

Directors' and Officers' Liability: Stockholder Litigation and Corporate Records Demands

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JUNE 14, 2012

The interplay between corporate books and records inspections and stockholder derivative claims is an essential strategic consideration in derivative suits. Delaware courts have long urged stockholder plaintiffs to invoke their qualified statutory right to inspect the books and records of the corporation and otherwise conduct an adequate pre-suit investigation before filing a derivative action. This sequence discourages an inefficient “fire, ready, aim” approach to stockholder derivative litigation and prevents stockholders with pending derivative claims from using a simultaneously filed books and records action as a substitute for discovery in pending plenary actions. Delaware law, however, imposes no bright-line bar against inspection relief merely because the plaintiff has filed a derivative action before seeking inspection relief.

Recent Delaware Court of Chancery decisions have limited the potential for abuse arising from a rule which does not categorically bar a stockholder books and records inspection to bolster a derivative complaint that has already been filed. These decisions limit a stockholder’s ability to pursue books and records relief post-commencement of derivative litigation to circumstances where the earlier-filed derivative complaint has been dismissed on demand futility grounds with express leave to amend. Separately, the Delaware Supreme Court last month revitalized the “form and manner” of demand requirements prescribed in the inspection statute, emphasizing that they are not mere formalities, but threshold requirements which must be satisfied in order for the company to have any obligation to respond to a demand.

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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 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 within five business days of the demand, the stockholder may seek to compel inspection in 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) explore whether a pre-suit demand on the board to pursue a claim was wrongfully refused, or whether a pre-suit demand on the board should be excused as futile, (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

The utility of inspection rights is most widely recognized in the context of derivative actions, which seek to enforce a right belonging to the corporation. A stockholder who brings a purported derivative action alleging that demand is excused as futile must demonstrate futility within the four corners of the complaint; the stockholder is not entitled to discovery in that action in order to assist it in meeting the particularized pleading requirements of Rule 23.1. The Delaware Supreme Court, however, has urged stockholders intending to file a derivative action to avail themselves of Section 220—calling it the “tools at hand”—in order to prepare derivative complaints for the heightened pleading requirements of Rule 23.1. If the purpose of the Section 220 action is to seek information necessary to

meet the pleading requirements in a derivative action, common sense and efficiency dictate that the Section 220 action precede the filing of the derivative action.

Of course, a stockholder and its counsel seeking to pursue derivative claims must balance their need to conduct adequate pre-suit investigation with their desire to be appointed lead plaintiff and counsel by the court supervising multiple parallel suits, which may turn in part on their filing quickly.

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; a Section 220 inspection is much narrower than discovery. 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.

Recent Decisions

In [*Central Laborers Pension Fund v. News Corp.*](#),⁵ three weeks after News Corp. announced that it had reached an agreement in principle with Shine Group for News Corp. to acquire all of Shine's outstanding shares, plaintiff sent News Corp. a letter seeking to inspect certain of News Corp.'s books and records (the "Demand"). The Demand stated that plaintiff's purpose for making demand was (i) to investigate potential breaches of fiduciary duty in connection with the Shine transaction, and (ii) to determine whether pre-suit demand on the board was necessary or would be excused prior to commencing any derivative suit on behalf of News Corp.

Section 220 expressly requires beneficial stockholders to meet three separate requirements. The demand under oath must (1) state the person's status as a stockholder, (2) be accompanied by documentary evidence of beneficial ownership of the stock, and (3) state that the documentary evidence is a true and correct copy of what it purports to be. The Demand did not include any documentary evidence of plaintiff's beneficial ownership of News Corp. stock and contained several errors. It identified the wrong company, seeking to inspect "the books and records of

Viacom and its subsidiaries.” The Demand was accompanied by an affidavit of a representative of plaintiff which asserted that plaintiff beneficially owned 14,110 shares of News Corp. A power of attorney signed by the same individual, however, indicated that plaintiff was the record owner of the same number of News Corp. shares.

A week after serving the Demand, plaintiff filed a putative derivative action challenging the Shine transaction as reflecting an unfair price resulting from an unfair sales process, and alleging breach of fiduciary duty claims against the News Corp. board. One hour later, plaintiff filed a books and records action to compel inspection of the documents demanded. News Corp. moved to dismiss the books and records action. As part of its opposition to the motion to dismiss, plaintiff filed a revised affidavit and supplied documentary evidence of its beneficial stock ownership.

Vice Chancellor John Noble dismissed the books and records action, anchoring his ruling in the proper purpose standard. Plaintiff’s pending derivative action, the court reasoned, “necessarily reflects [plaintiff’s] view that it had sufficient grounds for alleging both demand futility and its substantive claims without the need for assistance afforded by Section 220.” Consequently, the court determined that plaintiff was “unable to tender a proper purpose for pursuing its efforts to inspect the books and records.”

The Court of Chancery’s ruling is an important interpretation of the Delaware Supreme Court’s landmark ruling last year in [*King v. Verifone Holdings*](#),⁶ which rejected a bright-line rule that a stockholder’s filing of a putative derivative action is an “election” that bars the stockholder from pursuing a subsequent books and records action on the subject of the derivative litigation. In *Verifone*, the Supreme Court determined that a stockholder whose derivative complaint was dismissed for failure to adequately allege demand futility was not by virtue of bringing a derivative complaint alone, “legally precluded from prosecuting a later-filed Section 220 proceeding brought to bolster demand futility allegations in an amended derivative complaint.” The crucial fact underlying *Verifone* was that the federal court dismissal of the derivative complaint expressly granted the plaintiff leave to amend its complaint to see if it could develop sufficient demand futility allegations through a books and records demand.

In *News Corp.*, the Court of Chancery rejected the notion that *Verifone* was an open-ended approval of simultaneous derivative and Section 220 actions. According to

the Court of Chancery, if the plaintiff brings a derivative suit, “[u]ntil its implicit representation that it has sufficient facts for its pleadings in the Derivative Action is rejected (or, perhaps, seriously called into question) by the Court handling the Derivative Action, it simply cannot identify that proper purpose that is consistent with the statutory standard” to demand books and records.⁷ The determination that the pendency of a plaintiff’s derivative action continues to constitute a concession that plaintiff believes it has sufficient grounds to allege both substantive claims and demand futility without resorting to Section 220 is an important gloss on *Verifone*.

The Delaware Supreme Court on appeal did not reach the proper purpose issue, affirming the dismissal of the books and records action on an alternative ground — failure to satisfy the statute’s threshold requirements regarding the “form and manner” of making a demand. Section 220(c) provides that stockholders seeking to inspect books and records “shall first establish that: (1) [s]uch stockholder is a stockholder; (2) [s]uch stockholder has complied with [section 220] respecting the form and manner of making demand for inspection of such documents; and (3) [t]he inspection such stockholder seeks is for a proper purpose.” This sequence, the court ruled, requires that the stockholder comply with the “form and manner” of making the demand before the corporation has any obligation to respond, including determine whether the inspection request is for a proper purpose. This insistence on “strict adherence to the section 220 inspection demand procedural requirements” strikes the appropriate balance between the rights of stockholders and corporations.

The Demand did not comply with the procedural requirements in section 220 in several respects noted above. Significantly, the Delaware Supreme Court held that the procedural requirements must be met at the time the Demand is made, and lapses cannot be cured nunc pro tunc in litigation filings. Rather, the proper course for a stockholder to correct a flawed books and records request is to submit a new or an amended request to the company’s registered office or principal place of business.

The background of [*Amalgamated Bank v. NetApp*](#)⁸ begins following *Verifone*’s contours: Plaintiff filed a putative derivative action in California alleging failure of oversight breach of fiduciary duty and waste claims against NetApp’s board. Plaintiff made no pre-suit demand on the board, alleging that would have been futile. The California court dismissed the complaint for failure to plead demand futility, granting leave to amend so that plaintiff could pursue a Section 220 action in Delaware in order to supplement its demand futility allegations. Plaintiff filed the books and records action, but the following month went ahead and filed a

Second Amended Complaint in California, which would suggest that plaintiff believed it already had the information it needed to plead demand futility.

The Delaware court concluded, however, that the California court had expressly left open the possibility of further amendment, but only within a final deadline for plaintiff to seek leave to amend. In this posture, the Delaware court determined that plaintiff had a proper purpose to request certain documents—to amend its Second Amended Complaint to plead demand futility. Following this Delaware ruling, however, plaintiff never sought leave in California to amend in the allotted time. After the company produced records, plaintiff moved to compel the production of additional materials under its demand.

Vice Chancellor Sam Glasscock, III determined that plaintiff’s failure to file a third amended complaint within the California court’s schedule eliminated plaintiff’s proper purpose for its Section 220 action. The court emphasized first principles (expressly recognized by the Delaware Supreme Court in *Verifone*) noting that “[p]roperly, a books and records examination is pursued, if necessary, before filing a complaint.” This means 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.”

Verifone authorizes departure from this sequence in a limited circumstance: When a stockholder derivative complaint has been dismissed with leave to amend, a plaintiff may have a proper purpose for demanding records to develop demand futility allegations. “When that leave to amend no longer exists,” the court stated, “a plaintiff’s proper purpose is extinguished,” and [n]othing in [*Verifone*] or Section 220...permits a books and records examination to become a device for parallel discovery to be pursued in two jurisdictions, nor does the theoretical possibility of leave to amend a pleading convert the desire for such discovery into a proper purpose.”

Conclusion

By filing a derivative action, a stockholder declares its belief that it had sufficient grounds for alleging both demand futility and its substantive claims without need of a books and records action. Consequently, unless a court has dismissed a derivative action with express leave to replead, a stockholder properly pursues a

books and records examination, if necessary, before filing putative derivative claims.

Once the derivative action is filed, unless and until the court presiding over the derivative action affirmatively authorizes amendment of the complaint, the stockholder plaintiff generally may not demonstrate a proper purpose for invoking Section 220. If an inspection demand is to be made, the “form and manner” requirements of Section 220 receive a straightforward and literal interpretation; failure to comply with them will derail a books and records demand until a revised demand is made that cures any non-compliance.

Endnotes:

1. 8 Del. C. §220(c).
2. [*Compaq Computer Corp. v. Horton*](#), 631 A.2d 1 (Del. 1993).
3. [*Highland Select Equity Fund v. Motient*](#), 906 A.2d 156, 164 (Del. Ch. 2006), *aff’d*, 922 A.2d 415 (Del. 2007).
4. [*B&F Towing and Salvage*](#), 551 A.2d 45, 51 n.7 (Del. 1988).
5. 2012 WL 1925724 (Del. May 29, 2012).
6. 12 A.3d 1140 (Del. 2011).
7. [*Central Laborers Pension Fund v. News Corp.*](#), 2011 WL 6224538 (Del. Ch. Nov. 30, 2011).
8. 2012 WL 379908 (Del. Ch. Feb. 6, 2012).

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