

**DIRECTORS & OFFICERS LIABILITY;
THE RIGHT TO INSPECT CORPORATE BOOKS AND RECORDS**

JOSEPH M. MCLAUGHLIN*
SIMPSON THACHER & BARTLETT LLP

DECEMBER 11, 2003

Any stockholder of a Delaware corporation who satisfies the 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. Section 220 also grants sitting directors essentially unrestricted access to corporate books and records, allowing access for any purpose reasonably related to the director's service on the board.

A right to inspection by stockholders has been recognized in a number of circumstances, including investigation of possible waste, mismanagement or breach of fiduciary duty. Despite its prosaic-sounding title, § 220 codifies an important incident of stock ownership and board service, and generates a steady stream of decisions primarily addressing, frequently after the trial of a summary proceeding, [a] whether a stockholder has demonstrated a proper purpose for an inspection of the corporate books and records, and [b] the scope of any relief that should be granted.

Statutory Requirements

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 demand is made through counsel, a power of attorney authorizing the counsel to act on the stockholder's behalf must accompany the sworn demand. If the corporation declines to permit the requested inspection or does not respond to it within five business days of the demand, the stockholder's recourse is to seek to compel the inspection by way of a summary proceeding in the Delaware Court of Chancery. As the scope and purpose of a books and records action are narrow, § 220 contemplates expedited discovery and a prompt trial. Delaware courts have insisted that any objections to the form of the demand be asserted promptly by way of motion, or at least in the answer, or else they may be forfeited.¹

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." In the absence of circumstances supporting the disregard of

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

corporate formalities, § 220 authorizes a request only for books and records of the corporation in which the stockholder hold shares, and not those of affiliated companies.² The statute operates on the assumption that stockholder access to the stock ledger and stockholder list is, although not presumptive, ordinarily not controversial. Accordingly, where the stockholder seeks to inspect only the corporation's stock ledger or stockholder list, the corporation has the burden of proving that the stockholder has not followed the mandatory procedure or has an improper purpose for the request. Even if the shareholder seeks only the stock ledger or stockholder list, however, the corporation may withhold these documents if it believes the stockholder has not stated a proper purpose or that the stockholder has failed to satisfy the procedural requirements of § 220.

For example, the Delaware Supreme Court has rejected a request for a stockholder list made by a 5 percent stockholder in a corporation that failed to consummate an announced merger where, although the stated purpose of the request was to communicate with other stockholders about the failed merger, the plaintiff testified he was at a loss as to what he would actually do with the list.³

Where the stockholder seeks to inspect the corporation's books and records other than the stock ledger or stock list, the burden of proof is on the stockholder, who must establish first "[1] that he has complied with the provisions of [§ 220] respecting the form and manner of making demand for inspection of such documents; and [2] that the inspection he seeks is for a proper purpose."⁴

A proper purpose is one reasonably related to the plaintiff's interest as a stockholder. Even if a plaintiff proposes multiple "proper purposes," only its primary purpose must be proper; any secondary purpose or mixed motives, whether proper or not, are irrelevant.⁵ The determination of whether the plaintiff's asserted purpose for the inspection is in fact its true purpose is a question of fact about which the Court of Chancery must make credibility assessments entitled to substantial deference.

The Delaware Supreme Court has emphasized that "[t]he threshold for a plaintiff in a Section 220 case is not insubstantial. Mere curiosity or a desire for a fishing expedition will not suffice."⁶ Moreover, inspection may properly be denied where the shareholder already possesses all the requested information, or where the request is unrelated to any legitimate interest of the stockholder or intended to harass the corporation.⁷

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 shareholders on matters pertaining to the investment, and [d] solicit the participation of other shareholders in legitimate non-derivative litigation against the defendant corporation.

In cases in which the valuation of stock is a proper purpose, courts have permitted inspection of records reflecting book value, cash flow projections, operations projections of management and even tax returns.⁸ In contrast, a proper purpose is lacking, for example, where the records are sought to obtain a predicate for the assertion of claims against third party advisors to the company or to obtain evidence for use in a different proceeding, such as a federal securities action subject to an automatic stay of discovery during the pendency of a motion to dismiss.⁹ The sound justification for this limitation is that once proceedings are commenced, the discovery processes available in those cases should determine the information to which the plaintiff is entitled.¹⁰

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 § 220 proceeding the underlying wrongdoing by a preponderance of the evidence.

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 plaintiff who files a derivative suit ordinarily is not entitled to discovery in that action in order to assist it seeking to meet 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 § 220 -- calling it the "tools at hand" -- in order to gird derivative complaints against the heightened pleading requirements of Rule 23.1.¹²

For example, Delaware courts have repeatedly held that a books and records action is an appropriate vehicle to enable a shareholder to determine if its pre-suit demand on the board to take action was wrongfully refused, or if facts exist that excuse demand.¹¹ Delaware derivative plaintiffs should heed the Court of Chancery's rebuke this year to a plaintiff who "ignored the repeated admonitions of the Delaware Supreme Court and this court for derivative plaintiffs to proceed deliberately and to use the books and records device to gather the materials necessary to prepare a solid complaint."¹²

A petitioning stockholder who satisfies the procedural requirements of § 220 and who establishes a proper purpose for the requested inspection is entitled to inspect books and records reasonably necessary to effectuate the stockholder's rights and not harmful to the corporation's legitimate interests. The entitlement is not open-ended; inspection is restricted to the books and records needed to perform the established proper purpose.

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 shareholder's right of inspection by placing such reasonable restrictions and limitations as it deems proper on the exercise of the right."¹³ Accordingly, the plaintiff must describe with considerable particularity its purpose and the records it seeks to

inspect. In the Delaware Supreme Court's memorable phrasing, a § 220 proceeding "should result in an order circumscribed with rifled precision."

Subsequent decisions have not interpreted "rifled precision" overly rigorously. For example, courts have not insisted that the plaintiff identify requested records on a document-by-document basis, but have instead required that the records be identified by reasonably specific categories. "What is required is that, at least where the purpose is to investigate particularized claims of mismanagement, the categories of documents be identified more narrowly and precisely than is typical in ordinary civil discovery."¹⁴ Plaintiff must demonstrate that each requested category is essential and sufficient to its stated proper purpose.¹⁵ Particularly in cases in which the alleged mismanagement raises accounting or other complex economic issues, whether specific categories of records are essential to and sufficient for the purpose of the inspection often necessitates expert testimony.¹⁶

Conclusion

Corporations that receive a request for inspection or are sued under § 220 should insist on putting stockholders to their proof under the statute and require precision and clarity in the request, on a word-by-word basis if necessary. Even if a proper purpose is stated, careful attention should be given to the scope and breadth of the request, including the time period of records requested. It is also important to ensure that the plaintiff cannot disclose or use information obtained in the inspection in a manner harmful to the legitimate interests of the corporation, for example by disclosing the materials to a competitor of the company.

Accordingly, the corporation should condition any inspection on an undertaking from the plaintiff, its counsel, and any experts assisting them, memorialized in a suitable confidentiality agreement, that, among other things, [a] the documents to be inspected will be used solely for the precise purpose made in the request and not disclosed beyond the plaintiff's representatives, and [b] plaintiff and its representatives will not trade on the information provided.

ENDNOTES

- ¹ *Sahagen Satellite Tech. Group LLC v. Ellipso Inc.*, Del. Ch., 791 A.2d 794 [2001].
- ² *Landgarten v. York Research Corp.*, 1988 WL 7392, at *4 [Del. Ch. Feb. 3, 1988].
- ³ *Security First Corp. v. U.S. Die Casting and Development Co.*, Del. Supr., 687 A.2d 563, 570 [1997].
- ⁴ 8 Del. C. § 220[c].
- ⁵ *Carapico v. Philadelphia Stock Exchange, Inc.*, 791 A.2d 787, 789 [Del. Ch. 2000]; *CM & M Group Inc. v. Carroll*, Del. Supr., 453 A.2d 788, 792 [1982].

- 6 *Security First*, 687 A.2d at 568.
- 7 *CM & M Group, Inc. v. Carroll*, Del. Supr., 453 A.2d 788 [1982].
- 8 *Dobler v. Montgomery Cellular Holding Co. Inc.*, 2001 WL 1334182 [Del. Ch. Oct. 19, 2001].
- 9 *Magid v. Acceptance Ins. Co's Inc.*, 2001 WL 1497177 [Del Ch. Nov. 15, 2001]; *Saito v. McKesson HBOC Inc.*, 2001 WL 818173 [Del. Ch. July 10, 2001].
- 10 *Freund v. Lucent Technologies Inc.*, 2003 WL 139766 [Del. Ch. Jan. 9, 2003].
- 11 *In re Citigroup Inc. Sh. Litig.*, 2003 WL 21384599 [Del. Ch. June 5, 2003]; *Grimes v. DSC Comm. Corp.*, Del. Ch., 724 A.2d 561 [1998].
- 12 *Guttman v. Huang*, Del. Ch., 823 A.2d 492 [2003].
- 13 *B & F Towing*, 551 A.2d at 51 n.7.
- 14 *Carapico*, 791 A.2d at 792 n.13.
- 15 *Thomas & Betts Corp. v. Leviton Mfg. Co. Inc.*, Del. Supr., 681 A.2d 1026 [1996].
- 16 *Magid*, 2001 WL 1497177.