denied a Section 220 demand where it concluded that the stated purpose of the requests belied improper purposes, the requests were overbroad and where the party seeking inspection had itself sought a stay of discovery in a related federal class action under the PSLRA and SLUSA. The parties in Motient were litigating in several different fora, including in a previously dismissed derivative action in Delaware state court and a federal action in Texas. The Section 220 plaintiff was a large institutional stockholder of the defendant company in the federal action, with a principal of the plaintiff having formerly served as a director of the company. Plaintiff was also actively engaging in a proxy contest to replace the defendant company's board.

The prior Delaware derivative action had been brought by the now-Section 220 plaintiff and dismissed for failure to make pre-suit demand or plead demand futility. Post-dismissal, the plaintiff sent a books and record demand consisting of nearly 50 categories of documents and numbering 25 single-spaced pages. The company refused the demand. Prior to the filing of the Section 220 action, the company had filed a federal lawsuit against the Section 220 plaintiff alleging violations of federal securities laws related to the proxy contest. The facts underlying the federal suit overlapped with the facts underlying the Delaware derivative suit and the Section 220 action. The Section 220 plaintiff had moved to dismiss the federal action in which it was a defendant and obtained a stay discovery therein under the PSLRA and SLUSA.

While the court found that the stated purpose of the demand — to gather information to assess a potential proxy contest and to investigate wrongdoing—was proper, it determined that the facts adduced at trial established that the stated purpose was a ruse. The court concluded that plaintiff had sufficient material at its disposal for the proxy contest from public filings and having been a board member. The court further noted that plaintiff's books and records demand appeared to serve as nothing more that "a rhetorical platform" for its proxy contest.

Further, the breadth of the request resembled comprehensive discovery demands, which was contrary to Section 220's intent to provide narrow, targeted material relevant to a proper purpose: "Section 220 contemplates a limited, discrete investigation" where a stockholder has stated a proper purpose of investigation. Accordingly, the court dismissed the Section 220 demand as "broadly inconsistent with the statutory scheme."

Finally, the court found that permitting the inspection would have been unfair given the plaintiff's efforts to stay discovery elsewhere under federal law. In the court's view, plaintiff "could have conducted full discovery into the very same questions ... but chose to foreclose that possibility by invoking the mandatory stay provisions of the PSLRA and the SLUSA." Permitting a Section 220 investigation under such circumstances would have improperly amounted to "one-way discovery."

Federal courts have been reluctant to stay parallel state court Section 220 proceedings unless the concerns for circumventing the PLSRA that underlie SLUSA are implicated. In City of Austin Police Ret. Sys. v. ITT Educ. Servs., Inc.,[15] a company asked the federal court supervising a securities class action to invoke SLUSA to stay a Section 220 action commenced by a stockholder seeking corporate books and records to investigate a possible derivative action arising out of the same facts as the federal action. The Section 220 plaintiff had made a demand on the board to sue certain officers and directors for breach of their fiduciary duties based on the same conduct alleged in the federal class action and also demanded to inspect the company's books and records relating to the alleged wrongdoing. The company largely denied the inspection request. Although the Delaware plaintiff was not involved in the federal action, its counsel had unsuccessfully sought to be named Lead Plaintiff's counsel in the federal suit on behalf of another stockholder.

The court determined that a Section 220 action is a "discovery proceeding" and therefore may be stayed under SLUSA. The court next analyzed the legislative intent of SLUSA and noted that Congress enacted the law because it perceived that certain securities plaintiffs were circumventing the stay provision and other aspects of the PSLRA by filing parallel suits in state court. Thus, the court reasoned, an intent to evade the PSLRA weighs heavily in favor of granting a stay under SLUSA. But the court concluded that no such intent was apparent on the part of the Section 220 plaintiff in City of Austin.

First, although the Section 220 plaintiff's counsel had prior involvement in the federal action, it had withdrawn from the case. Moreover, the Section 220 plaintiff and its counsel agreed to sign a confidentiality agreement barring them from sharing material with counsel in the federal action. The court discerned no apparent intent to evade the PSLRA since the Section 220 action was not a precursor to the securities fraud case, but rather was a "precursor to a possible stockholder derivative action under the law and in the courts of the state of incorporation," which involved "issues at the core of state corporation law ... that Congress has left to the state...." The court therefore held that the Section 220 action posed no threat to its jurisdiction, its judgments or its ability to adjudicate the federal securities fraud case.

Conclusion

The PSLRA and SLUSA generally do not preclude a state court from considering a books and records demand simply because a party to the state action is protected by a PSLRA automatic discovery stay in a parallel federal securities class action. A conflict between the PSLRA and Section 220 may arise when the 220 action seeks records that would be discoverable in a pending federal securities class action. If the stockholder or counsel making the Section 220 demand is a party to the federal class action or assisting a party to the federal action, a "proper purpose" for a demand is not stated unless the party and counsel making the demand sign a confidentiality agreement ensuring that any materials produced in response to the Section 220 demand will not be used in the class action.

Joseph M. McLaughlin is a partner at Simpson Thacher & Bartlett. Patrick Smith, an associate at the firm, assisted in the preparation of this article.

Endnotes:

1. 8 Del. C. § 220(c).

2. Compaq Computer Corp. v. Horton, 631 A.2d 1 (Del. 1993); Macklowe v. Planet Hollywood, Inc., 1994 WL 560804, at *4 (Del. Ch. Sept. 29, 1994).

3. BBC Acquisition Corp. v. Durr-Fillauer Medical, Inc., 623 A.2d 85, 88 (Del. Ch 1992).

4. B & F Towing and Salvage Co., Inc., 551 A.2d 45, 51 n. 7 (Del. 1988).

5. 15 U.S.C. § 78u-4(b)(3)(B).

6. 15 U.S.C. § 78u-4(b)(3)(D)

7. H.R.Rep. No. 105-640, at 17-18 (1998).

8. Cohen v. El Paso Corp., 2004 WL 2340046, at *3 (Del. Ch. Oct. 18, 2004).

9. See In re Dot Hill Sys. Corp. Sec. Litig., 594 F.Supp.2d 1150 (S.D. Cal. 2008).

10. 338 F.3d 467, 472 (5th Cir. 2003).

11. 2009 WL 483321 (Del. Ch. Feb. 26, 2009).

12. Id. at *4.

13. 2009 WL 353746 (Del. Ch. Feb. 12, 2009).

14. 906 A.2d 156 (Del. Ch. 2006).

15. 2005 WL 280345 (S.D. Ind. Feb. 2, 2005).