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Under Delaware law, stockholders may inspect records

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Imagine the following scenario: A company has hit a rough patch — a below-expectations quarter, earnings restatement or power struggle among board members. Although no lawsuits have been filed, a stockholder sends a letter demanding, under Delaware Corporations Code § 220, access to broad categories of sensitive, nonpublic company accounting records, e-mail and other documents. The clear implication: This stockholder is fishing for evidence supporting a lawsuit. Must the company allow inspection?

For businesses incorporated in Delaware, the answer is probably "yes." Delaware Corporations Code § 220 permits stockholder inspection and copying of a corporation's stock ledger, list of stockholders and "other books and records." Del. Code tit. 8, § 220. The Delaware Court of Chancery has broadly construed the phrase "other books and records" to cover a wide variety of corporate documents. See e.g., *Dobler v. Montgomery Cellular Holding Co.*, nos. C.A. 18105, C.A. 18499, 2001 Del. Ch. Lexis 126, at *18-*29 (New Castle Co., Del., Ch. Oct. 19, 2001) (allowing access to memoranda, e-mail, letters, minutes, resolutions, invoices, agreements, ledgers and other documents); *Skoglund v. Ormand Indus. Inc.*, 372 A.2d 204, 210 (New Castle Co., Del., Ch. 1976) (allowing access to "all the corporate financial records"). Section 220 even extends, under certain circumstances, to the books and records of a corporation's subsidiaries. Del. Code tit. 8, § 220(b).

Delaware's Court of Chancery has, in a number of recent reported decisions, actually urged stockholders to exercise inspection rights as a prelude to litigation, reasoning that judicial resources will be conserved if inspection either uncovers evidence resulting in a more sufficiently pleaded complaint or reveals defects in (and thereby prevents the filing of) an unmeritorious claim. See e.g., *Guttman v. Huang*, 823 A.2d 492 (New Castle Co., Del., Ch. 2003); *Seinfeld v. Verizon Commc'ns Inc.*, 909 A.2d 117 (Del. 2006). In fact, Chancellor William B. Chandler recently encouraged corporations responding to inspection demands to volunteer exculpatory documents — even those not requested — as a means to deter nonmeritorious litigation. *In re Tyson Foods Inc. Consol. S'holder Litig.*, 919 A.2d 563, 578 (New Castle Co., Del., Ch. 2007).

Minimal requirements

Section 220 imposes minimal requirements on an inspection demand. The demand must be written and under oath, and it must state a proper purpose for the inspection. Del. Code tit. 8, § 220(b). If the stockholder making the demand is not a holder of record, the demand must be accompanied by evidence of the stockholder's status. *Id.*

Thus, for counsel advising Delaware corporations, familiarity with the requirements and limits of § 220 is critical to the protection and control of company documents.

Vigilance in keeping watch for stockholder inspection demands is critical. This is especially true in time of corporate stress, when a corporation is more vulnerable to stockholder suits. Upon receipt of an inspection demand, a company has only five business days to respond. Del. Code tit. 8, § 220(c). A thoughtfully crafted response to an inspection demand is the most effective move in controlling the scope of any inspection. As discussed below, failure to respond timely to an inspection demand can result in the corporation ceding to the Chancery Court control over the scope of a stockholder's access. Counsel should

therefore educate senior management and the board of directors about the need for prompt notification should a demand letter be received.

The initial response to an inspection demand can set the tone for all future dealings with the stockholder and the stockholder's counsel. If the stockholder later brings an action to compel compliance, an objectively reasonable response will support the company's argument that it was not simply stonewalling. Moreover, in many instances, a carefully crafted response to an inspection demand can lead to negotiations over the scope of the inspection that will satisfy the stockholder without handing over the keys to company files. (But counsel seeking to negotiate a narrow limit on the scope of inspection must remember that stockholders are not prohibited by the statute from making subsequent, more expansive demands following review of a limited set of agreed-upon documents.)

Counsel first should consider whether the demand satisfies § 220's technical requirements mentioned above. A technically defective letter may be rejected on that basis. But see *Skouras v. Admiralty Enters. Inc.*, 386 A.2d 674, 678 (New Castle Co., Del., Ch. 1978), superseded by statute on other grounds as stated in *Weinstein Enters. Inc. v. Orloff*, 870 A.2d 499 (Del. 2005) (corporation improperly denied an inspection demand, even though the demand letter failed to state the demand's purpose, when the stockholder sent a separate letter stating the purpose). Typically, however, a stockholder will be allowed to try to correct technical defects. *Everett v. Hollywood Park Inc.*, No. 14556, 1996 Del. Ch. Lexis 2, at *2 (New Castle Co., Del., Ch. Jan. 19, 1996).

When the demand satisfies § 220's technical requirements, counsel should then consider the stated purposes for the request, its scope and any issues of confidentiality or privilege. A response letter should provide specific grounds for the basis on which each document (or category of documents) is being provided or refused. This is the company's first opportunity to lay out its position regarding the appropriate scope of inspection, and will set the tone for any subsequent dispute. Despite the time constraints, it is critical to consider the response carefully.

Finally, unlike a litigation discovery request, § 220 requires only that the company provide access to documents for review and copying at company offices and during business hours. Del. Code tit. 8, § 220(b).

Responding to actions to compel

Following a rejection of an inspection demand, a failure to respond within five business days or a perceived insufficient response, a stockholder may file an action with the Chancery Court to compel inspection. Del. Code tit. 8, § 220(c). The Chancery Court has the exclusive jurisdiction to determine a stockholder's inspection rights, "summarily order" a corporation to permit inspection and "prescribe any limitations or conditions . . . or award such other or further relief" as it deems just and proper. *Id.* Once an action is brought, the stockholder must prove that the request has been made for a proper purpose.

Furthermore, "[a] plaintiff who states a proper purpose must also prove that it has some credible evidence sufficient to warrant further investigation. Mere satisfaction of the proper purpose and credible basis for suspicion prongs will not equal automatic entitlement to the materials sought. A plaintiff must also prove that the information it seeks is necessary and essential to satisfy its stated purpose. Finally, a plaintiff who proves all of these may be limited in its use of any information where the information is confidential and release would harm the company." *Pershing Square L.P. v. Ceridian Corp.*, 923 A.2d 810, 816 (New Castle Co., Del., Ch. 2007).

Challenging the stated purpose

A stockholder's right to inspect books and records is contingent on having a proper purpose for doing so. Del. Code tit. 8, § 220(c). A corporation's most effective argument before the Chancery Court often will be that the stockholder lacks the requisite proper purpose for an inspection. In contrast, arguments that the demand is overbroad, vague or contains a technical defect are less effective, because the Chancery Court has been willing to allow a stockholder to cure such problems or has simply recrafted the scope of the demand itself. See, e.g., *Skouras*, 386 A.2d at 678. In many instances it will be difficult to establish the lack of a proper purpose because § 220 and the Chancery Court demand very little from a stockholder to establish one.

A proper purpose is "any purpose reasonably related to such person's interest as a stockholder." Del. Code tit. 8, § 220(b). The Chancery Court has recognized a variety of purposes fitting this criteria. See, e.g., *Robotti & Co. v. Gulfport Energy Corp.*, No. 1811-VCN, 2007 Del. Ch. Lexis 94, at *5 (New Castle Co., Del., Ch. July 3, 2007) (valuation of a stockholder's interest in the corporation); *Melzer v. CNET Networks Inc.*, 934 A.2d 912, 919 (New Castle Co., Del., Ch. 2007) (search for information in order to plead demand futility); *La. Mun. Police Employees' Ret. Sys. v. Countrywide Fin. Corp.*, No. 2608-VCN, 2007 Del. Ch. Lexis 138, at *34 (New Castle Co., Del., Ch. Oct. 2, 2007) (investigation of corporate mismanagement, waste or wrongdoing). However, the Chancery Court has denied inspection when the stockholder's purpose is adverse to the interests of the corporation. See *Pershing Square*, 923 A.2d at 820 (public broadcast of confidential company information an improper purpose).

The Chancery Court has consistently found that a stockholder need show only "a credible basis" from which it can infer possible mismanagement warranting further investigation. *Seinfeld*, 909 A.2d at 123. "Mere suspicion" alone is insufficient, and grounds for denial of inspection. *Id.* But see *Countrywide*, 2007 Del. Ch. Lexis 138, at *4-*5 (statistical correlation suggesting option backdating sufficient basis for inspection). Similarly, the Chancery Court has held that a stockholder's disagreement with a board or management business decision is insufficient to establish a credible basis for inspection. See *Mattes v. Checkers Drive-In Rests. Inc.*, No. 17775, 2001 Del. Ch. Lexis 47 (New Castle Co., Del., Ch. March 28, 2001). In evaluating whether sufficient evidence of a credible basis to justify an inspection exists, the Chancery Court will consider the "totality of the circumstances." *Robotti & Co.*, 2007 Del. Ch. Lexis 94, at *10.

Finally, even when a stockholder has stated a proper purpose, a proper purpose cannot be a false pretense for an improper one. *Pershing Square*, 923 A.2d at 817.

Limiting the scope of inspection

When a § 220 inspection demand is supported by a proper purpose, the Chancery Court has wide discretion to grant access to "other books and records" in satisfaction of that purpose. But it must also protect the interests of the corporation by limiting access to only those documents the stockholder proves are "necessary and essential to the satisfaction of the stated purpose." *Kaufman v. CA Inc.*, 905 A.2d 749, 753 (New Castle Co., Del., Ch. 2006) (documents satisfying the purpose of evaluating a possible derivative suit are only those required to prepare a well-pleaded complaint). The inspection right is, in this respect, far more limited than a comparable litigation discovery request. *Id.* at 754.

The Chancery Court has, therefore, rejected requests unlimited by a tailored time frame or subject matter. See *Freund v. Lucent Techs. Inc.*, No. 18893, 2003 Del. Ch. Lexis 3, at *17-*18 (New Castle Co., Del., Ch. Jan. 9, 2003) (rejecting a request for "any other reports concerning the condition or effectiveness of the company's internal controls or financial, accounting or information systems"). Additionally, inspection was denied when publicly available or previously provided information sufficiently addressed

the stated purposes. See *Polygon Global Opportunities Master Funder v. West Corp.*, No. 2313-N, 2006 Del. Ch. Lexis 179, at *13 (New Castle Co., Del., Ch. Oct. 12, 2006); *Kaufman*, 905 A.2d at 754.

Finally, when an inspection demand encompasses documents containing confidential or otherwise sensitive company information, a corporation may have the right to a confidentiality agreement, but the fact of confidentiality may not be a sufficient basis to refuse inspection. *Stroud v. Grace*, 606 A.2d 75, 89 (Del. 1992); *Pershing Square*, 923 A.2d at 820-21.

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